Proceedings of the

Fourth Harvard University Forum on Islamic Finance

Islamic Finance: The Task Ahead

Harvard University
Cambridge, Massachusetts

September 30 – October 1, 2000

<Arabic calligraphy>

In the Name of God, the All-Merciful, the Mercy-Giving

Proceedings of the

Fourth Harvard University Forum on Islamic Finance

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Organized by

Harvard Islamic Finance Information Program
Center for Middle Eastern Studies

in association with

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The compilation of the Proceedings of the Fourth Harvard University Forum on Islamic Finance represents the successful collaboration of a variety of individuals and institutions. Their devoted efforts and support stand behind this volume.

The following pages feature the work of individuals who authored the papers presented at the Fourth Forum, and I thank them for their contributions. I would also like to thank Thomas D. Mullins (Executive Director of HIFIP and Associate Director of CMES) for graciously writing the Preface, and Samuel L. Hayes, III (Conference Chairman) for his Foreword. I extend my gratitude to Clement Henry, Gohar Bilal, Mohammed Obaidullah, and Muhammed-Shahid Ebrahim for their introductions to the individual sections of the Proceedings.

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I extend appreciation to Munir Zilanawala (A.B. '01) in particular, who has ably steered this project from the first publication of the Forum Proceedings three years ago to the final details of this volume. I would like to dedicate this volume to him in recognition of his outstanding role in the publication of the Proceedings of the Second, Third and Fourth sessions of the Harvard University Forum on Islamic Finance. I would be remiss to leave out mention of the HIFIP staff at large, to which the Program owes its success over the past five years. I would here like to personally mention the two individuals who have shared my labor since our first year: Abdur-Rahman Syed (A.B. '99) and Taha bin Hasan Abdul-Basser (Ph.D. candidate, NELC, Harvard University).

To the dedication of individuals must be added the support of institutions. I must first thank Harvard's Center for Middle Eastern Studies (CMES) and the Masters of Lowell House for their support of the Fourth Forum. Particular recognition goes to the Harvard Islamic Society, the student organization at the University that played a key role in helping to organize and staff the Forum. The generous financial support of the Forum's sponsors—Abu Dhabi Islamic Bank, Albaraka Investment & Development Company, Azzad Asset Management, Citi Islamic Investment Bank, Crescent Capital Management, First Islamic Investment Bank, HSBC Amanah Finance, The International Investor, and Kuwait Finance House—and our associate sponsors—Arif plc, King & Spalding, Wafra Investment Advisory Group, and Wellington Management Company—allowed HIFIP to bring its vision and plans for the Forum to fruition.

Finally, the Harvard Islamic Finance Information Program has been successful to a large extent due to the support, friendship, and faith of our many Program members (please see the inside back cover for a complete list). I extend my heartfelt gratitude and appreciation to all of them.

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

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Preface

The Fourth Forum follows the previous three fora held at Harvard University in 1997, 1998, and 1999. The conferences were organized by the Harvard Islamic Finance Information Program (HIFIP) at the Center for Middle Eastern Studies in association with the Harvard Islamic Society, and with the support of enlightened donors and members. The 2000 Forum was a gathering of some three hundred academics, scholars, financial professionals, members of the public, and students, all united in their keen interest in Islamic financial theory and practice.

These ongoing fora, with their holistic approach to exploring the ideals, practice, and prospects of the industry, have been extensively monitoring the development of Islamic finance while at the same time analyzing trends and pointing to future opportunities. This is in line with HIFIP's dual role as a clearinghouse for data on Islamic finance and a venue for research in the field, as well as with HIFIP's vision of the Forum as a gathering place where scholars and practitioners can exchange views in a supportive setting free of bias. The presentations dealt with *sharīʿa* perspectives, investments and financial products, new opportunities and directions, as well as other aspects of economics, finance, and development relevant to Islamic finance. They ranged from introductory programs for newcomers to discussions of sensitive and critical issues such as governmental regulation, business models, ethics, and Islamic jurisprudence.

The thirty papers selected for presentation and published in this volume were selected from all those submitted for consideration to HIFIP's Fourth Forum Committee. These included, on the first day of the Forum, four papers on critical issues, four dealing with *sharīʿa* perspectives, three with introductory matters and background, and four reports on current research. The second day followed with four papers on business perspectives, three on law and regulation, four on overall aspects of Islamic economics and finance, and four on Islamic funds. The Fourth Forum embraced a workshop for newcomers to Islamic economics and finance and, in addition, a presentation explaining the HIFIP *DataBank*.

HIFIP relied extensively on the Internet to organize the Fourth Forum. All communications concerning the Forum were distributed by e-mail, and many news items were disseminated on HIFIP's Web site (http://www.hifip.harvard.edu). All papers were submitted electronically as well.

These Proceedings follow the tradition of previous volumes in being published by the Harvard University Center for Middle Eastern Studies, and being prepared for publication under the supervision of Munir Zilanawala '01 by the crack team of student staff who have done such an excellent job of editing all annual volumes of Proceedings.

For the hard work of organizing and directing the Forum and these Proceedings, I would like to thank Dr. S. Nazim Ali, Director of Operations at HIFIP, whose inspiring dedication to the Islamic faith and the advancement of Islamic finance and economics have made him the moving spirit behind the whole Program.

Thomas D. Mullins
Executive Director, Harvard Islamic Finance Information Program
Associate Director, Center for Middle Eastern Studies

Foreword

Samuel L. Hayes, III*

It is a great pleasure to be back as a part of this annual review of the Islamic financial movement, which has been growing and burgeoning over the last few years. It is interesting that we come together this year in the midst of a rapid, almost radical evolution of the financial services sector worldwide. We are all familiar with the announcements of mergers and acquisitions that have been taking place among financial services firms, such as the recent announcement of Chase Bank's purchase of J.P. Morgan, or the not quite so recent merger between the Swiss Banking Corporation and Union Bank of Switzerland. I could mention other examples that would underscore the changes in the landscape of financial services in what is increasingly a global industry. One of my Harvard Business School colleagues, Ted Levitt, predicted some twenty years ago that the businesses we commonly call finance and label the financial markets sector would be the first industry to become truly global because money is fungible and it moves without much interference all over the world, and people shop all over the world for funds, looking for the best deal.

Despite the fact that the Islamic part of the financial marketplace is relatively small, it is useful to reflect on some of the trends taking place in the conventional financial marketplace, since they are in many cases also relevant to the Islamic financial sector. It is also quite true that because the Western conventional marketplace is an elephant and Islamic finance is a rabbit, it is important that the rabbit know where the elephant is likely to step. What stands out during the most recent period is, as already mentioned, the consolidation in the conventional financial vendor group. The rationale for these combinations is usually the benefits of both increased scale and broader scope of products and markets.

The scope aspect refers to the kinds of products and services that financial institutions believe they must offer in order to remain competitive. There is a conviction among financial institutions around the world that they must have a full portfolio of services and products to offer their customers. They do not really expect that the customers will buy everything that they offer, but they feel that they must offer them. They rationalize that a larger organization can better afford a wider array of offerings. The Chase Bank-J.P. Morgan combination offers an apt example. Chase is clearly reaching out for the investment capabilities of J.P. Morgan. Earlier, Chase had maintained that it would develop its investment banking capabilities internally. They obviously changed their mind, deciding that they could not afford to take the time required to accomplish that, so they made a dramatic acquisition of J.P. Morgan. There has been considerable comment in the press about the coalescence of J.P. Morgan, named for the great financier of the turn of the century, with the bank that has historically been identified with the Rockefeller family. This merger is also noteworthy on a personal historical level. There was a marked coolness between J. Pierpoint Morgan and John D. Rockefeller Senior at the turn of the century. Neither man trusted the other. Thus, they were not close friends at all, and to see the successors to their financial houses joining together almost a century later because each felt it needed the strengths of the other is a historical note of interest. This preoccupation with the broader array of financial products has an obvious parallel in the Islamic banking sector.

The notion of the need for increased scale has also been quite dramatic. The already-mentioned merger of the SBC and UBS is an example where the size of the combination dramatically increased the heft of the resulting bank. The earlier merger of Chemical Bank with the Chase Manhattan Bank also dramatically increased its scale. But what are the compelling benefits of the much larger surviving bank? There are, of course, economies of scale that result. If you can spread your infrastructure and back office costs over a broader base of revenues, you can enhance your margins. Profit enhancement can also be achieved by eliminating overlapping and redundant costs. But at some point in this endeavor, you reach the point of diminishing returns. I would speculate that the resulting size of some of the banks coming out of the current consolidation movement in the global financial services market sector is beyond the point where really important economies of scale can be realized. The current merger movement seems to be more of a case of follow-the-leader, where the first banks to "bulk up" and get larger are subsequently imitated by their competitors, who are afraid to be left behind. Have these financial institutions presented to their boards realistic assessments of post-merger operations that are so compelling?

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

Again, what is the relevance of these conventional financial market developments for Islamic finance? I have already suggested that in a world in which the Western conventional model is the dominant player, it is important that Islamic finance, a niche player, understand what is happening in that broader world, and plan its own development in ways that do not run head-on into the behemoths that dominate the conventional marketplace.

Also, Islamic finance is governed by the same economic realities that drive Western finance. I have given seminars in a number of different countries, with different currencies and local banking regulations, and yet I find that I can use similar teaching materials regardless of the location. The basic economic model still holds for a business entity: money comes in, money goes out, and at the end of the accounting period you hope that some money is left in the cash drawer after all the expenses have been paid. You can be as fancy and sophisticated in your financial accounting as you wish, but basically the "money in and money out" principle governs in the end. While there are important differences between the conventional Western financial model and the Islamic financial model, the underlying economic principles are quite similar.

At the same time, too much space in the finance literature has been devoted to making detailed comparisons of Islamic finance and conventional finance, often with the intent of dismissing the differences as superficial. There *are* important differences, even if they might not be obvious to some Western observers. Islamic finance has to be rational and reasonable to Muslims, and as long as that is the case, it does not matter if some academic has done a study of the *murāba®a* contract and concluded that it is a carbon copy of short-term bank lending in the Western sense. The subtle differences *are* meaningful to Muslims.

Nonetheless, I think that there are lessons to be learned for Islamic finance from the merger movement in the conventional banking sector with respect to both scope and scale. Scope, referring to the array of products available to Islamic users of capital as well as Islamic investors, is an important dimension that this Forum addresses. Historically, the scope of product and service offerings has been too narrow. This can be attributed in part to the predisposition of the Islamic deposit base for liquidity and low risk. Nonetheless, there is a real opportunity to develop a broader array of financing and investment options that, if properly packaged with appropriate safeguards, could expand the portfolio of Islamic offerings.

When it comes to scale, an important opportunity exists in the Islamic banking sector for cost savings through consolidation. Islamic banks are nowhere near the size level at which economies of scale begin to diminish. As the Islamic financial sector further grows and matures, we would expect to observe consolidations occurring among its vendors in order to realize cost savings and other economies of scale.

Referring back to issues of scope, despite Islamic investors' apparent predilection for short-term liquid instruments, the more profitable opportunities for investment are those that have a longer life and that are more closely structured to a particular investor's needs. Two particularly attractive areas are leasing and private equity investment. These are not new to anyone attending the Forum; during last year's conference we discussed leasing possibilities extensively. We know that the Islamic leasing contract is quite similar to the Western leasing contract, and that the opportunity for accommodating non-Muslim capital users with Muslim investment funds in leasing form is quite large. The details of the contracts, their fungibility, and their liquidity potential have all progressed, but I continue to feel that we have barely scratched the surface in exploiting financial opportunities using various forms of Islamic leases.

The other area that I think promising is the private equity area. In well-managed investment portfolios, a portion of the funds will be committed to non-traded equity investments. The Islamic model is an ideal one for private equity. The notion of partnership—of sharing risks, of sharing in both the upside profits and the downside losses—is the essence of both private equity investing and Islamic investing. It is important to distinguish this sort of venture investing from leveraged buy-outs of mature companies, in which the use of debt would be unacceptable to Muslims. In financing new businesses, or with businesses in the early stages of development, however, Islamic investors make ideal partners.

Until quite recently, relatively little of this kind of investing has taken place in the Islamic financial world. I have run across several investor groups from the Gulf area who have made special arrangements with some leading U.S. private equity venture firms to develop these kinds of investments, but the volume is very small compared to the total amount of such investments realized in the U.S. Given that the Standard and Poor's 500 stock index of equity for the year ending June 2000 was approximately 7.5% and that the prospect for future returns on an equity portfolio composed of publicly-traded U.S. equities is expected to be less than 10% per year, the private equity area has real appeal.

In closing, Islamic finance has some meaningful limitations and constraints imposed by religious beliefs, and yet those limitations need not be serious if we see Islamic funds channeled into those permitted uses with the greatest potential. That effort is central to the agenda of this conference, and I know we all look forward to the papers published in this volume.

PART I

ISLAMIC ECONOMICS

Introduction

Clement Henry*

Proponents and practitioners of "Islamic economics" do not claim a separate and distinct academic discipline. Insofar as it may be an applied rather than theoretical science, it still remains closer to plain old "Western" economics than, say, acupuncture is to conventional medicine. As the following papers demonstrate, its practitioners are deeply steeped in modern economic theories and in the applied arts of econometrics. They disagree, however, about the nature of their undertaking. Is "Islamic economics" simply economics as it applies to Muslim societies? If so, is it supposed to defend economic policy prescriptions that are based on Islamic principles? And what might these principles be? Are they just what Muslim jurists say they should be, or are there some general rules, such as the ban on interest, around which a truly Islamic economy should be organized? Since there are no truly Islamic economies, in the sense of national economies organized along agreed distinctively "Islamic" lines, the subject matter of Islamic economics remains elusive. The writers below do not agree on what it means, but the first essayist, Mahmoud A. El-Gamal, offers a brilliant way of mapping various schools of thought in the field of Islamic finance.

While Islamic economics is fraught with intellectual ambiguities, Islamic finance connotes a tangible set of institutions, the Islamic banks and other finance companies that have proliferated since the mid-1970s. Concrete financial institutions and practices are available for study and analysis. Since the institutions coexist and compete in many Muslim countries with conventional commercial banks and investment companies, they offer interesting opportunities for comparative analysis. Mahmoud A. El-Gamal imaginatively places them at a certain point (I in Figure 2 below) along a straight line that indicates the trade-offs between equity and efficiency under the constraints of current financial technology. He notes that there is a wide gap between much of the subject matter of Islamic economics, on the one hand, and the realities of Islamic finance, on the other. He ingeniously maps different schools of Islamic economics in relation to these realities.

Much of the Islamic economics literature deals with some ideal economy quite beyond the realm of what is possible, given the current state of financial technology. That is, these proponents advocate more equity than any set of institutions, operating under current technological constraints, could possibly offer if it were to be even minimally "efficient" or financially viable. Put crudely, no bank could long survive exclusively by handing out interest-free loans to those in need, however much Islamically minded economists and jurists might prefer such practices. Many Islamic banks do indeed engage in such charitable activities, for public relations, but only with a symbolic proportion of their balance sheets. However, none of the present papers engages in speculation about these ideal financial practices, noted by El-Gamal as point E in his model. Possibly Islamic economics has become less concerned about the ideal Islamic economy because of the real progress that Islamic finance has made in the contemporary world.

Yet there is clearly a certain tension between the existing practices of Islamic financial institutions and the ideal state of affairs that jurists might advocate, if they had financial theories. Here some "Islamic economists" step into the breach and advocate sets of financial practices that are within the realm of the technologically possible while maximizing the imagined preferences of the jurists (El-Gamal's point D). One trouble with this sort of Islamic economics is that the economists tend to be more Islamically rigorous than the jurists. They situate themselves inside the jurists' "permissibility frontier," in El-Gamal's felicitous phrase, and thus advocate less efficient, albeit more equitable, financial arrangements than jurists will permit. The second paper, *Islamic Finance and Economic Stability*, seems to fall into this category of Islamic economics, and in ways that the authors perhaps do not intend, as will be discussed in a moment. The third paper, by contrast, compares transactions costs in conventional and Islamic economies and prescribes policies that might slightly improve the trade-offs in financial technology between equity and efficiency (i.e., raise El-Gamal's line AA in Figure 2) by altering the rules of commercial banking so as to bring point I closer to Q, the level of efficiency of conventional banks. The fourth paper, highly critical of most "Islamic economics," presents a fresh look at what might be meant by the term.

Mahmoud A. El-Gamal not only offers a convenient map of Islamic economics in his *Economics of 21st-Century Islamic Jurisprudence* but also, as the title suggests, presents an economy of *sharīʿa* justice. Most Islamic financial institutions rely, for their Islamic legitimacy, upon boards of Muslim jurists to monitor their financial

* Professor of Government, University of Texas, Austin, Tex.

practices. The financial managers strive for efficiency as they compete with conventional institutions for profits as well as customers. Their financial efficiency depends upon being permitted to develop new financial instruments and to deploy established ones, such as *murāba®a*, in ways that may be incompatible with strict interpretations of the *sharīᶜa*. The managers and owners of these Islamic institutions select the jurists and of course have an interest in hiring those jurists who combine credibility as Islamic scholars with flexible interpretations of the *sharīᶜa* that can maximize the institution's profits. El-Gamal models the trade-off between a scholar's credibility and the flexibility that may be needed for financial innovation and profits. In competition with other scholars for posts on the *sharīᶜa* boards of Islamic banks, they will try to be relatively flexible in their interpretations while preserving their credibility. Some banks will be stricter than others so as to enhance their Islamic credibility and maximize their shares of the market for pious investor-depositors. Other banks, monitored by more flexible sets of *sharīᶜa* scholars, will strive for greater efficiency so as to achieve greater returns on their assets. El-Gamal shows the market segmentation to be more optimal for the entire Islamic financial community than a unitary policy based on a single Islamic permissibility frontier. The optimal set of trade-offs between Islamic credibility and financial efficiency involves a small number of scholars, however. If their numbers become too large, the new equilibrium might sacrifice scholarly credibility for flexibility and profits, as Figure 5 suggests.

In fact, the jurists may be happy to trade-off their collective credibility for more profits—and thereby collectively redefine the permissibility frontier and regain credibility in a new environment of scholarly consensus. Tight little oligopolies are always hard to preserve. One model not presented in this article is the scholar-prisoner's dilemma that is implied by their remaining small in number. This game may not have the happy iterated solution of oligopoly that El-Gamal suggests. If the jurists share in the expanding profits of innovation, they may lose some collective credibility but push Islamic finance forward into greater innovation. It seems unrealistic to expect that the number of jurists can be restricted to the ten or so in Figure 5. More banks will create a greater demand for economically educated *sharīᶜa* scholars. The market for *sharīᶜa* scholars is barely more than two decades old and is bound to expand. Presumably more scholarly discourse can be expected from the *sharīᶜa* lawyers who will be defining the new frontiers, and the legal discourse may have more practical relevance than most Islamic economics.

In the second paper, *Islamic Finance and Economic Stability*, M. Kabir Hassan and M. Imtiaz Ahmed Mazumder strike a more traditional tone of Islamic economics by advocating an ideal state of affairs that apparently approaches El-Gamal's point D. They claim empirically to demonstrate that the supply of interest-free money is more stable than that of quasi-money, the time deposits and savings accounts that collect interest. Their demonstration consists of comparing the volatility of the time series measures of different kinds of money for 17 Muslim countries over the years 1970 to 1998. They show that for each country the variance of interest-free money is significantly less than the variance of quasi-money. They infer from their findings that the money supply would be more stable if none of it were interest-based. They claim that "the financial system becomes more efficient if interest-based financial transactions are eliminated." They develop a further argument that the monetary authority can better control the supply of interest-free money than that of quasi-money to keep inflation under control.

Few of these 17 countries have much interest-free banking today, however, and most of it materialized in the past decade. Consequently, the panel data from 1970 to 1998 cannot illustrate the workings of Islamic finance. Much of the supply of interest-free money is in fact currency held outside the respective commercial systems. Its incidence is indeed high in many of the member states of the Organization of the Islamic Conference (OIC). Other studies have demonstrated that substantial portions of the money supply held outside the banking system are associated with low growth rates as well as inefficient financial intermediation. Indeed, the phenomenon may reflect not only a distrust of (conventional) banks but also a general distrust of state institutions and their intentions toward private property. Many OIC states still display disproportionate amounts of cash outside their banking systems, despite Islam's respect for private property rights. It might be that the introduction of Islamic banking can alleviate this condition, which is especially acute in Algeria and Syria, both of which were included in the authors' sample of 17 OIC countries. The authors offer no evidence to this effect, however, nor do they even estimate the market shares of Islamic finance in the commercial banking systems of the other 15 states. These range from recent highs of less than 0.5% in Tunisia and to 16% in Kuwait and 18% in Qatar. Only three of the OIC states, Iran, Pakistan, and Sudan, have exclusively Islamic banking systems.

In the third article, Mabid Ali Al Jarhi argues that under competitive conditions the transaction costs associated with a *murāba®a* contract—whereby the bank buys a good and sells it back to the client at a profit—will be less than those incurred by the client who buys the good with a conventional loan from the bank. The writer, who is the director of research at the Islamic Development Bank in Jeddah, applies standard economic modeling to a real Islamic banking practice situated on El-Gamal's map at point I. He proposes that the monetary authorities permit all banks to engage in wholesale merchandizing that would achieve economies of scale and thereby reduce transaction costs. Islamic and conventional banks could thus compete on a level playing field, and the reduced transaction costs

would presumably enhance the equity and efficiency of banking operations. Translated to El-Gamal's map, the line AA representing existing financial technology would be raised a bit, whereby any given point would have higher values of both equity and efficiency. Al Jarhi shows that Islamic economics can be quite practical, though conventional banking regulators would probably object to banks' carrying the added commercial risk.

The final paper is an interesting counterpoint to the two preceding ones because it questions the concentration of Islamic economics on interest-free banking. M.A. Muqtedar Khan argues that the Islamic prohibition of *ribā* is only one of many economically relevant injunctions. Without questioning this particular injunction, he insists that other values, such as good governance and transparent economic practices, may be more important. Indeed, by comparing the frequencies of suras concerning *ribā* with those discussing other economic virtues and vices, he argues that other economic concerns may be more salient than the prohibition of *ribā*. He views as Islamic many of the elements of the Confucian ethic that may help to explain the economic success of Japan and the newly industrialized economies (NIEs) of the Far East. Would it confuse matters to suggest that his version of Islamic economics has become catholic in its advocacy of sound economic strategies?

"Islamic economics" has indeed progressed beyond the fuzzy ideals depicted as point E on El-Gamal's map to embrace the entire spectrum of economics. Its "Islamic" qualifier may connote a variety of ethical values or simply refer to countries predominantly inhabited by Muslims. The most distinctively Islamic economic studies, however, focus on the evolving institutions associated with Islamic finance that are the subject matter of three of the following articles and many of those of the remaining parts of the present volume.

The Economics of 21st-Century Islamic Jurisprudence

Mahmoud A. El-Gamal*

ABSTRACT

The recent history of Islamic finance is riddled with a number of paradoxes. First, there is a great rift between the economics literature on Islamic finance, and the practical approaches taken by financial experts and practitioners in the area. Second, despite two or more decades of rhetoric regarding the development of uniform standards for Islamic finance, the market remains largely segmented. Third, despite the many juristic questions that are being raised by financial experts and practitioners, very few active jurists operate in the area. Fourth, while those jurists have approved a number of new financial contracts that are extensively used in the Islamic finance industry, those same jurists have consistently criticized the overuse of those same contracts that they have declared to be Islamically permissible (e.g. *murāba®a*). This paper presents a simple economic model to explain all four paradoxes.

I. WHICH "ISLAMIC FINANCE?"

Most observers of the Islamic finance movement over the past two decades will acknowledge (and perhaps lament) the great rift between the early and current literature on "Islamic economics" on the one hand, and the reality of Islamic finance on the other. In this regard, I would like to present a simple explanation of this difference. To make my analysis clear, I shall use simple economic schematics to describe my views. The diagrams in the remainder of this section have two axes, labeled "efficiency" and "equity," reflecting the trade-offs in any economic system between efficiency (the size of the economic pie to be shared by economic agents) and equity (how justly, and how equally, the pie shares are determined). Our simple model is comprised of three main components:

1. **Preferences**: First, we consider the preferences of jurists, which are interpreted as manifestations of their understanding of the objectives of Islamic law (*maqāÆid al-sharī*ca*). As shown in Figure 1, those preferences are assumed to be relatively flat, i.e., giving a higher weight to considerations of equity (*al-*cadl*) relative to the weight given to considerations of economic efficiency (*al-kafā'a al-iqtiÆādiyya*). In contrast, it is assumed that the preferences of bankers and other economic agents are more biased toward considerations of efficiency relative to those of Islamic jurists. Hence, the latter preferences are drawn more vertical than the former.

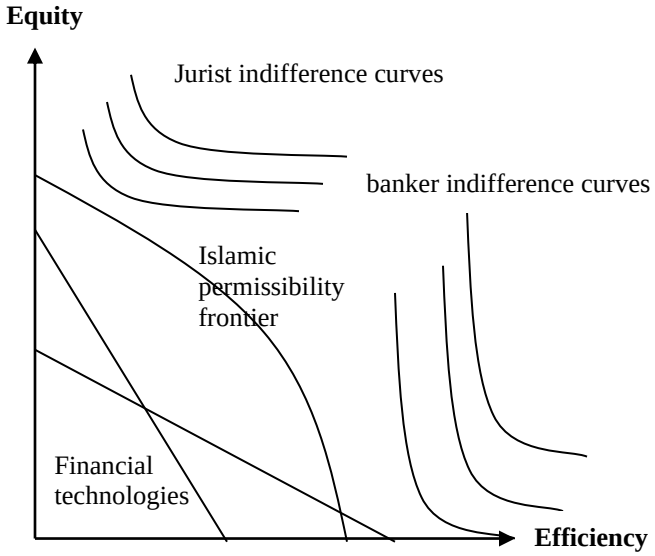

Figure 1

2. **Financial technologies**: Those are institutional frameworks that render certain types of contracts and transactions feasible. Each technology allows for linear trade-offs between efficiency and equity by simply allowing for redistribution schemes.

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* Chaired Professor of Islamic Economics, Finance, and Management and Professor of Economics and Statistics, Rice University, Houston, Tex. The following is the text of El-Gamal's Keynote Speech on Islamic Economics at the Fourth Harvard University Forum on Islamic Finance.

3. ***Sharī'a* boundary**: The Islamically permissible set of allocations is drawn as a convex set, with an "Islamic permissibility frontier." Convexity follows from the fact that if two points are permissible, any convex combination thereof is permissible. For instance, if it is permissible to perform all transactions according to *murāba®a*, and it is permissible to perform all of them according to *mu∞āraba*, then performing half as one and half as the other must also be permissible. The set contains the origin, corresponding to no transactions taking place, and its boundary is drawn as a "permissibility frontier."

We may now revert to the question posed by the title of this section: which Islamic finance? The line **AA** in Figure 2 represents the current financial technology, which evolved over the past few centuries. Since this technology evolved in response to the secular financial needs of economies worldwide, it tends to cater to the secular/banker preferences, thus producing the status quo tangency point **Q**, in the Southeast part of the Figure, which affords society a high level of economic efficiency, at the expense of low levels of equity.

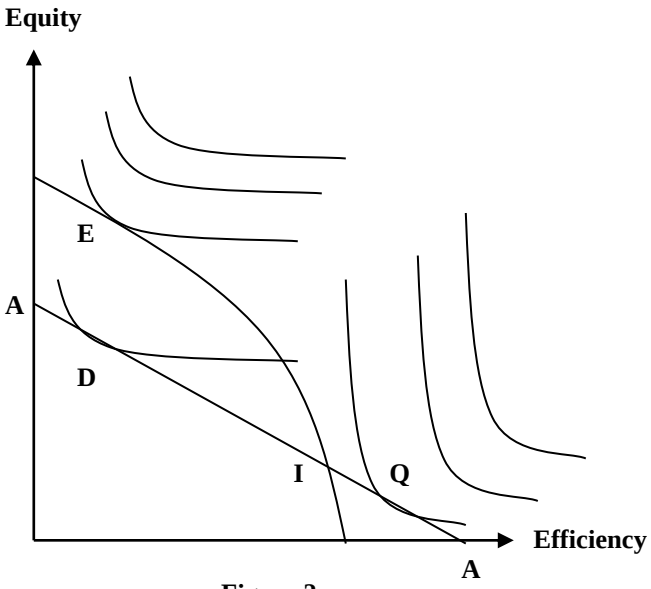

Figure 2

The Islamic economics literature, in contrast, aims to describe and analyze the point that is optimal to Islamic jurists, that is the tangency point **E** in the Northwest region of Figure 2. After more than half a century, this literature has failed to develop a coherent and effective financial Islamic system, since the evolution of a financial technology that goes through their favorite point **E** requires many more decades of trial and error. For instance, the existing financial technology represented by the point **Q** evolved over a period of six or more centuries. Recognizing the difficulties surrounding the of development of a financial technology that passes through the ideal point **E**, many Islamic economists and some practitioners in Islamic finance turned to point **D**, at which the jurist preferences are maximized subject to the current financial technological constraints. Unfortunately, since this point is interior to the permissibility frontier, it is easily viewed by theoreticians and practitioners as socially inefficient. Thus, while those who attempt to use interest-free loans and other Islamically permissible contracts for poverty alleviation play a qualitatively important role, their approach cannot possibly be successful in developing an Islamic finance industry.

Thus, when Muslim bankers and newcomers to the field started developing an Islamic finance industry, it was clear "which Islamic finance" they would pick: Point **I**, at the intersection of the current financial technology and the permissibility frontier, is sufficiently close to point **Q** that they could draw on conventional financial industry skills to develop the new industry. Moreover, identifying the types of Islamically permissible contracts that produce point **I** was relatively easy to accomplish. The Islamic Jurisprudence institution of *fatwā* and *istiftā''* (the issuance and solicitation of Juristic opinions, respectively) is particularly suitable for financial practitioners to solicit opinions regarding small modifications of existing financial contracts commonly used to provide point **Q**, and Jurists can then provide qualified "yes" or "no" answers. In this sense, point **I** represents "the closest permissible point subject to the current financial technology."

We can now understand the three incompatible views we find in the Islamic finance and economics literatures. Those who are writing about point **E** address the problems of a theoretical society imbued with Islamic values, and promote their visions of a very different financial system with a heretofore unknown set of instruments, that will produce justice for humankind (a paradigm shift). Second, those who are writing about or implementing point **D** emphasize finding practical (i.e., conventional) solutions for the lack of socioeconomic equity in our current system. Finally, those whose voice has become loudest, since it is backed by relatively massive profit-and-efficiency-seeking financial assets, as well as decades of experience in the conventional financial sector, are mainly talking about point **I**. In fact, this last trend has grown so significantly in the past two decades, that it has become necessary to associate the term "Islamic finance" exclusively with this "closest permissible point" approach, represented by point **I** in Figure 2. Those who insist on the superiority of point **E** have been derided as "ultra-theoretical" and "dogmatic," and the title of Islamic finance has been *de facto* withdrawn from their research efforts.

In the meantime, those who focus on point **D** have been partially adopted by the Islamic finance industry, given a minimally effective but significant public relations role to add credibility to the "Islamic" label that puts more emphasis on equity than point I can provide.

II. How Close Is Too Close? The Paradox of Criticizing One's Own Work

We now turn to the last paradox listed in the abstract. There is no doubt that jurists prefer point **D** to point **I** (by construction, point **D** is a point of tangency of Jurist preferences with the **AA** line, while point **I** will fall on a lower indifference curve). Therefore, when asked whether or not point **I** is permissible, they are happy to issue the opinion that it is permissible, and more than happy to encourage the adoption of point **I** instead of the forbidden contracts that are associated with point **Q**. However, most of them view the adoption of point **I** as an interim solution that is part of an Islamization process that will ultimately produce an "ideal" Islamic financial system. For instance, numerous jurists refer to the principle of *al-kharāj bi-al-∞amān* (return must be commensurate with risk) to argue that explicit risk-sharing arrangements (such as partnerships) are superior to guaranteed return contracts (such as the predominant use of deferred cost-plus sale financing). While I would argue that reliance on this principle for this argument illustrates the jurists' lack of understanding that the issue is truly a trade-off of one type of risk sharing for another (credit financing still exposes the bank to credit risk, which is characterized by a small probability of a large loss, whereas direct risk sharing results in a more continuous distribution of potential losses), it is nonetheless true that jurists seem to be leaning more toward points **D** and **E**. In fact, since point **E** is unattainable given the current financial technology (or any we can readily imagine), the Islamic financial movement adopted point **D** partially to appease jurists who insist that Islamic financial institutions need to engage in such equity enhancing transactions.

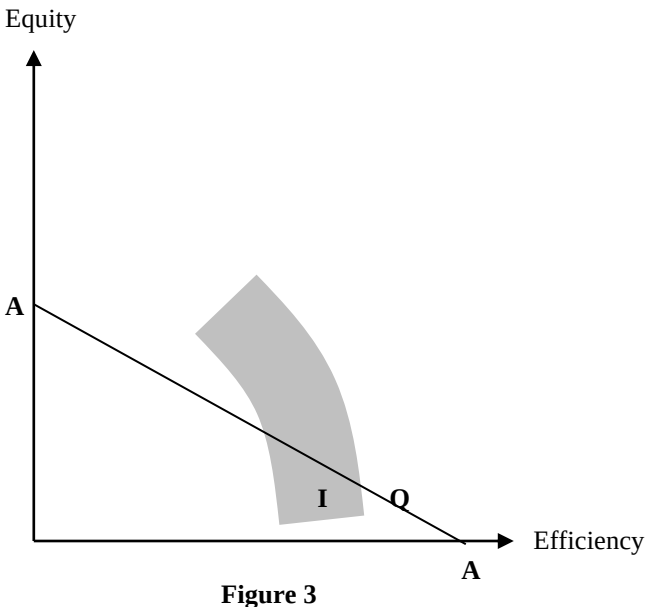

Figure 3

The problem gets more interesting once we take a closer look at "point" **I**, and recognize that the boundary of permissibility is in fact fuzzy. For instance, in the contract of cost-plus sale financing, jurists may and may not insist that an Islamic bank first purchase the financed item, and then sell it cost-plus with a deferred price to the customer. In the "two-contract" case, jurists may (and in fact do) differ in their prescriptions for the degree of guaranty the customer needs to offer the Islamic bank that he will purchase the item once the bank acquires it. There are also some recent opinions that have been voiced in the U.S. that due to tax considerations, the two-sale arrangement may be reduced to a single sale (which brings the *murāba®a* contract sufficiently close to traditional financing to make the two virtually indistinguishable in the eyes of some observers). Therefore, as shown in Figure 3, as we move from the conventional finance model represented by point **Q**, we can pick any point along a *segment* (rather than point) **I** of potential "closest" Islamically permissible point, depending on juristic interpretation.

III. Multiple Jurists, Fuzzy Boundary

In what follows, we shall model that line segment **I** in Figure 3 as the [0,1] interval on the real line, where point zero corresponds to the point on the segment that everyone agrees to be Islamically permissible, and point 1 corresponding to the other extreme. In our model, the credibility of a point along that segment will be a function of how conservative (closeness to zero) or innovative (closeness to one) it is, as well as the number of jurists who are active in the Islamic finance arena. In this regard, the point zero (most conservative interpretation, e.g. two separate sales with no promise in *murāba®a*) always has maximal credibility (set to be one), and the point at the very edge falls under the category of "too close for comfort" (as the *®adīth* says "*ka-al-rāᶜī ya®ūmu ®awla al-®imā yūshiku ᶜan yaqaᶜa fīhi*"; like a shepherd getting too close to a pack of wolves). We shall therefore model the degree of credibility of any point along the segment as one less a cumulative distribution function. Thus, credibility will be

interpreted as the proportion of jurists supporting a particular degree of innovation. In what follows, we shall consider the industry with n active jurists, and we shall define the credibility of a point x in [0,1] as one less the Beta cumulative distribution function $F(x) = B(x|\alpha,\lambda)$ with parameters $\alpha = \pi n$, $\lambda = (1-\pi)n - 1$ (the graphs in this remainder of the paper are shown with $\pi = 0.6$, for illustration). The resulting credibility function has the interpretation of the proportion of jurists supporting the given level of innovation, given that the "correct" level of innovation to support is $0 < \pi < 1$. As the number of jurists becomes large, the credibility function degenerates to one for all innovations below that correct level and zero for all innovations above it. On the other hand, the smaller the number of active jurists in the industry, the more uncertain is the location of that correct level of innovation, and the more room there will be for market segmentation, as we shall see shortly.

In figure 4, we plot the credibility function for various values of n, the number of jurists. We also plot the assumed profit function for a monopolist in Islamic finance. Normalizing profits from providing innovation level x to pious Muslims to be equal to x, and assuming that the proportion of such pious Muslims who will actually give their business to the Islamic finance monopolist with innovation level x to be equal to the credibility function $1\text{-}F(x)$, the monopolist's profit function at innovation level x will be $profit(x) = x\,(1\text{-}F(x))$.

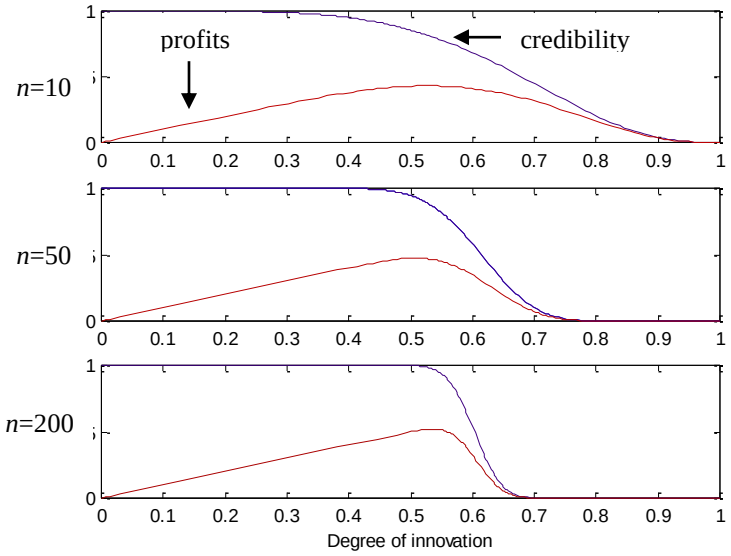

Figure 4

IV. Multiple Islamic Finance Firms: Cooperation vs. Competition

We now turn to the problem of how Islamic finance firms react to market conditions. The qualitative results can be illustrated with only two firms. Assume one firm is already providing Islamic financial services up to some level of innovation. The second firm can do one of three things:

1. The new firm can cooperate with the first firm, thus acting jointly as a monopolist, with the same level of innovation, and sharing monopoly profits.
2. The new firm can decide to innovate further, thus obtaining a monopoly over the more innovative Islamic financial products, while gaining a small share of the less innovative product market, since its innovation level lowers its "Islamic" credibility.
3. The new firm can decide to challenge the incumbent firm, thus innovating less and undermining the incumbent firm's credibility by charging that it is innovating too much and getting too close to conventional finance.

In either of the last two cases, we have one firm innovating more than the other. Without loss of generality, let x_2 be the lower level of maximal innovation, and $x_1 > x_2$ be the higher level of maximal innovation. Then the profits of the more conservative firm 2 will be:

$$\pi_2(x_1, x_2) = x_2 \frac{(1-F(x_2))^2}{2-F(x_1)-F(x_2)}$$

while the profits of the more innovative firm 1 will be:

$$\pi_1(x_1, x_2) = x_2 \frac{(1-F(x_1))^2}{2-F(x_1)-F(x_2)} + (x_1 - x_2)(1-F(x_1))$$

Given the two profit functions, we can derive each firm's best response to the other firm's level of innovation by calculating that firm's first order condition of profit maximization. Solving the two first order conditions simultaneously for the optimal x_1 and x_2, we obtain the Cournot-Nash equilibrium to the competitive game where one firm innovates more than the other. We perform this equilibrium calculation for each number of jurists between 1 and 100, and plot the levels of innovation and profits of the innovator and conservative firms, as well as the level of innovation of the monopolist and each firm's share of monopoly profits for comparison.

There are two main patterns to highlight in the results shown graphically in Figure 5, explaining the two remaining paradoxes that we highlighted in the abstract:

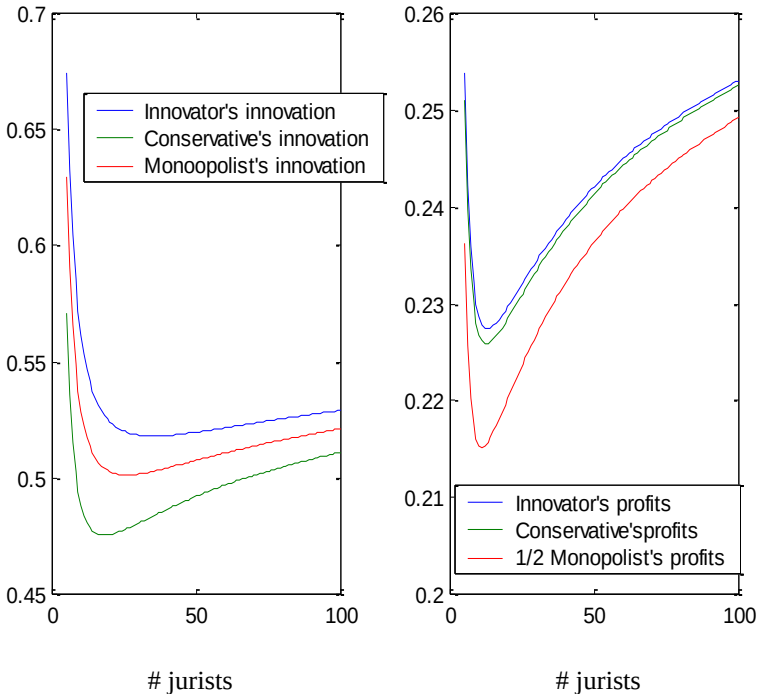

Figure 5

1. Compared to the monopolist level of innovation, one firm innovates more, and the other innovates less. As a result, the two firms divide the market, one appealing exclusively to the ultra-pious (the conservative firm), and the other appealing mainly to the relatively more "liberal" Muslim population that does not mind a high degree of similarity between Islamic and conventional financial products. As a result of the market segmentation (a form of price discrimination), both firms' shares exceed their share of the monopolist profits. In other words, overall industry profits increase, with the innovator holding a slight advantage, but both firms benefiting from the market segmentation. This suggests that even if there were only one monopolist in the Islamic finance market, he would still benefit from artificially splitting into two entities: one more conservative and the other more innovative. This also explains why, despite many years of continued rhetoric regarding the establishment of uniform standards for Islamic financial products, the market remains segmented: All firms in the market benefit from this market segmentation.

2. A second important trend can be observed by comparing the levels of innovation and profit as the number of jurists increases. Without any jurists, some providers may call themselves Islamic and provide very "innovative" labels for relatively conventional products.

    a. As jurists' numbers increase, the credibility of such firms drops quickly, and they are forced to adopt much more conservative profiles, thus reducing their profits. Therefore, jurists have an incentive to get involved at this stage of development of the industry. Their intervention at this stage helps to reduce the level of innovation, thus bringing the industry away from point **Q** (conventional finance) and closer to points **D** and **E** (preferred by the jurists). This is in fact what happened in the early days of Islamic finance, when jurists' involvement put many heretofore non-existent restrictions on the sets of contracts that Islamic banks can give the Islamic label (especially, cost-plus and lease financing).

    b. However, as the number of jurists increases further, more credibility is lent to slightly more innovative practices. Therefore, if Islamic banks could not stop jurists from getting involved in

the first place, it is in their best interest to get more of them involved, thus achieving moderate levels of innovation with increased credibility, and restoring profits to the level they would obtain without any jurists auditing their behavior. However, if this were allowed to continue, jurists' preferences will be compromised as their very participation lends more credibility to such increased innovations that move the industry back away from points **D** and **E** and toward **Q**. Therefore, after a small number of jurists participate in the industry to limit the degree of unwarranted innovation, it is in the best interests of all jurists that no more of them enter the industry. Hence, if jurists are attempting to increase equity and move to safer juristic grounds (away from **Q**), and if they act strategically—taking into account the reaction function of Islamic finance firms given the level of credibility their presence would lend the industry—they will keep the number of jurists who enter the industry relatively small. Therefore, we have explained the small number of active jurists in the industry, which is the remaining paradox mentioned in the abstract.

V. CONCLUSION

I do not pretend to have any answers to the truly fundamental problem posed by Figure 1: which Islamic finance should we strive to develop? Indeed, the answer to such a question requires a full understanding of the possibilities of developing entirely new financial structures, and/or developing a new and more sophisticated jurisprudence of financial transactions. The purpose of this brief essay is simply to increase understanding of the current state of affairs in Islamic finance. Unfortunately, as is the case with all economic reasoning, clarity of understanding can only be obtained at the expense of providing an overly stylized account of the relevant factors. I hope that, stylized as it may be, this analysis provides sufficient clarity while maintaining enough relevance to the facts of Islamic finance. Such clarity of understanding is necessary if we are to achieve lucidity of direction for building the financial industry and re-invigorating the Islamic jurisprudence of financial transactions with a full understanding of the incentives, strengths, and weaknesses of all the parties involved in the journey ahead.

Islamic Finance and Economic Stability

An Econometric Analysis

M. Kabir Hassan[*] and M. Imtiaz Ahmed Mazumder[†]

ABSTRACT

This paper examines the relative efficiency of an economic system that prohibits receipt and payment of pre-determined interest on financial transactions and the Western economic system, which does not have such prohibitions. Efficiency is defined in terms of stability of the velocity of money (Thornton, 1983, Darrat, 1988, and Hassan and Aldayel, 1998), policy controllability of monetary aggregates (Batten and Thornton, 1983, Hassan and Aldayel, 1998), and the monetary aggregate-ultimate policy goal linkages (Zaki 1995, Hassan and Aldayel, 1998, Darrat, 2000). A number of econometric models are used to examine the efficiency of the Islamic financial system using panel data over a 29-year period from 17 OIC countries with extensive Islamic financial systems. This study supports the relative effectiveness of interest-free banking in OIC countries in terms of stable and smooth velocity of money, controllability of monetary aggregates (MNI and MI), and stronger linkage between monetary policy instruments and the ultimate policy goals of the economy.

I. INTRODUCTION

Islamic banking and finance is gaining popularity in many countries. The basic premise of Islamic banking lies in the sharing of risk of profit-loss among depositors, investors, and the banks. The concept of Islamic banking and finance is spreading rapidly in the world because of a resurgence of Islamic values in many Muslim countries as well as significant theoretical research in support of the relative efficiency of Islamic financial system. According to the *International Association of Islamic Banks*, there are about two hundred "Islamic" banks in more than sixty nations worldwide.

Although there exists an extensive literature on Islamic economics, banking and finance, there are only a few studies that explore the relative efficiency of Islamic financial system. Khan (1986) demonstrates that the traditional practice of paying depositors a pre-determined interest, regardless of whether or not the bank is doing well, prevents banks instantaneously adjusting to potential asset shocks, and such rigidity could lead to financial instability. Khan, however, suggests that evidence generated from actual data may give credence to the claim that Islamic interest-free financial system is a superior alternative to Western interest-based financial system.

The concept of an Islamic bank is that it is completely based on Islamic values and rules. An important component of the Islamic economic system is the prohibition of any payment or receipt of fixed and predetermined interest rates. Money is treated as a store of value and medium of exchange under Islamic views. The Qur'an dictates the prohibition of interest in Islam. The Qur'an says "O' you who believe, fear Allah and give up what is left from *ribā* if you are believers. So, if you do not give it up, then he warned of war from Allah and His Messenger, and if you repent, you will have your principal, you will not be unfair to others and you will not be unfairly treated." *(Chapter 3, Verses 278-79).* For further discussion of the Islamic prohibition of interest, see Ahmed et. al. (1983), Darrat and Sulaiman (1990) and Chapra (1992).

Islam is not the only religion that prohibits the practice of interest. The Biblical religions as well as notable thinkers in human history condemned the institution of interest. Aristotle dwelt on the "barren nature of money" and condemned interest on the ground that interest is "birth of money from money." Under Judaism, the Israelites were forbidden to demand any increase on the principal of money lent among themselves, though interest could be charged by Israelites from Gentiles. In Christianity, the scripture "lend freely, hoping nothing thereby" (Luke 6:35) is taken by many Christian scholars as condemnation of interest. However, the Church gradually changed its doctrine on the subject of interest. The dichotomy of religion and state after the Reformation opened the door to the widespread practice of interest in the Christian world.

[*] Associate Professor of Finance, Department of Economics and Finance, University of New Orleans, New Orleans, La.
[†] Doctoral Student, Department of Economics and Finance, University of New Orleans.

Many contemporary Western theories to justify pre-determined interest rates have been refuted, including Bohem-Bowerks' Time-Preference (Uzair, 1976), and Abstinence Theory (Mawdudi, 1961), Samuelson's theory of interest as "rent for the use of money (Abu Saud, 1976), Patinkin's handling of interest as "a form of income from property" (Abu Saud, 1976) and Keynes' Liquidity Preference Theory (Uzair, 1976). While the Muslim scholars commend the interest-free financial system, Western scholars such as Pryor (1985) question the viability of an Islamic banking system. Khan (1986), however, shows that an interest-free banking system is quite compatible with both Keynesian and classical economic theories. Moreover, an interest-free banking system is not totally alien to Western economic thought. Simon (1948) and Kindleberger (1985) have proposed certain banking reforms that, in effect, yield a banking system resembling a secularized and asocietal Islamic system, in particular on the deposit side. Weitzman (1984) has rigorously advocated the principle of profit-loss sharing as opposed to a pre-determined wage rate as a cure for stagflation.

An "Islamic bank" can be defined as a financial institution that employs investors' funds in real product or capital markets under one or more modes of Islamic financial contracts. Therefore, it may enter into joint partnership agreements with the client to finance real investment, or it may act as a mutual fund or unit trust to buy shares in new or established companies. Islamic banks can be considered universal banks (along the German model) that offer all financial services rendered by commercial, merchant, investment, and development banks, but on interest-free basis, the constraints laid down by Islamic law.

The prohibition of interest in Islam derives from notions of property rights, values, and economic justice. Khan and Mirakhor (1985) attempted to explain interest as cited in the Qur'an and argued that "money represents the monetized claim of its owner to property rights created by assets that were obtained through work or transfer. The act of lending of money is a transfer of this right and in return one could not claim more than its equivalent." The minimization of agency costs between lenders and borrowers is a benefit of the Islamic prohibition of interest. Islamic banks are operated by the concept of *mu∞āraba*. Thus, the peer-monitoring system of Islamic financial institutions rules out insurance against financial defaults. All interest-free banks agree on the basic principle of money.

Darrat (1988) initiated tests of the relative efficiency of interest-free Islamic banking. Using data from Tunisia, Darrat found that the interest-free financial system exhibits stable income velocity of money, and that a strong positive link exists between policy instruments and the ultimate objective of monetary policy because there exists in an interest-free financial system an effective environment for controlling policy. Hassan and Aldayel (1998) followed a methodology similar to Darrat's for 15 Islamic countries and achieved consistent results. Darrat (2000) empirically examined the relative efficiency of the interest-bearing and interest-free banking system in Iran and Pakistan and found results similar to those of his from twelve years earlier.

The purpose of this paper is to examine empirically, using a longer and more recent annual data for selected Organization of Islamic Conference (OIC) countries, the hypothesis that the financial system becomes more efficient if interest-based financial transactions are eliminated. We define efficiency in terms of stability of the velocity of money (Thornton, 1983, Darrat, 1988, and Hassan and Aldayel, 1998), policy controllability of monetary aggregates (Batten and Thornton, 1983), and the monetary aggregate-ultimate policy goal linkages (Zaki 1995, Darrat, 2000). Econometric models and tests are employed to examine the efficiency of the Islamic financial system. First, we analyze the historical record of velocity of interest-bearing and interest-based money over a 29-year period for 17 OIC countries with an Islamic financial system. Second, we estimate demand for interest-based and interest-free money and run various stability tests to see which financial system is more stable. Finally, we examine within a co-integration framework the relative usefulness and effectiveness of interest-based and interest-free financial aggregates for policy purposes.

II. DATA AND METHODOLOGY

The data used in this paper is annual data over 29 years (1970–1998) from the *International Financial Statistics* (IFS). Interpolated data was used to approximate the missing observations when a country had up to two missing observations for a particular variable. Countries were dropped from the sample when more than two observations were missing. The sample countries are sub-divided into four groups based on their social, political and economic similarities. The names of the sample countries are listed in Table 1.

The definition and notation of the data are summarized in Table 2. Interest-free money (MNI) comprises of currency and checkable or demand deposits of commercial banks, which do not earn nor pay interest. Interest-bearing money (MI) consists of time and savings deposits, which both pay interest.

This study follows a co-integration method similar to Darrat's methodology in his study of Iran and Pakistan. Estimation of time series data involves spurious regression as it shows a trend (Phillips, 1986).

Regressing a time series dependent variable against other independent variables often produces inflated R^2 and incorrect test statistics although there might not be any economically meaningful relationship among them. Gujrati (1995) shows that a stochastic or random process can generate any time series data and a specific set of data can be regarded as a realization of the underlying stochastic process. Recent studies by Stock and Watson (1988) and Harris (1995) reveal that to avoid the spurious regression problem any estimated time series equation should not comprise non-stationary variables. Empirical research based on time series data assumes that the basic time series is stationary. A variable is stationary and has no unit root if stochastic properties (mean, variance and covariance) of the variable are time invariant. A time series data is non-stationary if its stochastic properties are time variant. If the time series data is non-stationary then serial correlation exists among the time series variables. Thus any regression result will be biased and the tested parameter will produce inconsistent regression output. For any empirical time series study non-stationarity test of data becomes important. A non-stationary variable can be converted to a stationary process by differencing it properly. Most time series economic variables are non-stationary in levels but achieve stationarity in first-differences (Darrat 2000).

Two variables are co-integrated if they move close together and have long-run equilibrium relationship. There are two steps to test the co-integration: First, checking the stationary properties of the individual variable and testing the order of integration of the variables by employing unit root tests. Second, likelihood ratio tests (eigenvalue and trace statistics) are employed to test for the number of co-integrating vectors among the tested variables. Following Engle and Granger (1987) we check whether all the series are integrated of the same order prior to estimating the demand for money. This is done by using augmented Dickey-Fuller (1981) and Phillips-Perron (1988) test. The presence of co-integration implies the existence of a logical error-correction model (Granger, 1986 and Engle and Granger, 1987). The Granger representation theorem, developed in Engle and Granger (1987), confirms that the presence of co-integration implies the existence of an error-correction model. Prior to attempting to model the short-run dynamics, it is important to check whether co-integration exists among the variables. An error correction model adds an error correction term (i.e., residual with one lag obtained from the underlying co-integration relationship) to the original model that contains stationary variables. The coefficient of the error correction term shows the process by which the dependent variable in the error correction model equation adjusts in the short-run to its long-run equilibrium position. We use the stationary properties of monetary variables in this study.

III. VELOCITY OF MONEY

For a useful policy target the demand for money should be a stable function of a relatively small number of economic variables and the central bank must be able to control the monetary growth. We know that the stable behavior of the velocity of money (V) is a pre-condition for effective monetary policy. Here we will use the Fisher's equation of exchange:

$$M*V = Y$$

where M = Money (alternatively defined in this study), V = Velocity of Money and Y = Nominal income or GDP. The variance of V indicates the stability of the demand for alternatively defined money.

The central bank controls the money stock because one of the principal objectives of monetary policy is to have a stable high nominal income with low inflation and low unemployment. With a stable velocity of money, the monetary authority can use the money supply to control the overall economic activities and consequently the growth rate of GDP (Blanchard and Fisher, 1989). The government is concerned with the demand for money function to predict the effects of changes in the money supply on interest rates, real income, prices etc. (Laidler, 1993). However if velocity is unstable over time, this objective cannot be achieved in the long run. An unstable V may lead to macroeconomic and financial instability and induce high inflation with low unemployment. Inflation makes money an inequitable standard of deferred payments and an untrustworthy store of value (Hassan and Aldayel, 1998). Purchasing power is decreased as too much money chases too few goods due to inflation. Investment and savings are decreased as inflation increases monetary value of consumption. Thus, capital formation is hampered, which leads to a misallocation of resources. This further impairs the efficiency of the monetary system and imposes huge welfare costs on the economy. Inflation tends to pervert values, rewarding speculation (discouraged by Islam) at the cost of productive activities (idealized by Islam) and intensifying inequalities of income (condemned by Islam) (Hassan and Aldayel, 1998). The monetary authority of Islamic countries can expand money supply with the long-run growth of the economy if the interest-free money is stable over time. Stable and smooth money velocity is an important factor for successful monetary policymaking and for an affluent economy.

Darrat (1988, 2000) tests the velocity and stability of money (both interest-bearing and non-interest-free) for Tunisia (Darrat, 1988) and for Iran and Pakistan (Darrat, 2000). He uses the variance of velocity of alternatively defined money finds that the variance of the velocity of non-interest-bearing money is less than that of interest-bearing money, which implies that non-interest-bearing money is more stable than the interest-bearing money. Darrat argue that introducing interest-free banking practices would promote financial and economic stability, thus providing monetary authorities with a more conducive environment in which to conduct effective policies.

We test the hypothesis that variance of the velocity of interest-free money is less than that of interest-based money. The statistics for the velocity of interest-bearing and interest-free money are shown in table 3. When we compare the velocity of money we find a consistent and expected result across countries and subgroups. The Variances of VMNI are lower than VMI across the sample. Even the standard deviation of the variance of VMNI is lower than that of VMI for the sample countries. We performed an F-test of the hypothesis that variance of VMNI is lower than the variance of VMI, and the results support our hypothesis. The test results confirm significantly that the interest-free money is more stable than the interest-bearing money.

IV. POLICY CONTROLLABILITY

Havrilesky and Boorman (1980) and McCallum (1989) show that the policy usefulness of alternative monetary aggregates depends on two issues: Policy controllability and linkage to economic policy goal. Darrat (2000) and Zaki (1995) argue that a given monetary aggregate is useful for the purpose of policy if it satisfies two prerequisites: First, the monetary authority must control the monetary aggregate and second, there is reliable linkage between the monetary aggregate and principal policy goal. The monetary aggregate will lose its policy appeal in the absence of this linkage even if it is under policy control. On the other hand, the monetary aggregate that has strong links to the major policy goal may not be useful if the monetary authority cannot control and handle it. Batten and Thornton (1983) propose two criteria for any monetary aggregates to be policy-effective. Firstly the central monetary authority must have full and direct control over monetary aggregate and secondly there should be strong and reliable link between monetary aggregate and the goals of the monetary authority. Monetary base (MB) is one of the main instruments of monetary policy and one can examine the statistical relationship between MNI (or MI) and MB to gauge controllability of MNI or MI. Darrat (1988) and Hassan and Aldayel (1998) regress MNI against MB and alternatively MI against MB and conclude that if MNI (or MI) is highly correlated (in terms of high R^2 value) with MB then the particular monetary aggregate is more policy controllable and the monetary authorities have more and direct control on the money supply.

To apply the co-integration procedures, the main prerequisite is to test the unit root properties of the time series data. The unit root properties of the data are presented in Table 4. Two sets of statistics were used: augmented Dickey-Fuller (ADF) and Phillips-Perron test. The latter was relied upon, as it is a more powerful test than ADF. Non-stationarity was tested in MNI, MI and MB and it was determined that all the series of MNI, MI and MB were non-stationary in their levels and stationary in their first difference. Proper lags are selected by using Akaike Information Criterion (AIC). Each variable is transformed to logarithmic form as a convention to stabilize error processes across time. Each of the three variables is individually non-stationary in log-levels. Thus, it is important to check and determine the co-integration (long-run) relationship (1) between MB and MNI and (2) between MB and MI.

Co-integration tests based on Johansen (1988) were also conducted. Table 5 reports the Johansen test of Co-integration. When focusing on the λ_{max} test results, the null hypothesis of no co-integration ($r = 0$) was rejected in favor of alternative hypothesis of $r = 1$ only for MNI in each group. The calculated λ_{max} test statistics for MNI range from a low of 35.71 in the Gulf to a high of 41.48 in other countries consisting of Iran, Jordan, Syria, and Turkey. Both the trace-value and Eigenvalue suggest that there is a long-run relationship between MNI and MB and there is no co-integration relationship between MI and MB. Thus the monetary authority of the OIC countries can control the MNI as it has a long-run relationship with MB. Since there is no potential long-run relationship between MI and MB, the monetary authority of OIC countries cannot control MI as a monetary aggregate.

This paper is also interested in the short-run relationship between MNI and MB and between MI and MB, as monetary authorities have some short-run goals along with long-run goals. Error correction results are presented in table 6. A long-run relationship between MNI and MB was found; thus an error correction term, denoted by ECM, entered into the estimated equation of MNI. The MI equation was regressed without an ECM, as no long-run relationship between MI and MB was ascertainable. The regression results show high correlation between MNI and MB and low correlation between MI and MB. These are represented by the R^2 value. The growth of MNI is more closely correlated with the growth of MB. MB explains 69%, 78%, 53%, 79% and 56% of the total variation in MNI of Africa, Asia, Gulf, other countries and the whole sample respectively. Compared to this, the MB explains

25%, 33%, 5%, 32% and 17% of the total variation in MI of Africa, Asia, Gulf, other countries and the whole sample respectively. The differences between the elasticity of the two monetary aggregates (the degree of responsiveness of MNI or MI to changes in MB) are also significant. The coefficients of the independent variable (MB) reflect this, as most of the coefficients are statistically significant. This suggests that if the monetary authority increases the monetary base (MB) it will increase the MNI more than the MI.

V. LINKAGE BETWEEN THE MONETARY AGGREGATE AND ECONOMIC GOALS

The main purpose of using a monetary aggregate by the monetary authority is that the monetary aggregate must have a reliable and consistent link with ultimate policy objectives. Close identification of the linkage between money stock and ultimate policy goals is a prerequisite for achieving full employment and price level stability. Price stability is viewed as the principal and primary policy goal of the monetary authorities of most countries.

Monetarists believe that there is a long-run relationship between money stock and inflation and that money is neutral in the short run. This paper was also interested in investigating the short-run relationship of money and inflation in Muslim countries. Prior to estimating the long-run relationship between money stock and inflation, it was verified that all the series were integrated of the same order. Non-stationarity was tested in MNI, MI, and P, where P was the price level that was measured by the Consumer Price Index (CPI). Proper lags were selected by using Akaike Information Criterion (AIC). Each of the three variables was non-stationary in log-levels but achieved stationarity in first differences. Accordingly, the presence of a co-integration (long-run) relationship between (a) MNI and P and (b) MI and P was investigated. Co-integration tests of Johansen (1988) were conducted to investigate the presence of long-run relationships between prices and alternatively defined money. Table 7 reports the Johansen test of co-integration through maximum eigenvalue and trace statistics.

Focusing on the λ_{max} and λ_{trace} test result, the null hypothesis of no co-integration ($r = 0$) was rejected in favor of alternative hypothesis of $r = 1$ only for MNI in each group. Both the trace-value and eigenvalue suggest that there was a long-run relationship between MNI and P and that there was no significant long-run relationship between MI and P. Thus the monetary authority of the OIC countries could control the MNI to combat inflation as it had a long-run relationship with P. Since there was no potential long-run relationship between MI and P, the monetary authority of OIC countries could not control MI as a monetary aggregate to tackle inflation.

Like policy controllability issues, the short-run relationship between MNI and P and between MI and P was also investigated. Since there was a co-integration relationship between MNI and P, estimates for the regressions for inflation through error correction model were conducted. The estimated results for ECM are presented in table 8. We use the standard ordinary least squares regression for the MI equation without ECM since we do not find any long-run relationship between MI and P. Since inflation is one of the major policy goals of the monetary authorities of OIC countries, it was assumed that an increase in money supply has an immediate impact on current prices (inflation) and current prices possibly have some effects on current money stocks. So the current growth rate of money stock was excluded as an independent variable from our regression to avoid inconsistent and biased results from simultaneous equation problem. Hence, lag values of the growth of MNI and MI entered in the estimated equations and was theoretically appealing as per rational expectation theory (Barro 1979, McCallum 1980).

The regression results for inflation demonstrated low R^2 for interest-free money compared to the interest-bearing money. The value of R^2 indicated that the growth of MNI paved the way for the monetary authorities of OIC countries to have a short-run linkage between money stocks and price stability. It indicated that the short-run growth rate of inflation (P) was more closely correlated with the lagged growth rate of MNI. The differences between the elasticity of the two monetary aggregates (the degree of responsiveness of Inflation due to changes in money stock) were significant. The coefficients of the independent variables reflect this fact, as most of the coefficients were significant statistically. As expected, the sign of the error correction term was negative and statistically significant for each sample group.

There were both short-run and long-run relationships between the growth rates of MNI and P while no short-run and long-run relationships were found for the growth rates of MI and P. This suggests that the growth of MNI was steady and in tangent with the policymaker's goal of price stability.

VI. CONCLUSION

This paper tested the comparative efficiency and merits of the interest-free banking for selected OIC countries using time series data for 1970-1998 period. The results are deduced from the summery statistics, co-integration analysis and regression analysis for error correction. This study supports the relative effectiveness of interest-free banking in OIC countries in terms of stable and smooth velocity of money, controllability of monetary

aggregates (MNI and MI) and stronger linkage between monetary policy instruments and ultimate policy goals of the economy.

What should the monetary authorities of the OIC countries do in light of our estimated results on two alternatively defined monetary aggregates (MNI and MI) to control the monetary policy and achieve the monetary goals? The monetary authorities of the OIC countries should design their monetary policies in such a way so that they serve the basic socioeconomic objectives of Islam. From the distribution aspect of the monetary policy the objectives of the monetary authority must be to ensure the egalitarian distribution of income. Through the choice management and use of interest-free money, the Islamic banking system can create a practicable economic system with distributive justice. Generation of full employment, low inflation, and reducing welfare costs are other purposes of the monetary authorities to make the economy a stable one. The behavior and growth of inflation will give signal to the monetary authorities whether the money supply will be contractionary or expansionary. Monetary authorities must have full control over monetary aggregates to ensure real growth of the economy by fulfilling their ultimate policy goals. The motivation of Islamic banking coupled with stable currency would influence strong and real economic growth in OIC countries.

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TABLE 1. SAMPLE OF COUNTRIES

Group	Country
Africa	Algeria, Egypt, Morocco, Nigeria, Sudan, Tunisia
East and South Asia	Indonesia, Malaysia, Pakistan
GCC	Bahrain, Kuwait, Qatar, Saudi Arabia
Other	Iran, Jordan, Syria, Turkey

TABLE 2. DEFINITION OF DATA

Abbreviation	Definition	Description
MNI	Currency + demand deposits	Money that does not earn interest
MI	Time deposits + savings deposits	Money that earns interest
CPI, P	Measures of price and inflation	Consumer price index
MB	Currency + reserves	Monetary base
VMNI		Velocity of non-interest-bearing money (MNI)
VMI		Velocity of interest-earning money (MI)
GDP		gross domestic product

TABLE 3. SUMMARY STATISTICS AND TESTS OF VARIANCES IN THE VELOCITY OF MONEY

Country	Variance of VMNI	Variance of VMI	F-Test	Number of Observations
Egypt	1.0289 (m = 3.56, s.d. = 1.01)	14.4767 (m = 4.505, s.d. = 3.804)	0.0710*	29
Indonesia	1.2251 (m = 10.09, s.d. = 1.1)	88.1453 (m = 11.84, s.d. = 9.39)	0.0139*	29
Iran	1.2960 (m = 4.70, s.d. = 1.14)	4.9976 (m = 5.54, s.d. = 2.24)	0.2593*	29
Jordan	0.1578 (m = 2.19, s.d. = 0.40)	5.9643 (m = 3.33, s.d. = 2.44)	0.0265*	29
Kuwait	2.9069 (m = 2.65, s.d. = 1.70)	9.5705 (m = 8.04, s.d. = 3.09)	0.3037*	29
Malaysia	0.5075 (m = 5.15, s.d. = 0.71)	1.6139 (m = 2.95, s.d. = 1.27)	0.3145*	29
Morocco	0.3020 (m = 3.00, s.d. = 0.55)	179.7088 (m = 16.13, s.d. = 13.41)	0.0017*	29
Pakistan	0.1056 (m = 3.63, s.d. = 0.33)	2.4244 (m = 7.35, s.d. = 1.56)	0.0436*	29
Qatar	4.2869 (m = 7.47, s.d. = 2.07)	16.2648 (m = 5.62, s.d. = 4.03)	0.2636*	29
Saudi Arabia	18.3861 (m = 6.35, s.d. = 4.29)	396.6102 (m = 22.00, s.d. = 19.92)	0.0464*	29
Sudan	11.4946 (m = 6.72, s.d. = 3.39)	82.8717 (m = 22.84, s.d. = 9.10)	0.1387*	29
Syria	0.1977 (m = 2.52, s.d. = 0.44)	186.7845 (m = 20.07, s.d. = 13.67)	0.0011*	29
Tunisia	0.2765 (m = 4.13, s.d. = 0.53)	10.2881 (m = 6.74, s.d. = 3.21)	0.0268*	29
Africa	0.1364 (m = 3.49, s.d. = 0.37)	30.1974 (m = 6.76, s.d. = 5.50)	0.0045*	116
Asia	0.2485 (m = 6.22, s.d. = 0.50)	8.3510 (m = 6.04, s.d. = 2.89)	0.0298*	87
Gulf Asia	8.7291 (m = 4.93, s.d. = 2.95)	96.4756 (m = 13.81, s.d. = 9.82)	0.0904*	87
Other	0.9186 (m = 4.17, s.d. = 0.96)	5.9835 (m = 5.92, s.d. = 2.45)	0.1535*	87
Whole sample	2.3609 (m = 4.51, s.d. = 0.87)	19.6701 (m = 6.85, s.d. = 3.83)	0.12*	377

* Significant at 5% level.
m = mean; s.d. = standard deviation.

TABLE 4. UNIT ROOT TESTS

Group	Variables		ADF*		Phillips-Perron*	
Africa	Log Level	MNI	–3.19459	(2)	–2.24218	(2)
		MI	–1.98645	(2)	–1.48247	(3)
		MB	–0.70074	(3)	–1.70920	(4)
	First Difference	MNI	–0.17902	(4)	–16.14591	(4)
		MI	–3.38649	(4)	–18.44320	(4)
		MB	–2.24468	(2)	–11.61115	(4)
Asia	Log Level	MNI	–0.63107	(3)	–1.37374	(4)
		MI	–1.39549	(4)	1.61063	(2)
		MB	–2.00103	(2)	–5.24719	(4)
	First Difference	MNI	–0.68590	(4)	–10.10504	(4)
		MI	–2.24100	(4)	–6.17246	(4)
		MB	–1.20239	(2)	–15.20085	(4)
Gulf	Log Level	MNI	–3.40680	(3)	–2.03386	(4)
		MI	–5.47478	(3)	–1.93677	(3)
		MB	–2.76879	(3)	–2.29949	(4)
	First Difference	MNI	–2.05968	(3)	–14.19765	(3)
		MI	–2.13738	(3)	–10.45309	(3)
		MB	–2.49291	(2)	–16.79851	(4)
Other	Log Level	MNI	–1.45141	(2)	–3.39745	(2)
		MI	–0.86652	(2)	–2.76481	(3)
		MB	0.87381	(2)	–1.65198	(2)
	First Difference	MNI	–3.05117	(2)	–15.18364	(2)
		MI	–2.04927	(2)	–16.37414	(3)
		MB	–1.47924	(3)	–16.25472	(3)
World	Log Level	MNI	–1.31206	(3)	–0.63200	(3)
		MI	–0.53261	(2)	–0.009629	(2)
		MB	–0.00821	(2)	–0.62863	(2)
	First Difference	MNI	–3.88639	(2)	–24.17911	(2)
		MI	–2.78327	(2)	–17.20366	(2)
		MB	–3.61800	(3)	–15.61139	(3)

*The 5% and 10% critical values for the ADF and Phillips-Perron tests are –3.50 and –3.18.

TABLE 5. JOHANSEN TEST FOR POLICY CONTROLLABILITY

Group	Null Hypothesis	Alternative Hypothesis	Maximum Eigenvalue (λ_{max})		Alternative Hypothesis	Trace Statistics (λ_{trace})	
			MNI, MB	MI, MB		MNI, MB	MI, MB
Africa	r = 0	r = 1	36.21*	22.46	r ≥1	28.34*	19.72
	r ≤ 1	r = 2	6.23	7.29	r = 2	6.23	7.29
Asia	r = 0	r = 1	37.48*	25.23	r ≥1	33.46*	21.24
	r ≤ 1	r = 2	13.72	10.65	r = 2	13.72	10.65
Gulf	r = 0	r = 1	35.71*	24.67	r ≥1	28.06*	20.13
	r ≤ 1	r = 2	6.92	7.64	r = 2	6.92	7.64
Other	r = 0	r = 1	41.48*	21.09	r ≥1	29.62*	17.89
	r ≤ 1	r = 2	8.52	9.43	r = 2	8.52	9.43
World	r = 0	r = 1	38.63*	23.36	r ≥1	30.31*	19.96
	r ≤ 1	r = 2	10.72	9.46	r = 2	10.72	9.46

*Significant at 5% level.

TABLE 6. ESTIMATION OF ERROR-CORRECTION MODEL FOR POLICY CONTROLLABILITY

Group	Dependent Variable (Log level)	Constant	Independent Variable (MB) (Log level)	Error Correction Term (ECM_{T-1})	R^2
Africa	ΔMNI	–0.0128**	0.6724**	–0.0096*	0.6887
	ΔMI	–0.0662*	0.2831*	——	0.2475
Asia	ΔMNI	–0.0251**	0.6528*	–0.0031*	0.7779
	ΔMI	0.0891	–0.3967	——	0.3304
Gulf	ΔMNI	–0.0404*	0.7984*	–0.0178	0.5308
	ΔMI	0.1031	0.3336	——	0.0487
Other	ΔMNI	–0.0553**	0.7421*	–0.0051*	0.7862
	ΔMI	–0.1476*	0.4847	——	0.3211
World	ΔMNI	–0.0248**	0.5903**	–0.0073*	0.5612
	ΔMI	0.0677	0.2290**	——	0.1672

** 10% significance level for *t*-statistics
* 5% significance level for *t*-statistics

TABLE 7. JOHANSEN TEST FOR POLICY LINKAGE

Group	Null Hypothesis	Alternative Hypothesis	Maximum Eigenvalue (λ_{max})		Alternative Hypothesis	Trace Statistics (λ_{trace})	
			P, MNI	P, MI		P, MNI	P, MI
Africa	r = 0	r = 1	46.93*	27.63	r ≥1	35.08*	22.27
	r ≤ 1	r = 2	9.03	10.31	r = 2	9.03	10.31
Asia	r = 0	r = 1	53.97*	31.07	r ≥1	41.36*	24.03
	r ≤ 1	r = 2	15.24	12.42	r = 2	15.24	12.42
Gulf	r = 0	r = 1	41.14*	23.06	r ≥1	34.03*	21.56
	r ≤ 1	r = 2	8.42	9.85	r = 2	8.42	9.85
Other	r = 0	r = 1	49.37*	28.36	r ≥1	35.67*	22.73
	r ≤ 1	r = 2	10.11	10.29	r = 2	10.11	10.11
World	r = 0	r = 1	50.81*	28.96	r ≥1	36.94*	24.03
	r ≤ 1	r = 2	11.57	10.46	r = 2	11.57	10.46

*Significant at 5% level.

TABLE 8. ESTIMATION OF ERROR-CORRECTION MODEL FOR POLICY LINKAGE

Group	Monetary Aggregate	Dep. Var. (Log level)	Constant	Ind.Var. (ΔM_{T-1})	Ind. Var. (Log level) (ΔP_{T-1})	Ind. Var. (Log level) (ΔP_{T-2})	Error Corr. Term (ECM_{T-1})	R^2
Africa	Interest-free	ΔP_T	–0.0326**	0.1163*	0.2143**	0.3071	–0.0031**	0.4721
	Interest-bearing	ΔP_T	–0.0132	0.0921	–0.0521**	–0.1710	——	0.0312
Asia	Interest-free	ΔP_T	–0.0421*	0.1681**	0.2937*	0. 4811	–0.0073*	0.5237
	Interest-bearing	ΔP_T	0.0019**	0.0092	–0.0739	–0.1036**	——	0.2163
Gulf	Interest-free	ΔP_T	–0.0263**	0.0918	0.1037**	0.0522	–0.0041*	0.3822
	Interest-bearing	ΔP_T	–0.0094*	–0.2734	0.0956	0.0773	——	0.0264
Other	Interest-free	ΔP_T	–0.0519*	0.0915**	0.1031	0.0392**	–0.0057*	0.6429
	Interest-bearing	ΔP_T	–0.0236	0.0429	–0.0107	0.0217**	——	0.3408
World	Interest-free	ΔP_T	–0.0427**	0.2491*	0.1623**	0.0791	–0.0051*	0.5371
	Interest-bearing	ΔP_T	–0.0117**	–0.1928	0.0861	0.1834	——	0.2381

** 10% significance level for *t*-statistics
* 5% significance level for *t*-statistics

A Comparison of Transactions in Conventional and Islamic Economies

Mabid Ali Al Jarhi*

ABSTRACT

This paper compares the transactions costs in two economies, one conventional, the other Islamic. The conventional economy is characterized by borrowing to finance some current purchases, while the Islamic economy disallows interest-based lending and operates on the basis of universal banking that mixes commerce and commercial and investment banking. To finance current purchases, it provides customers with credit purchase agreements, which entail that the bank buy the commodities and assets from suppliers and resell them on credit to customers satisfying conditions of creditworthiness similar to those that conventional banks require for borrowers. The paper uses simple calculations to compare transactions costs in both economies. It argues that under competitive competition, credit purchase arrangements occasion lower transactions costs than borrow-and-purchase arrangements in the conventional economy. The most important implication is that a policy that lifts entry barriers in the Islamic banking market and allows banks to combine commerce with banking activities contributes to social welfare. The paper concludes with suggestions for further points of research.

I. INTRODUCTION[1]

This paper compares the transactions costs in two economies, one conventional and another Islamic. The conventional economy is characterized by borrowing as a means of financing some of the current purchases. The Islamic economy does not allow interest-based lending.[2] Its banking system operates on the basis of universal banking that mixes commerce, commercial and investment banking together. It provides customers with an alternative means to finance current purchases, namely *credit purchase* arrangements. Such arrangements entail that the bank purchases the commodities and assets from their respective suppliers and resells them on credit to customers satisfying conditions of credit worthiness similar to those required by conventional banks for borrowers.

The paper uses simple calculations to compare the transactions costs in both economies. It argues that under competitive competition, *credit purchase* arrangements would carry less transactions costs than *borrow and purchase arrangements* in the conventional economy. The most important implication is that a policy that lifts entry barriers in the Islamic banking market and allows banks to combine commerce with banking activities would contribute to social welfare. The paper concludes with suggestions for further points of research.

II. REAL TRANSACTIONS

Real transactions are defined as the purchase of real commodities and assets against spot or future cash payment.

A. Spot Purchases of Commodities and Assets

Economic agents would exchange money directly for goods, services, and assets. Such transactions can be termed *real transactions, type I*. Their total value is a function of output (the available flow of goods and services Y , prices $P = \{p_i\}$ as well as transactions costs.[3]

A priori, the conduct of the above transactions will cost some resources. The cost per transaction in the i[th] commodity is defined as $(v_i)_Y^y$ and in the i[th] asset as $(v_i)_Y^a$. The total cost of real spot transactions can be defined as the sum of spot transactions in goods and services plus the cost of spot transactions in assets $V_Y = V_Y^y + V_Y^A$. This in turn can be written as: $V_Y = \sum_{N}^{i=1} (v_i)_Y^y + (v_i)_Y^A$, where N is the number of either commodities (goods and services) or assets, whichever is largest.

* Director, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia.

Total transactions of type I would be equal to the value of spot transactions in commodities T_Y^y plus the value of spot transactions in assets T_Y^A, i.e., $T_Y = T_Y^y + T_Y^A$. Given that the value of transactions in the ith commodity is equal to its price, p_i^y multiplied by its quantity, y_i,[4] and the value of transactions in the ith real asset is equal to its price p_i^A multiplied by its quantity a_i^y, $T_Y = \sum_{N}^{i=1} p_i^y y_i + p_i^a a_i^y$. Similarly, the total value of transactions in commodities can be expressed as a function of commodity current prices $P^y = \{p_i^y\}$, their expected prices $P^{\bar{Y}} = \{\bar{p}_i^y\}$, total income PY as well as their transactions costs V_Y^Y.

$$T_Y^y = T_Y^y(P^Y, P^{\bar{Y}}, PY, V_Y^Y) \quad \ldots\ldots(1)$$

Similarly, the total value of transactions in assets T_Y^A can be expressed as a function of asset current prices $P^A = \{p_i^a\}$, their expected prices $P^{\bar{A}} = \{\bar{p}_i^a\}$, their current rates of return $\mathrm{P} = \{\rho_i\}$, their expected rates of return $\bar{\mathrm{P}} = \{\bar{\rho}_i\}$, total income PY as well as their transactions costs V_Y^A.

$$T_Y^A = T_Y^A(P^A, P^{\bar{A}}, \mathrm{P}, \bar{\mathrm{P}}, PY, V_Y^A) \quad \ldots\ldots(2)$$

We can therefore write the total value of real transactions type I as a function of current and expected commodity as well as asset prices, current and expected rates of return on assets as well as transactions costs.

$$T_Y = T_Y(PY, P^Y, P^A, P^{\bar{Y}}, P^{\bar{A}}, \mathrm{P}, \bar{\mathrm{P}}, V_Y) \quad \ldots\ldots(3)$$

An increase in the flow of goods and services would lead to greater volume of this type of transactions. Lower prices imply higher quantities demanded and more purchases, while higher prices would mean lower quantities demanded and more sales. In both cases, changes in prices, whether up or down would lead to more transactions.[5] Similarly, changes in asset rates of return would lead to more transactions. In addition, higher transactions costs imply a smaller volume of transactions.

B. Purchase of Commodities and Assets on Credit

In all transactions, it is possible to postpone either side of the deal: the payment of the price or the delivery of commodities. The postponement of payment is associated with buying on credit. The postponement of delivery of goods, services, and real assets against spot payment would be equivalent of purchasing a real asset promising their future delivery. This has been dealt with in the above category.

C. Combining Commerce with Banking

Credit finance can be offered either directly by suppliers or indirectly through banks. Suppliers would offer their customers opportunities to purchase on credit, provided they fulfill certain criteria regarding creditworthiness. In an Islamic banking environment, the same suppliers would have an incentive to offer banks standing arrangements to buy their commodities and assets for cash, most surely at a discount.[6] Obviously, the sale contracts between suppliers and banks would carry less transactions costs than the corresponding multiplicity of contracts with ordinary customers. In all cases, banks would be doing repetitive purchases, presumably to satisfy customers demands. Repetition would induce banks to make standing arrangements that would reduce transactions costs immensely. In addition, when selling to banks on credit, suppliers would incur lower transactions costs, as bank creditworthiness is cheaper to ascertain than that of an individual.

In addition, banks as information specialists are capable of ascertaining individuals' creditworthiness more cheaply than suppliers can. They can also take advantage of quantity discounts when buying in bulk, as well as standing arrangements in place of repetitive contracting. This would enable banks to reduce their transactions costs of buying and then selling on credit, below that of purchasing on credit directly from suppliers.[7] In addition, barring barriers to entry, distributors would also compete with banks in buying in bulk and selling to the public at a discount. Banks would therefore be forced through competition to reduce their transactions costs further.

Accordingly, we can claim that the transactions costs of credit purchase through banks should generally be less than that through suppliers, although the former involves two contracts and the latter involves one. The former would ultimately dominate the latter in an Islamic banking environment.[8]

The above logic implies that the transactions costs of CP directly from suppliers ${}^{d}v_{y}$ should be higher than that of the corresponding purchases from banks $({}^{d}v_{y})^{b}$, i.e.,

$${}^{d}v_{y} > ({}^{d}v_{y})^{b} \quad \ldots\ldots(4)$$

D. Transactions Costs of Credit Purchase

When people buy on credit, they would be receiving their purchases while providing monetary assets (promises to pay fixed sums of money at certain future times) in return. Providers of commodities and real assets on credit will require a premium over and above their spot prices, called *markup*.[9] It will depend on the demand for purchase and supply for sale of the same commodity or asset on credit as well as the repayment time schedule. Presumably, markups would also be different for different commodities.[10] The total value of such transactions ${}^{d}T_{Y}$ is equal to the sum of transactions of credit purchase of both goods and services, ${}^{d}T_{Y}^{y}$ and of assets, ${}^{d}T_{Y}^{A}$. Both components depend on income, commodity and asset CP prices, ${}^{d}P^{Y} = \{{}^{d}p_{j}^{y}\}$, ${}^{d}P^{A} = \{{}^{d}p_{j}^{a}\}$ respectively, markups on commodities and assets, $U^{Y} = \{u_{j}^{y}\}$, $U^{A} = \{u_{h}^{a}\}$ as well as transactions costs, ${}^{d}V_{Y} = {}^{d}V_{Y}^{y} + {}^{d}V_{Y}^{a}$. Naturally, we can expect transactions costs for the same commodity to be higher for future than spot transactions, i. e., ${}^{d}v_{j} > v_{j}$.

We can call this type of transactions *real transactions type II*. Their total value would be defined as:

$${}^{d}T_{Y} = {}^{d}T_{Y}^{y} + {}^{d}T_{Y}^{A} = \sum_{D}^{j=1} {}^{d}p_{j}^{y} y_{i} + {}^{d}p_{j}^{a} a_{j}^{y}$$

Total real transactions type II can therefore be determined through the following function, which is similar to (3) above.

$${}^{d}T_{Y} = {}^{d}T_{Y}[Y, \bar{P^{Y}}, \bar{P^{A}}, P^{Y}, P^{A}, \mathrm{P}, \bar{\mathrm{P}}, U^{Y}, U^{A}, {}^{d}V_{Y}] \quad \ldots\ldots(5)$$

Transactions would continue to react in the same manner to income, prices, and transactions costs. In addition, higher markup leads to lower level of transactions.

E. Real Transactions and Total Output

We can draw the following implications from (3) and (5):

1. At times of changing price and rate of return expectations, traders would attempt to buy (sell) more of the goods whose prices are expected to rise (fall). The volume of transactions would therefore increase, requiring, either higher velocity or faster monetary growth. If both velocity and monetary growth stayed the same, the price level would tend, *ceteris paribus*, to decline. Most probably, the market would provide internal mechanisms to increase velocity in the face of higher transactions, as more transactions would mean a higher rate of turnover of money, and goods. We can therefore claim that velocity would be a function of price expectations as well as the volume of transactions.[11]
2. Real transactions can be viewed as reactions to changes in demands and supplies of commodities and assets, prompted by price as well as rate-of-return expectations. They would ultimately produce a new set of prices and rates of return that would directly influence output plans. One could envision the existence of *reaction functions* operating between changes in demands and supplies, changes in transactions, and finally changes in output plans. There would therefore be a relationship between transactions on the one hand and output of goods, services, and assets on the other through those reaction functions. Such relationship could emanate from two sources.
3. First, as commodities and assets are exchanged, additional values are created. This is because the exchange of goods and services from one individual to another would improve the allocation of resources and produce extra efficiency, which would benefit all traders in different proportions. Extra efficiency can be translated into extra output. This implies that there is a positive relationship between real transactions and output, such that $\frac{\partial Y}{\partial T^{Y}} \succ 0$.
4. Second, transactions in commodities and assets whose demand has declined (increased) relative to their supplies would be associated with decreasing (increasing) prices, which would send a signal to producers to

decrease (increase) output. The greater the volume of those transactions, the stronger the intensity of such signals, and the faster resources are reallocated from decreasing- to increasing-demand commodities. Faster adjustment would produce efficiency gains in terms of better production plans and less inventories. This can also be translated into higher output, so that $\frac{\partial Y}{\partial T^Y} \geq 0$.[12]

III. NOMINAL TRANSACTIONS

A. Spot Money against Monetary Assets

The act of borrowing can be viewed as a purchase of monetary assets, i.e., promises of future delivery of fixed sums of money. Here we assume that the payment of the current value of the monetary asset is done immediately.[13]

Such transactions could be termed *nominal transactions*. Their total value $T_M^A = \sum_{K}^{k=1} a_k^m$ is a function of the current and expected rates of interest as well as their transactions costs.

$$T_M^A = T_M^A(r_0, r_1^*, V_M^A) \quad \ldots\ldots(6)$$

As the current rate of interest rises, the amount of borrowing and consequently, T_M^m, declines. When the expected future rate of interest rises, current borrowing as well as T_M^m increases, and *vise versa*.

B. Comparing the Transactions Costs of Credit and Cash Purchases

1. We notice that each real transaction on credit can be substituted for by two transactions. If one wants to buy a commodity on credit, he can make one real transaction for a direct CP. His transactions costs would be equal to ${}^d v_i^y$.[14] To the whole society, the transactions costs of that exchange is equal to ${}^d v_i^y + {}^b v_y$, where the first term refers to the cost of the CP contract and the second refers to the cost of acquiring the commodity by the bank from its supplier. Alternatively, he can borrow through selling a nominal asset incurring transactions costs equal to v_k. Then he uses the proceeds to make *another* real transaction to purchase the desired commodity for cash, incurring transactions costs equal to .[15]
2. We turn now to compare the transactions costs of a CP contract, ${}^d v_i^y$, with that of selling a bond (borrowing), v_k. The underlying elements of ascertaining the creditworthiness of the agent who is buying on credit in the first case and borrowing in the second are the same. However, we can refer to some reasons that would bring the transactions costs of credit purchase below that of borrowing.
   - In the case of purchase of real assets and other durables on credit, the commodity sold would serve as collateral subject to repossessing by the seller. In the case of lending, suitable collateral has to be identified separately. Conceivably, that would reduce the transaction costs involved in buying assets and durables on credit below the corresponding costs of borrowing.
   - We can assume that transactions costs would depend on the ability to repay a loan, which in turn would depend, among other things, on what the borrower does with it. The more such behavior is predictable, the more predictable becomes the ability to repay. In the case of CP, the debtor is certain to use the loan toward the acquisition of the commodity or asset in question. Meanwhile, in case of borrowing, there is no way of telling for certain how the loan would be spent. The ability to repay would therefore be more predictable in the case of credit finance, which would imply lower transactions costs.
   - Banks in an Islamic economic system operate on the bases of universal banking, i.e., they can take equity and provide credit finance simultaneously to the same enterprise. The practice of universal banking in a world of asymmetric information is known to reduce the cost of monitoring borrowers (Aoki 1994, Boyd; 1998 Diamond, 1998). This means that the transactions costs of credit finance provided by banks to enterprises in which they take stock would be lower with universal rather than commercial banking. This in turn would imply lower transactions costs of providing credit purchase to enterprises in which banks have stakes.

3. We can therefore conclude that in a world of Islamic banking, where universal banking is practiced, and especially in the case of financing the purchase of assets and durables, the transactions costs of CP tend to be lower than that of borrowing, namely ${}^{d}v_i^y \leq v_k$.[16]
4. So far, we have compared the transactions costs of a CP contract with that of making a loan of equal value. Adding the transactions costs of using the loan proceeds to make a cash purchase to the transactions costs of borrowing, and that of purchasing the commodity directly from the supplier, and noting (4) above, we obtain:

   ${}^{d}v_i^y + {}^{b}v_i < (v_k + v_i^y)$ ……(7)

   This implies that under competitive conditions, purchase on credit, CP is more efficient than borrowing followed by cash purchase of the same commodities, BAP.

C. Nominal Transactions and Real Output

We can look into how nominal transactions affect output from several angles.

1. At the outset, nominal transactions provide liquidity to those who sell nominal assets, which they could use to carry out real transactions type I. To the extent that this could *not* be done through credit purchases, nominal transactions could influence real output through stimulating *real transactions type I*. As we have seen above, people will find it cheaper to carry out credit purchases in one step rather than to do it in two steps: borrowing and then purchasing, especially if banks were allowed to sell on credit.
2. We can then ask why people would resort to borrowing to finance their purchases when credit purchase arrangements are available, despite the higher transactions costs of the former. One reason would be incomplete information. The calculus of transactions costs may not be as simple and straightforward to many agents. However, this would not continue in the long run, as traders would gradually gain more information through exchange. A more important source would be weaker competition in the CP markets relative to the borrowing market, thereby raising the rate of markup above the rate of interest sufficiently to counteract any savings in transactions costs.[17] In either case, there is a deadweight loss at the macroeconomic level. Such deadweight loss can be avoided by credit purchase.

IV. COMPARING ECONOMIES WITH AND WITHOUT BORROWING

Let us assume two economies of equal resources, one conventional and another Islamic. The aggregate output of each can be divided between consumption, investment, and transactions costs according to the following identity:

$$Y = C + I + V \quad \ldots\ldots (8)$$

The aggregate transactions costs in a conventional economy, with no CP arrangements through banks, would be composed of the cost of borrowing (selling monetary assets), the cost of spot purchase of commodities:

$$V_1 = V_M^A + V_Y^1 \quad \ldots\ldots (9)$$

In an economy with CP arrangements through the banking system, like the Islamic economy, aggregate transactions costs would be composed of the cost of credit purchase through banks and the cost of cash purchase of commodities by banks from suppliers:

$$V_2 = V_Y^2 + {}^{d}V_y^2 \quad \ldots\ldots (10)$$

As shown in (7) above, the total of CP and cash purchase transactions costs (by banks) in (10) would be less that the corresponding total of borrowing and cash purchase transactions costs (by individuals) in (9). This implies that

$$C^2 + I^2 \succ C^1 + I^1 \quad \ldots\ldots (11)$$

We can therefore conclude under the above assumptions, that economies with CP arrangements through banks would have relatively more resources available for consumption and investment.

V. CONCLUSION

The main conclusion of the above analysis is that, under competitive conditions, purchase on credit costs less than borrowing to finance spot purchases. Some observed market behavior confirms that result. Suppliers of

durable goods sometimes join banks to offer financing packages to their customers, which combine borrowing and spot purchase in one deal, mimicking credit purchase arrangements.

Islamic banks usually offer credit purchase deals to their customers. In most countries conventional banks are not allowed to use similar modes of finance, while entry to the Islamic banking market is severely restricted. Some Islamic banks in such countries have the opportunity to take advantage of such monopolistic edge by charging markups, which would be higher than market rates of interest, presumably by the expected savings in transactions costs.

We can therefore conclude that a policy that lifts entry barriers facing Islamic banks and allows conventional banks to combine commerce with banking activities contributes to social welfare.

VI. FURTHER RESEARCH

Relaxing some of the assumptions, especially competition in either the commodity or credit markets would conceivably produce different results. The dynamic comparison of both Islamic and conventional economies would also be interesting. If both started with the same resources, would they end up with the same size? The Islamic economy has a fragmented credit market, as credit must be associated with the purchase of some commodity. Conventional economies have integrated credit markets. The implications of this on efficiency and stability need to be further explored. Debt created through purchase on credit is unsalable against money, i.e., it is not marketable in the usual economic sense. However, under some institutional arrangements, it can be swapped against real assets. The effect of such swapping on debt liquidity as well as social welfare requires investigation. In addition, perhaps alternative institutional arrangement for debt swapping could be looked into. In any case, we can say that debt in an Islamic economy is of limited marketability.

A further complication relates to the pattern of behavior toward liquidity in economies with debt of limited marketability. In such economies, money defined broadly would contain a shorter list of quasi-monetary assets. In addition, credit purchase should have satisfied some "monetary needs" the resulting debt would satisfy some more, albeit within a limited scope. Analysis of the financial market in such economy would need to consider the full menu of financial assets to see to what extent people who wish to maintain a certain degree of liquidity can do so.

Finally, we have so far assumed that borrowing would be made exclusively for the purchase of commodities and real assets. It is possible though that people would borrow to finance the purchase of nominal assets. This would be mainly for speculative purposes. Here we need to know how such transactions would affect output on the one hand and whether it would have some bearing on economic stability.

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[1] The author is indebted to M. Elgari, M.N. Siddiqi, and his colleagues at the Islamic Research and Training Institute who provided helpful comments on earlier drafts. Any mistakes and shortcomings remain the sole responsibility of the author.

[2] Lending money in an Islamic economy is considered to be a philanthropic act, through which someone provides temporary liquidity to one who is temporarily short of liquidity and who presumably wishes to fulfill some basic needs. In such cases, loans are forwarded interest-free. Obviously, such activity would occur only on a limited scale and within special circles, e.g., relatives, friends, and neighbors, in whose cases creditworthiness can easily be ascertained and debt collection can be done at low costs. The author has pointed out elsewhere that interest-free lending could take place on a large scale with proper institutional arrangements (Al Jarhi, 1983). Debt resulting from CP can be exchanged for cash and monetary assets only at face value. It can be swapped against real commodities and assets. This is tantamount to saying that debt has rather limited appeal. This would represent an implicit restraint on credit finance.

[3] Transaction costs are the costs associated with transacting trades. They include: commissions, bid-ask spreads, impact costs associated with carrying out large transactions off the market, and administrative costs (which include the costs of confirming, documenting, reconciling, and clearing trades). For further information, see http://www.contingencyanalysis.com.

[4] The question arises when several transactions, each entailing a different price, are made in the same commodity. The value of transactions in such a commodity would be equal to the sum of transactions values (price times quantity) at each price. For simplicity, we can assume that either the exchange time horizon allows for only one transaction in each commodity, or the value of transactions in each commodity implies already summing over each transaction at each price.

[5] As long as demand is not perfectly inelastic, there will be more transactions in reaction to changes in prices. The size of the demand elasticity would determine the quantities purchased but would not inhibit reaction to changes in price.

[6] Suppliers can offer banks facilities to provide customers with loans to finance their purchases. However, such transactions would revert to lending then purchasing.

[7] There are other advantages of combining banking and commerce (Haubrich and Santos, 1999).

[8] Therefore, as will be seen later, we can venture to say that it would be more efficient in a conventional banking environment to allow banks to directly finance credit purchases.

[9] The commonly known justifications for that premium include time preference and alternative uses of the sold commodities and assets in the production process. The markup on the spot price of each good and service,

$u_j^y = ({}^d p_j^y - p_j^y) / p_j^y$, and each asset, $u_j^a = ({}^d p_j^a - p_j^a) / p_j^a$, is equal to the difference between the credit-purchase price and the cash price of each, divided by the latter price.

[10] It is also possible that markups on the credit sale of any particular commodity would be different for different buyers, depending on the risk element associated with each.

[11] Obviously, this would have implications regarding the constancy of velocity and the stability of the demand function for money.

[12] In a growing economy, an increase in transactions would lead to more signals to increase than to decrease output, as the decline in the demand for some commodities and assets would be more than offset by the increase in the demand for others.

[13] We can perceive of cases where some agents would borrow to buy monetary assets, i.e., exchanging monetary assets for monetary assets. We are excluding such possibilities.

[14] He would pay a markup over the spot price equal to u_i, his total cost of making the exchange, over and above the current purchase value; the total is equal to ${}^d v_i^y + u_i . p_i y_i$.

[15] His total cost, over and above the purchase value for that exchange, is equal to $(v_k + r.a_k) + v_i^y$.

[16] Comparing the interest payment on borrowing, $r.a_k$, in the case of BAP, with the markup on CP, $u_i . p_i y$, would be more complicated. The rate of interest is charged for delivering present money in return for future money. Meanwhile, markups are charged for delivering commodities and assets, also in return for future money. Both interest rates and markups would vary with loan maturities as well as with the creditworthiness of borrowers. Markups may also vary with commodities and assets.

Under competition, both elements should be equivalent. However, in general, imperfections are more prevalent in credit than in commodity markets, especially as credit markets are usually more subject to regulation. Matters are complicated by the fact that while the rate of interest reflects the rate of time preference on money, markups would reflect the rate of time preference on commodities. Their comparison would be rather difficult.

[17] This would be particularly common in countries that restrict the establishment of Islamic banks, thereby giving monopolistic advantages to existing participants in the Islamic banking market.

The Mythology of Islamic Economics and the Theology of the East Asian Economic Miracle

M.A. Muqtedar Khan*

ABSTRACT

This paper examines how the equation of Islamic economics with interest-free banking in the current discourse has not only distorted the meaning of Islamic economics but has also marginalized some of the most important and even constitutive elements of Islamic economics, such as justice and poverty elimination. The paper raises the question, "Why is Islamic economics not just economics?" After explaining why discussions of justice are marginal to the current discourse on Islamic economics, the paper identifies several questions, which expose the interests that underpin the dominant understanding of Islamic economics. It is argued that the ideas of justice in the economic arena, consultative decision-making, and sensitivity to income disparities are equally crucial for an economy to be "®*alāl*." The prohibition of interest may be a necessary condition, but it is certainly not a sufficient condition, for an economy to qualify as Islamic.

I. INTRODUCTION

This paper seeks to identify the missing dimensions of Islamic economics and the Islamic dimensions of East Asian economies. While there is much talk about Islamic economics, there is no Islamic economy, which implies that all theorization about Islamic economics is more like wishful thinking than based on practical analysis. Moreover, for reasons that have not been explored systematically but are intuitively discernable, Islamic economics has become synonymous with interest-free banking. Many other important elements of Islamic economics are completely ignored or even suppressed. Perhaps this may be a reason that Islamic economies have not really materialized. Finally, this paper intends to demonstrate how East Asian economies have institutionalized Islamic principles in contemporary economic practices and are harvesting great benefits. The blinders that prohibit most Islamic economists from looking at anything other than interest-free practices has precluded them from even recognizing the existing Islamic practices in "other economies."

II. THE MYTHOLOGY OF ISLAMIC ECONOMICS

The only aspect of the so-called "Islamic economics" that has enjoyed limited application, is "interest-free banking." The limited amount of empirical work one encounters in Islamic economics is confined to discussing and fine tuning the problems and extant solutions (*like murāba®a*) of commercial lending without the institution becoming a full partner or a pure lender. The former would discourage deposits and the latter is forbidden. For some mysterious reason, Islamic economists have chosen to make absence of interest as the defining characteristic of an Islamic economy. While usury/*ribā* is indeed forbidden, the widespread assumption that the absence of *ribā*/interest is necessary in an economy for it to qualify as Islamic is puzzling.

In spite of the growing agreement that interest is *ribā*, I believe that there is more to *ribā* than interest. When we describe *ribā* as interest we do injustice to it *by limiting it.* In a way, all kinds of "excesses" constitute *ribā*/*isrāf.* Even if we accept that *ribā* and interest are similar, why should it be necessarily absent from an economy. *Ribā* is forbidden for Muslims, not for non-Muslims, and non-Muslims are not banished from Islamic economies, are they? Even in the Prophet's Medina, *ribā* was in vogue. Muslims were forbidden from taking or giving *ribā*, but non-Muslims, who under the Medinan covenant were allowed to practice their own *sharī*ᶜ*a* (®*alaqa*), freely gave and took *ribā*. These same usurers also bought and sold goods in the same market places as the *Æa®āba*. The Medinan economy was therefore not an Islamic economy if the absence of interest/usury/*ribā* is made a litmus test for defining an economy as Islamic.

The answer to the puzzle, why Islamic economics is reduced to Islamic banking can be gleaned from two contemporary conditions. First that absence of an Islamic political economy and second the lack of autonomous markets/economies. The first is easy to understand. In many parts of the Muslim world the existing political

* Assistant Professor of International Politics, Adrian College, Adrian, Mich.

structures are not specifically geared toward realizing an Islamic society. Many of the legal codes have been borrowed/imported wholesale from colonial regimes. Not only are the polities based on non-Islamic jurisprudence, but also the program of liberalization of Muslim economies, often dictated by the IMF and World Bank or conditional foreign aid, is based on assumptions far from Islamic in their origins. Foreign norms and new economic policies serving the interests of globalization rather than Islamization undermine the prospects of Islamic political economies taking root in the Muslim world.

The global economy has increasingly become interdependent. The complex network of exchanges of raw material, intermediate goods, finished products, capital, labor and technology, in addition to the multi-layered ownership of the modes of production across borders generating multiple forms of traffic in goods—inter-industry, intra-industry, inter-firm and intra-firm, has made it impossible for any society to carve out an autonomous economic arena where "local norms" can be implemented or enforced. Moreover, the global norms that shape the character of the global economy are dictated by the most powerful players in the system—U.S., Japan and EU. Even though Muslim societies are not as deeply embedded in the interdependent dimension of the global economy (except for the biggest oil exporters), they remain highly dependent on the global economy. Interdependence undermines autonomy and limits the scope for Islamization of economies.

This double jeopardy precludes the development of an Islamic political economy and reduces the role of Islamic principles in the economic arena. While global governance and interdependence prevent the Islamization of economies, they have little bearing on the discussion of economics generated by Muslims. Thus, one sees the rapid Islamization of economics without any concomitant effect in the practical arena. The growth of oil-generated surpluses in some Muslim countries has allowed some degrees of freedom in the banking industry and thus the advances in Islamic economics have translated into limited Islamic banking practices.

While it is easy to understand the conditions that limit the realization of an Islamic economy, namely the absence of an Islamic political economy and the lack of autonomy, the limits on the discussion are difficult to comprehend. Why has *ribā* alone taken center stage? Why are other aspects of Islamic economy, such as *ᶜadl* (justice), *zakāt* (distributive justice), *isrāf* (prohibition of extravagance), *falā*® (welfare), ignored or marginalized? Why have not issues such as equality of opportunity, public welfare, frugality, charity, just wages, compulsory education, transparency in fiscal policies, *i*®*tisāb* commissions on *isrāf,* discrimination in the work place, poverty alleviation, redistribution of wealth, attracted the attention of scholars seeking to Islamize economics? There is no evidence either in the Qur'an or the Prophet's (peace be upon him) traditions that suggest a hierarchy of Islamic economic values. There is no evidence that *ribā* is worse than *isrāf* or that instituting *ᶜadl* is less important that prohibiting *ribā*? We do know that the Qur'an places social justice as the second most important value after individual virtue (5:8). So why are we ignoring the issue of justice? Why is Islamic economics not synonymous with "just economics" and not just interest-free banking?

While we are in this critical mood, let us explore some more fundamental aspects of Islamic economics. Can we have an Islamic economy without first realizing an Islamic polity? Is Islamic economy autonomous of Islamic governance? Can we have Islamic economic practices while the rest of the society is living according to the Swiss or the French legal codes? What is an Islamic economy? Is it a set of norms or the practices of Muslims? Is it necessary that those who claim to practice Islamic economics should necessarily be Muslims? What it the purpose of Islamic economic principles? Are they given by God as a test of the believer's commitment to Islam, meaning that they add to the cost of economic transaction and undermine the efficiency of the economy? Or are they principles that enhance the capacity of the economy to fulfill the aspirations of the people and actually contribute to development?

The subsequent section shall seek to demonstrate that many of the Islamic economic principles so blatantly ignored in the Muslim world are widely practiced by and have given benefit to other societies. In particular, by the East Asian economies, whose performance in the last three decades has earned extensive admiration and has been labeled as "the East Asian Miracle."

III. THE THEOLOGY OF EAST ASIAN ECONOMIES

This section will explore some of the more widely circulated explanations for the East Asian economic miracle. In doing so, it will identify three important ingredients of the miracle—high savings, consultative decision-making and more even distribution of wealth—which are the elements one should find in the hypothesized Islamic economy. While Muslim economists marginalize these Islamic criteria, non-Muslims assiduously adhere to them and benefit from their virtues.

The phenomenal development and growth sustained by East Asian economies for over three decades has attracted the attention of scholars from developed and developing nations alike. Developing countries have sought

to emulate these countries in order to achieve their growth patterns, while Western nations study these economies with fear and uncertainty as it is becoming increasingly clear that East Asia will eclipse the West in the economic arena. Already Japan, the world's second largest economy, has exceeded all Western countries, in particular the U.S., when it comes to indicators of wealth and prosperity such as balance of trade, per capita income, life expectancy, and current reserves.

TABLE 1. VITAL STATISTICS FOR LEADING ECONOMIES

Country	GNP ($ billion)	Rank	GNP/head ($)	Life Expectancy (Male/Female)	Current Account Balance ($ billion)	Foreign Exchange Reserves ($ billion)
Japan	4,772	2	37,850	77/83	65.884	227.018
USA	7,690	1	28,740	74/80	–148.726	134.880
Germany	2,320	3	28,260	73/80	–13.072	105.208
France	1,526	4	26,050	74/82	20.561	54.651
UK	1,220	5	20,710	74/80	–2.889	37.636

Source: World Bank Report on World Development, 1998/1999

Western scholars, particularly after the end of the Cold War with Western priorities shifting from security concerns to economic concerns, have pondered the miraculous development of East Asia and its implications for global economy and the balance of economic power. Many explanations have been advanced. Some superficial and some profound. Regardless of the character or the nature of the narrative, all agree that the outstanding feature has been the *sustained nature* of East Asian growth. It is not the wealth of these societies that is the issue here, it is their ability to identify and institutionalize policies that consistently bring extraordinarily high growth rates, sometimes even in double digits, that is remarkable.[1]

For analytical purposes the East Asian region is usually divided into five sub-regions. The first area is Japan, which is distinct from the rest of the region. The second sub-region consists of South Korea, Taiwan, Hong Kong and Singapore, the Asian Tigers and the NIEs (Newly Industrialized Economies). The third region includes Malaysia, Indonesia, and Thailand. The fourth region is China, and the fifth includes North Korea and Philippines.

Japan remains Asia's only nation to have industrialized in the nineteenth century and it actually lagged only four decades behind the English industrial revolution. Japan has grown in a fashion similar to the West. It too shifted from agriculture to industry in the late nineteenth century, went on an imperial binge, and colonized China and Korea and much of the region. It was a principal player in the Second World War and in spite of the devastation in that war, grew courtesy of the Korean War. China is a world by itself. It has joined the Asian economic march late but is rapidly growing economically. North Korea and Philippines are remarkable only for their failure to benefit from the overall growth in the region. Malaysia, Indonesia, and Thailand have enjoyed high growths like the NIEs but unlike the NIEs, much of it comes from an initial reliance on natural resources. No doubt they are growing rapidly, but they are not as advanced or as prosperous as the NIEs. Our focus in this essay is on the NIEs, which includes South Korea, Taiwan, Hong Kong, and Singapore.

TABLE 2. GROWTH RATES IN EAST ASIA

Country	Growth Rate, 1955–1970	Growth Rate, 1965–1980	Growth Rate, 1980–1993	Current GNP/head ($)
South Korea	6.7%	9.9%	9.7%	10,550
Hong Kong	9.6%	8.6%	7.1%	25,280
Singapore	—	10.0%	6.4%	32,940
Taiwan	8.7%	8.9%	8.8%	12,400
Malaysia	5.3%	7.4%	5.2%	4,680
Indonesia	3.6%	7.0%	5.5%	1,110
Thailand	6.9%	7.3%	7.6%	2,800
China	—	6.8%	9.5%	860

Source: World Bank Report on World Development, various years.

There are many theories that seek to explain the performance of East Asia's NIEs. The simplest explanation and the one preferred by East Asians is the political culture argument. This argument suggests that there is something inherent to Confucian values, such as respect for order and harmony, that has facilitated this Asian miracle—development and prosperity without the negative aspects of modernity, declining moral values, disintegration of the family structure and growth of crime and drugs, which have plagued Western societies. Indeed, the amazing growth of societies with little or no natural resources, Hong Kong, Singapore, South Korea and Taiwan, is largely due to the diligence, ingenuity and handwork of their human resources, who have one thing in common—the Confucian way.[2] Other societies in the region like Indonesia and Malaysia where Islam dominates, natural resources have played as much a role in development as have human resources. For example oil for Indonesia and tin and rubber for Malaysia. But even in these places, it is the Chinese who have dominated industrialization and most of the investments and technology has come from Chinese conglomerates.

However, there are many flaws in this theory. If Confucian values are singularly responsible for the East Asian growth, then why did not these values provide growth earlier and only after the 1960s? More importantly, why have not these values vitalized other societies that adhere to the same principles? One may argue that once development took place, Asian values protected these newly modernized societies from plunging into moral decline like some Western societies. But that idea remains a thesis that has not been subject to serious exploration. Nonetheless, the theory of Asian/Confucian values provides Asian leaders with great fodder for their after-dinner speeches in foreign capitals but nothing more.

The political economic explanation of the region's growth may offer more important clues for understanding it. According to this perspective, the two most important elements of the growth has been the role of a benign and authoritarian state that has single-mindedly pursued economic growth, and the role of the U.S., which has provided security guarantees, foreign and development aid, open and unfettered access to American markets without any reciprocal gesture and the continued flow of technology from both Japan and the U.S.[3] The U.S. has invested over $20 billion dollars in foreign aid into the region, subsidized defense and provided necessary infra structural support for establishing capitalist economies East Asia. Currently the East Asian tigers run positive balance of trade of about $55 billion per year with the U.S.[4] The prosperity of Japan has also assisted the region, as it has increasingly become a "Japanese zone of co-prosperity." Fear of NAFTA and the EU has also driven Japan toward providing more financial support, through FDI (Foreign Direct Investments), ODA (Official Development Aid), Consumer lending and lending through multilateral institutions like Asian Development Bank whose primary

sponsors are Japan and the U.S. Japan is also opening up its markets for East Asian products by exporting them intermediate goods and important finished goods. But Japan runs a positive trade balance with East Asia and the American market makes up the deficit.[5] Thus in many ways the East Asian miracle is dependent on American and Japanese markets, investments and technology transfers, besides American security guarantees and open-market policy even in the face of heavy trade barriers to American goods in the same countries.

The International Political Economy (IPE approach) of Strange et. al does shed light on my many aspects of the development phenomenon, technology, resources markets, but there are some elements of the process, such as savings rate and frugality, consultative decision-making and equitable distribution of wealth, which cannot be explained through IPE models. These are the elements that are not only crucial for understanding East Asian growth but are also, in my opinion, elements of an Islamic economy. Perhaps these are qualities that the Asian people hold in common due to their common Confucian heritage. But they are found not only in the Chinese dominated East Asian countries but also in Japan, and in Malaysia and Indonesia, which are predominantly Muslim societies. It is widely accepted that these three elements have played a key function in the East Asian miracle. It is submitted that these same elements constitute the key elements of an Islamic economy.

IV. ISLAMIC ECONOMIC PRINCIPLES

A. Avoiding *Isrāf*

In verses 17:27 and 7:31, The Qur'an condemns *isrāf* or wasteful expenditure. Some Islamic economists too recognize the prohibition of *isrāf* or the sanction against wasteful expenditure/consumerism as an important principle of Islamic economics.[6] Elsewhere I too have recognized it as a founding principle of Islamic political economy.[7] While richer Muslim societies in the past and the present are outstanding for their grandiose consumption patterns, East Asian economies on the other hand are remarkable for the high savings rates of 30-40% of GDP that they have maintained for nearly four decades.[8] These savings rate play a major role in the miracle of East Asia.

High savings have enabled these societies to finance their own growth, expansion, and development and avoid the foreign aid trap that has been the bane of many underdeveloped countries. Many countries in the hope of sparking growth have borrowed heavily from foreign countries and multilateral institutions. The debt burden and sometimes just the cost of servicing these debts have crippled many economies. But East Asians, thanks to their high savings, sometimes even forced as in Singapore, have managed to finance much of their capital need. Indeed the enormous capital accumulation that has resulted from these savings has made East Asian economies capable of making FDI in the U.S. and China. East Asia has shown that avoiding *isrāf,* something that Islamic economists have only talked about as a minor addendum to interest-free banking, can play a significant role in economic growth and autonomous development.

B. Consultative Governance

An important principle of Islamic social organization is the principle of *shūra* or consultative decision-making. The Qur'an advises Muslims to conduct their affairs through a process of mutual consultation (3:159). The Qur'an also considers them as blessed those who conduct their affairs through mutual consultation (42:38). The contemporary discussions among Islamists, Western scholars of Islam, and many Muslim intellectuals about the form democracy would take within an Islamic ethos, centers around the concept of *shūra.*[9] While there is little clarity on how an Islamic democracy or "shurocracy" would look like, there is widespread agreement that *shūra* or consultation is not just desirable but a necessary ingredient of Islamic governance. Given the centrality of consultation to management of Islamic affairs, it is remarkable how little attention Islamic economics/economists pay to *shūra* and its role in Islamic economics.

East Asia now manifests some transition to democracy in Taiwan and South Korean. During the miracle years they were either single party authoritarian regimes or military dictatorships. But nevertheless these places demonstrated a remarkable degree of state-society interface and many of the policies advocated by the government were those desired by the economic sector. The social policies too reflected the popular will and therefore these states had little problem in implementing effective policies over decades. The confidence that they were able to generate in the society was because they were able to understand and pursue the goals of the society at large and therefore the policy outcomes were more consultative than authoritative. In an interesting fashion these East Asian states were ruling with both consent and through cooperation of the ruled without actually creating any Western style democratic institutions.[10]

The governments created consultative bodies, called advisory committees, which were composed of leaders from the society and from the state (bureaucrats and politicians). The governments also facilitated the development

of associations and chambers of commerce, which became their partners in collecting industry information, and devising development strategies that would optimize the joint resources of the public as well as the private sector. These consultative bodies (which, ironically, is exactly what they are called) created multiple levels of interface between the rulers and the ruled, in many ways "tying the hands of the rulers." The governments always sought to build consensus in order to facilitate a harmonious society.[11] These interfaces helped legitimize the rulers as well as enabled the ruled to systematically give their input to policy making. Trust and cooperation emerged and state and society became partners in the pursuit of economic development and social welfare.[12] Henry Rowen in his "Overview" uses a headline to describe this phenomenon in Qur'anic terms.[13] He calls it: "Understanding good and avoiding or abandoning bad policies" resonating the Qur'anic injunction: "Enjoin what is good and forbid what is wrong." (31:17)

Consultative governance, or *shūra*, has clearly played a significant role in the miraculous development of East Asian economies. What is striking about this is that East Asian societies have discovered the merits of Islamic decision-making, through possibly a trial and error method, or from within the Confucian tradition, and have demonstrated its merit.

C. Distributive Justice

While there are only seven verses in The Qur'an that prohibit interest (2:275, 2:276, 2:278, 2:279, 3:130, 4:161, 30:39), there are 60 verses that stipulate, mandate, encourage charity, discuss its virtues and rewards, warn of punishment to those who eschew charity and also warn against hoarding (9:34, 2:261, 2:265, 2:276, 2:280, 30:39, 34:39, 35:29, 57:11, 57:18, 64:17, 2:271, 2:245, 5:12, 57:11, 57:18, 64:17, 73:20, 2:273, 2:83, 19:31, 19:55, 9:91, 17:29, 2:3, 2:43, 2:110, 2:177, 2:195, 2:254, 2:267, 2:227, 5:55, 9:71, 13:22, 14:31, 21:73, 22:41, 22:78, 24:37, 24:55, 24:56, 27:3, 30:38, 31:4, 33:33, 47:38, 57:7, 57:10, 58:12, 58:13, 63:10, 64:16, 2: 264, 2:266, 16:75, 4:38, 2:3, 3:180, 2:215). It is astounding how Islamic economists have overlooked the significance of charity, welfare, redistribution of wealth and prevention of income inequalities and wealth disparities. If anything, the sheer weight of Allah's interest in charity and distributive justice should have made Islamic economics synonymous with "charitable/welfare/distributively-just economics" rather than interest-free banking. Islamic economists have made charity a personal issue, a desirable element of piety but not a necessary element of economy. They study *zakāt* under taxation and not as an organizing principle of society. Of course there are exceptions like Umer Chapra and M.A. Mannan. Chapra actually states the importance of distributive justice eloquently.[14] He argues:

> "Hence Islam not only requires the fulfillment of everyone's needs, primarily through a respectable source of earning, but also emphasizes an equitable distribution of income and wealth so that, in the words of the Qur'an 'wealth does not circulate only among your rich' (59:7)."[15]

Fortunately for East Asia, their economists, unlike contemporary Islamic economists, did not give the short end of the stick to issues of income and wealth equality. Distributive justice has remained an integral aspect of the region's development. From the earliest phase of its development, East Asia has opted for "growth with equality" or "shared growth." Nearly the entire population of each of these countries has benefited from the regional growth. Indeed Indonesia's struggle against poverty, 60% of the population below poverty levels in 1970 to only 14% in 1993 is symptomatic of the region's success in not only eliminating poverty but also providing a higher lifestyle for a majority of its population. From 1965 till now all the countries that have combined high growth with high-income equality are in East Asia. Distributive justice, while being a worthwhile goal in itself also has many social and political benefits. It leads to widespread literacy, human development and reduces tensions between different groups and reduces the possibilities of political unrest and crime. The prosperity and relative internal peace enjoyed by East Asia is a handsome testimony to the virtues of distributive justice.

V. CONCLUSION

The purpose of this essay is to offer a critique of the discourse on Islamic economics with the twin purposes of showing how its obsession with interest is marginalizing other important elements of Islamic economics such as justice, distributive justice and consultative decision-making, and how other economies are thriving by paying attention to these very principles. We hope that in the future Islamic economics will pay greater attention to issues of poverty alleviation, justice, redistribution of wealth and resources, and Islamic forms of governance. More importantly, it is hoped that Islamic economists will stop attempting to produce a hypothetical system in theory that will meet their "Islamic criteria," but rather work toward the economic development and betterment of Muslim societies in real life.

[1] Pei, Minxin. "Constructing the Political Foundations of an Economic Miracle" in Rowen, H.S. (ed.). Behind East Asian Growth: The Political and Social Foundations of Prosperity. London: Routledge, 1998. pp. 39-60.

[2] Jones, David Martin. Political Development in Pacific Asia. London: Polity Press, 1977. pp. 5-57.

[3] Refer to the essays in Ross, Robert S. (ed.). East Asia in Transition: Toward a New Regional Order. Boston: M.E. Sharpe, 1995.

[4] See Mochizuki, Mike M. "Japan as an Asia-Pacific Power"; and Zagoria, Donald S. "The United States and the Asia-Pacific Region in the Post-Cold War Era" in Ross (ed.), *supra*.

[5] See the essays by Raphael, James H. and Thomas P. Rohlen. "How Many Models of Japanese Growth Do We Want or Need?"; and Kosai, Yutaka and Fumihide Takeuchi. "Japan's Influence on the East Asian Economies" in Rowen (ed.), *supra*.

[6] Siddiqi, M. Nejatullah. "Muslim Economic Thinking: A Survey of Contemporary Literature" in Ahmad, Khurshid (ed.). Studies in Islamic Economics. Leicester: Islamic Foundation, 1980. p. 196.

[7] Khan, M.A. Muqtedar. "The Philosophical Foundations of Islamic Political Economy." American Journal of Islamic Social Sciences 13(3) (Fall 1999). pp. 389-400.

[8] Rowen, Henry S. "The Political and Social Foundations of the Rise of East Asia: An Overview" in Rowen (ed.), *supra*.

[9] Esposito, John and John Voll. Islam and Democracy. Oxford: Oxford University Press, 1996. p. 27.

[10] Root, Henry L. "Distinctive Institutions in the Rise of Industrial Asia" in Rowen (ed.), *supra*. Pei, Minxin. "Constructing the Political Foundations of an Economic Miracle" in Rowen (ed.), *supra*.

[11] Jones, *supra*. pp. 55-57.

[12] Root, *supra*.

[13] Rowen. "An Overview." *supra*. p. 18.

[14] Chapra, M. Umer. Islam and the Economic Challenge. London and Virginia: Islamic Foundation and the International Institute of Islamic Thought, 1995. Mannan, M.A. Economic Development and Social Peace in Islam. London: TaHa Publishers, 1989.

[15] Chapra, *supra*. p. 212.

PART II

THE *SHARĪʿA*

Introduction

Gohar Bilal*

As a practitioner, *sharīʿa* scholars have taught me much of what I know of the field of Islamic finance. On the other hand, experience has taught me that without a firm understanding of some of the advanced topics (in addition to the fundamentals) it is very difficult to comprehend what the *sharīʿa* is actually trying to preserve. By comprehending some of the more profound legal issues, we can do justice in innovating Islamic financial products and give the area the attention that it deserves. For most practitioners, Islamic finance and the *sharīʿa* are all about questioning the legitimacy and permissibility of every single financial concept. Yet, be it from interest and speculation to savings and investments, the quest for answers continues to guide us toward something much more profound, yet still very simple. For the whole nucleus of Islamic finance (and for that matter, of any subject viewed under an Islamic microscope) is based upon *taw®īd*. As a professor of mine once said, "Under Islamic law, everything is inner directed." All actions must converge into unity, truth, honesty, ethics, and justice; it then radiates into our personal, social, and economic lives to create a harmonious balance. This concept is an essential foundation for structuring any issue, particularly financial. The result is a balanced system based on ethics and fairness, which conforms to the faith of those seeking financial products devoid of the forbidden *ribā*, as well as to those looking for alternatives to conventional finance. The pursuit of such an ideal system has only just begun.

For *sharīʿa* scholars and designers of Islamic financial products alike, keeping abreast of the continuing developments in today's financial markets is a formidable task. To bring Islamic finance on par with conventional finance, a clear regulatory framework must be in place. This framework is needed not only to develop the more traditional financial products, but also to establish guidelines for more complex products and techniques such as derivatives, bonds, management buyouts (MBOs), asset-backed securities (ABS), and electronic banking.

The *sharīʿa* scholars of the present have enormous responsibilities, but present challenges can only be addressed with the cooperation of academics and practitioners. Moreover, *ijti®ād*, or reasoning and discussion, is essential between *sharīʿa* scholars and financial professionals. The topics addressed in the *sharīʿa* section of the Proceedings of the Fourth Harvard University Forum on Islamic Finance illustrate such attempts. They also highlight some of the more popular areas and developments within the present financial environment.

The Internet has surely been among the most significant inventions of the twentieth century. Much of the information in the world can now be accessed at the touch of a few buttons from millions of networked computers located worldwide. Simple and complicated financial matters are both managed through use of our interconnected machines. Islamic banks, like most conventional banks, have begun offering electronic banking services to their clients. Yet, this realm of new services comes with the difficulty of assessing the permissibility of transactions conducted through such media. What limits does the *sharīʿa* ordain for online transactions? Are they the same as for non-electronic transactions, rules, and criteria? If so, do transactions conducted via the Internet comply with the same rules?

Islamic e-banking, as reviewed by Mohd. Daud Bakar and Zainudin Jaffar, highlights the key areas that would come under *sharīʿa* rules. The *sharīʿa*, it is argued, is "technology neutral." It still must, however, address the detailed issues in Islamic e-banking transactions in order to safeguard security and maintain a balance in the benefits derived by consumers and financial institutions. If e-banking is faceless and relatively quick, can traditional *fiqh* rulings be applied as if the online transaction were a paper-based one? Bakar and Jaffar's paper touches on relevant areas in the *sharīʿa* that affect online transactions. Contracts, offers and acceptances, the purchase of real estate via electronic contracts, defects in the good, the right to revoke the contract, and confidentiality are among the burning issues he examines.

With the boom in the technology sector (until last year), stock market investments have been the most popular area of finance. The focus of Islamic investors on the stock market is no exception. The *sharīʿa* guidelines for this area are fairly comprehensive, and papers by Messrs. Chappuis, DeLorenzo, Elgari, Hamid, Knight, Thompson, and Yaquby all address the various aspects of equity investments.

Laurent Chappuis shares the experiences he has had withthe roles played by *sharīʿa* boards for Islamic equity funds. His analysis is based on a comparison of the FTSE and Dow Jones Islamic indexes. He argues that the performance of these funds is directly affected by decisions of the *sharīʿa* boards. Despite the important role

* Consultant, United Bank of Kuwait, London, United Kingdom.

these boards play, decisions are not always uniform. He points out that *sharīʿa* boards differ on the types of screens applied to potential as well as existing investments. Moreover, they also disagree on the definitions and levels of the financial ratios falling into the same category (aside from one concerning the leverage of a company). In turn, these differences affect the performance and risk levels of the equity funds.

His observations demonstrate that these indexes create regional and sector allocation differences. Comparing the performance of Islamic indexes to conventional ones, he concludes that with regard to regional allocation, Islamic investors presently have higher exposure to the United States than traditional investors do. Second, with regard to sector allocation, Islamic investors have greater exposure to the technology and pharmaceutical industries.

Yusuf Talal DeLorenzo addresses changing perspectives in *sharīʿa* supervision: that is, the dynamics of the relationship between financial institutions and *sharīʿa* supervisory boards. With the increasing power of technology and the range of Islamic financial products, the palette of options and services available to us will correspondingly broaden. At the same time, direct supervision and compliance with the *sharīʿa* will become more complex. As Bakar and Jaffar noted, in pointing out problems associated with transactions conducted over the Internet (i.e., e-banking), *sharīʿa* supervisory boards have become burdened with the responsibility of constantly learning about and assessing new areas. DeLorenzo, a *sharīʿa* scholar himself, therefore observes that the greatest challenge for *sharīʿa* supervision is for the scholars to keep abreast of technological change.

Despite such problems, the Internet has facilitated the role of supervision. Here, *sharīʿa* boards act as "consumer advocates," ensuring that financial products are permissible in Islam, and as "consumer educators," increasing awareness of available Islamic financial alternatives. Technology therefore is a tool for *sharīʿa* boards to promote the lofty ideals of "competition, transparency, and accountability, benefiting consumers and businesses alike." DeLorenzo tells us that supervision also has other benefits. It indirectly promotes "socially responsible" investing and provides prestige and legitimacy to financial firms, while simultaneously fulfilling Islamic religious obligations. In sum, a close relationship between financial professionals and *sharīʿa* scholars will continue to be essential for the progress and development of Islamic finance.

Mohamed Ali Elgari's "Purification of Islamic Equity Funds" first delineates the historical development of the concept of purification. In the early 1980s, this concept enabled scholars to bypass many of the problemsthen faced by Islamic financial institutions. However, it is not easy to apply, as different *sharīʿa* scholars have different opinions. Differences exist as to whether capital gains, dividends, assets, or liabilities should be purified. Moreover, scholars disagree over whether interest earned on government bonds and the like should be treated as income or revenue; the precise placement of fixed-income securities on the balance sheet affects the ultimate total that needs to be purified. Elgari presents the three most common methods used to calculate this amount.

In his paper on corporate debt in Islam, Shaikh Abdul Hamid discusses the benefits and harmful effects of conventional debt. He points out that the use of debt is widespread, particularly by companies that require extensive amounts of capital. Meanwhile, Islam prohibits the use of interest-bearing debt. Companies needing capital are therefore in a difficult position. In addition, investors often find companies that use debt to offer very attractive risk-return profiles. In order to break free of this dilemma, some Islamic jurists have allowed Muslims to invest in companies with a certain percentage of debt. Hamid explores the burdens as well as benefits of debt, ultimately showing that the harmful effects outweigh the benefits gained.

Upon a detailed analysis of company performances, Hamid concludes that companies with higher debt have experienced higher ROE (return on equity) and higher five-year compound average revenue growth rates. Muslim investors who avoid investing in companies with debt would have to invest in companies with lower financial risk, lower total risk, and thus lower returns. However, high-debt companies are also exposed to greater risk, such as that of bankruptcy. A firm with high debt may have cash flow problems and find it difficult to make interest payments, and may be forced into bankruptcy. This leads to business failures, and creates a moral hazard of uneven risk allocation. On the other hand, if a company is equity financed and net income becomes negative, it can forgo dividend payments to shareholders.

The paper on "Structuring Islamic Investment Funds" by W. Donald Knight Jr. and Henry Thompson discusses the important tax, legal and regulatory aspects of funds in the U.S. The paper reviews structural issues of Islamic investment and leasing funds. Numerous legal and tax-related questions arise when one structures Islamic investment funds that will ultimately be invested in the United States. Answers must satisfy not only U.S. legal and tax considerations, but also the principles of the *sharīʿa*.

Knight and Thompson analyze issues relating to U.S. income taxation and techniques of avoiding estate and gift taxes. A fund's legal structure depends on whether it is closed or open-ended, which therefore determines the U.S. and foreign securities that apply. In order to avoid such taxes, they examine different offshore jurisdictions and the rights and liabilities involved. The paper also examines management issues, responsibilities of the funds,

and issues pertaining to the marketing of the fund's shares. Finally, the paper discusses government approvals that a fund's sponsor state may require in order to conduct the structural transaction.

The paper on "Trading on Islamic Equities: A *Sharī'a* Perspective" by Nizam Yaquby reviews the Arabic literature on participation and equity trading. He examines issues dealing with the permissibility of transacting in shares of companies whose primary business is lawful but who occasionally enter into conventional transactions. The paper also highlights the pros and cons of different types of allowable investments.

Yaquby discusses arguments presented by other *sharī'a* scholars about the meaning of several legal maxims. He further analyzes the idea that the general need may take the rule of "specific" necessity, and the issue of combining a negligible amount of an unlawful element with a majority of a lawful element. These maxims lead scholars to designate categories of companies in which investment is permissible. For example: firms whose activities are totally prohibited; companies whose debt and cash form 50% of existing assets; companies with a debt to equity ratio of over 30:70%; companies whose interest income or unlawful gains exceed 5-15%. Yaquby cites two divergent schools of thought on this last issue. One group asserts that transacting in the shares of companies whose earnings come in part from interest-yielding bank accounts and interest-bearing loans is lawful if certain conditions are met, while the other group does not make such exceptions. Yaquby himself sides with the former, adding that many who originally opposed this view have since reversed their opinions.

The paper on "Regulation of Risk in Islamic Law, the Common Law, and Federal Regulatory Law" by Mohammad Fadel compares the rules on speculative contracts within three legal systems. Fadel first briefly analyzes the salient features of Islamic law, the common law, and federal regulatory law withrespectto the decision-making structures of each system. This comparison provides a framework for the focus of his paper: the legal status of speculation and speculative contracts within these three legal systems.

Under common law, speculative contracts are also looked upon suspiciously and condemned. Fadel examines both insurance contracts and futures contracts, pointing out that although they were deemed speculative, certain exceptions enabled them to be enforceable. Fadel also examines the federal perspective through the Commodity Exchange Act (CEA) and the Federal Regulation of Speculative Contracts. These permit speculative contracts within certain regulated conditions.

Therefore, in the event of a dispute, the court applying Islamic law will "simply not intervene to enforce a contract where the court cannot be *certain* that the speculative element is either *immaterial*, or *unavoidable*." Under the common law system, the courts similarly use a case-by-case method of decision-making. However, they are a more lenient in their acceptance by distinguishing contracts that are welfare-enhancing and those that are simply tools for gambling, which are forbidden. Under federal law and the CEA, courts make a difference between "valuable" speculation and "mere" speculation. Thus, certain speculative contracts are not gambling, but rather further a legitimate business purpose. Fadel's analysis suggests that Islamic law should re-examine the criteria and distinctions made by the other systems. Such analysis may lead Islamic law to be more efficient in its application of speculative elements in contracts.

As a practitioner, I have purposely refrained from presenting my own views about these papers contributed by eminent *sharī'a* scholars, experienced professionals, and intelligent academics. The success of this field can nevertheless be gauged by the depth of the analysis and the interest undertaken by such individuals. Their combined intellectual strengths bolster the goals and ideals we practitioners and Muslims ultimately seek.

Sharīʿa and Legal Issues of Online Islamic Banking and Finance

Mohd. Daud Bakar* **and Zainudin Jaffar†**

ABSTRACT

Although its recent development is welcome, online Islamic banking poses many unprecedented *sharīʿa* and legal dilemmas, warranting creative solutions. This paper highlights some of the relevant issues associated with e-banking and online banking practices, including principles of contract law and rights and liabilities. Issues include, *inter alia*, session of contract, various contract options, misrepresentation, fraud, and undue influence. Equal attention is given to modern methods of online payment, which can be problematic when purchasing equities, bonds, and certificates. Questions related to which law governs cross-border online Islamic banking transactions is also raised. Furthermore, actual and potential problems facing Islamic financial institutions are addressed. Though the focus is primarily on Islamic banking and Islamic capital market products and instruments, the paper does touch on the related topics of online *zakāt*, *waqf*, and *Æadaqa*.

I. INTRODUCTION

Online banking is an integral element of electronic commerce (e-commerce). E-commerce is the umbrella term describing automated business-related transactions through largely paperless mechanisms and represents a broad range of technologies, processes, and practices. It typically involves information communicated via electronic mail. Conceptually, electronic transactions are similar to traditional paper-based commercial transactions. Under both approaches, vendors present their products, prices, and terms to prospective buyers. Buyers consider their options, negotiate prices and terms (where feasible), place orders, and make payment. Vendors deliver the purchased products. These processes apply to traditional as well as electronic commerce alike. E-commerce however poses new and interesting differences not only from modern legal perspectives but also from *sharīʿa* perspectives.

Islamic banking activities are rooted primarily on trade, leases, and investments. Unlike conventional banking, they share a lot in common with e-commerce as they involve actual and bona-fide transactions. Conventional banking on the other hand is simply a lending-based activity and thus, issues of sale, leases, and other related actions are not pertinent. This key difference renders the present discussion more relevant simply because online Islamic banking, to a large extent, provides sale and lease transactions via electronic mail. Online Islamic banking is not about advancing a loan to a customer via electronic mail. Instead, it involves a number of processes, the ultimate result being either a transfer of ownership or an usufruct, as the case may be. All of these actions are done via electronic mail.

In order to assist online Islamic banking providers and operators[1] in managing their transactions to comply with *sharīʿa* principles, this paper aims to address a number of relevant topics, such as the formulation of Web contracts, incorporation of certain terms, conditions and warranties, exclusion clauses, misrepresentation, and methods of payment. Discussion of these terms might even influence *sharīʿa* perspectives on how contracts are concluded via the Web or the Internet.

II. *SHARĪʿA* FRAMEWORK FOR WEB CONTRACTS

The *sharīʿa* would most probably perceive contracts concluded via the Web just as another method of parties' expressions of consent, i.e., offer and acceptance.[2] This is simply because the *sharīʿa* does not require or insist on any specific technique to reflect an offer and an acceptance. A contract is *prima facie* concluded once the elements of offer and acceptance have been satisfied, irrespective of whether this is affected through oral pronouncement, or in writing, or in such other forms as telephone, fax, or telex,[3] or even conduct and body language of the contracting parties; these are better known as circumstantial evidence (*dilālat al-dhurūf*).[4]

* Associate Professor of Islamic Law, International Islamic University, Kuala Lumpur, Malaysia.
† President and CEO, Darul Ehsan Islamic College, Kuala Lumpur, Malaysia.

As a basic rule, the *sharī*ʿ*a* provides that a transaction is not invalid merely because it took place wholly or partly by means of electronic communication. Unless otherwise agreed, a contract can be formed electronically between the parties. In other words, one can conclude that the *sharī*ʿ*a* is technologically neutral; it does not discriminate between different types of technologies. In this sense, paper-based commerce and electronic commerce are to be treated equally by law. Hence, a Web contract is *prima facie* valid. Transactions involving the sale of goods and services via this method will result in the physical delivery of goods and services to the customer.[5]

III. Formalities of a Contract in Islamic Law and the Position of the Web Contract

A valid contract in Islamic law essentially requires that six elements must be satisfied. These elements are as follows: 1. an offer; 2. an acceptance; 3. that is to be accepted in unequivocal terms; 4. subject matter; 5. the consideration, which is very often the price of the product or services purchased; and 6. the offeror and offeree who enter into the contract must have legal capacity. The question remains: do these elements vary in electronic commerce?

A. Offer for an Online Contract

As for the offer, *Mejelle* for example, has defined it as "the statement made in the first place with a view to making a disposition of property and such disposition is proved thereby."[6] What constitutes an offer is a question of fact. It is relevant to note that an e-merchant, that is, Islamic financial institution, must be certain of what constitutes an offer. Failure to appreciate this principle could render the e-merchant making an offer without actually knowing it, or making an offer to the world when they were only prepared to sell a particular product to a limited class of persons. One suggested solution would be to announce clearly on the Web site that all advertisements and similar activities by the institution pertaining to its products are an "invitation to treat" just as in the common law principle.[7]

As far as Islamic law is concerned, the legal perspectives vary. While some scholars have required that an offer must refer to a definite party, some Mālikī scholars do not require such a condition. The view of the these Mālikī scholars is evident in their statement, for example, that if someone has presented his good for sale and offered to sell it at ten *dinars*, the sale is concluded for the one who has paid such amount because he has heard the offer or has been informed about it. The sale is binding on the offeror and he has no right to decline from selling this good, except where the buyer who came forward to purchase has not heard of the offer or has not been informed about it.[8]

It is respectfully suggested that within the context of electronic contracts, any "offer" made on the web be *prima facie* considered as just an invitation to treat. Thus, when a customer submits an online form or faxes a copy of the form to an Islamic financial institution, it is treated only as an offer to buy and not as an acceptance of that offer. The result will be that the institution will have the option to either accept or reject the customer's offer. Arguably, this is the intended result by many online operators, including Islamic banks.

The rule, however, does not necessarily mean that all communications from an Islamic financial institution to its customers online will be treated as an invitation to treat. The institution may choose to regard any specific statement on the Web as the offer. Once the customer has accepted the offer through the prescribed methods of acceptance, then a contract is immediately concluded. This procedure requires the institution to be precise in offering any of its products, as any immediate acceptance by the customer will conclude the contract and thus will render it binding. It appears that this technique is more apt to Islamic stock purchases and sales, as customers normally prefer a spot transaction either to acquire a share or to dispose of it. Any time delay particularly in this sort of market might be detrimental to customers.

Another point worthy of consideration, is the time and place of the offeror's and offeree's meeting. Since an electronic contract is concluded via a certain instrument, it does not come under contracts of *inter praesentes*, that is, when two contracting parties or their representatives physically meet each other while concluding the contract. On the contrary, it comes under the purview of contracts *inter absentes*. Islamic law of contracts is well known for its requirement of unity of time and place (*itti®ād al-majlis*) whereby both the offer and acceptance are conducted in the same *majlis* (session of contract).[9] This doctrine is relatively easy within contracts *inter praesentes*, but its compliance with contracts *inter absentes* is problematic. Here, Muslim jurists have to extend the theory of *majlis* by way of construction.[10] The doctrine of *majlis* is held to communicate an offer to the offeree and is to take place wherever the offeree receives that offer.[11] According to classical Islamic law, the *majlis inter absentes* terminates after a reasonable lapse of time if the offeree has failed to respond to the offer, or when the offeree makes a declaration of acceptance.[12]

With all this in mind, it is respectfully suggested as a good practice, the offeror in electronic contracts should specify a time limit within which he expects to receive a response from the offeree. The offer will therefore

stand so long as that specified period has not lapsed.[13] If the offeror does not specify such a time, then the offer remains valid until acceptance is given, so long as it is deemed proper according to the circumstances of the case. Yet, this later scenario will, as a matter of fact, give rise to doubt and uncertainty. Therefore, to avoid any such uncertainty, it is recommended that the duration of the offer made on the Web be strictly disclosed. So once there is a lapse in time, any "response" from the customer cannot be considered as an acceptance as there is no link between the offer and the acceptance. Any such response from the customer is treated as a new offer to be accepted by the Islamic banking institution. Another suggestion is to repeat the offer daily on the Web site. This action would ultimately create a new *majlis* for a new acceptance.

It is also of relevance to discuss revocation of an offer that has already been made online. In other words, can an Islamic institution withdraw the offer it made earlier? As for revocation prior to acceptance by the offeree, the majority of scholars have allowed the offeror to withdraw his offer during the period of *majlis*.[14] The Mālikīs however are of the view that the offeror must stand by his offer until it has received a response from the offeree, before the lapse of the session of the contract.[15] The view of the majority is probably best suited for web contracts as it gives greater flexibility to the offeror to retract his offer, particularly when the offeree is yet to accept the offer. The foregoing issue is not as difficult as the case of revocation of the offer after the offeree has already accepted and communicated his acceptance. Consider further what would happen if a financial institution's e-mail to revoke its offer is sent to the offeree but is received after the latter had already accepted the offer. In this situation, it is proposed that online procedures should expressly deal with such scenarios.

B. Acceptance of an Online Contract

If an offer is to be accepted, the unequivocal acceptance of that offer must be communicated to the person who has made the offer. Generally speaking, acceptance must be made in the manner specified in the offer. If the offer is silent on this issue, then the acceptance can be made in any manner that is reasonable under the circumstances. When the offer is made through an electronic medium, such as e-mail, a response could constitute an acceptance of the offer. It could also be communicated through other means, such as by fax or post. The e-merchant or online Islamic banking institution ought also to explain to their potential customers how their acceptance of the offer will be communicated to them and when such acceptance will take effect.

While it is clear that communication of an acceptance can take many forms, it is less clear when acceptance takes place. When an acceptance is made over the telephone, the acceptance is deemed to occur at the time and place it is heard by the offeror. This rule has been held to apply to other instantaneous forms of communication, e.g. telex or facsimile. An acceptance sent by post is also deemed effective upon the receipt of the letter.[16]

Due to the nature of online communications, it is not clear whether this rule is applicable. Communications made via the Web, unlike the telephone and the facsimile, are not instantaneous in the strict sense of the word. Once dispatched through the Internet, they are routed through several service providers and/or text messaging agents before finally arriving at their destination. If we were to adhere to the receipt rule, it is not clear when the actual receipt occurs. Does it occur when the e-mail arrives at the customer's mail server or is it when the customer actually opens and reads the e-mail response?

As communications of offer and acceptance via the Web is unprecedented in Islamic law, in the sense that it cannot be simply made analogous to other forms of communications in contracts *inter absentes*, one would need to exercise his or her legal reasoning or *ijti®ād* to arrive at the legal rule that is compatible to *sharīᶜa* principles. It is the author's personal view, after contemplating the features of ᶜ*illa* in Islamic law, that the communication of an acceptance via the Web is effective once it reaches the offeror's mail server and the offeror has actually opened the mail.

The so-called "mailbox rule" therefore would not be applicable to online Islamic banking. This is because the mailbox rule, as a legal principle, hinges legal effectiveness at the time of dispatch, as opposed to the time of receipt, resulting in various anomalies. Following this principle, an offeror may be bound by an acceptance he or she never received, or by an acceptance mailed prior to a revocation of the offer. Islamic law's perspective would probably render the administration of law and justice more workable. Here, law is based on an attribute that is evident and constant, that is, receipt of the acceptance by the offeror.

The ßanafīs, who argue the above points, contend that the contract is concluded and effective when the two parties have heard each other.[17] This principle requires that the offeror actually know of the acceptance made by the offeree because hearing of an acceptance is required in *inter praesentes* contracts. Knowledge of acceptance is equally required in contracts of *inter absentes*.[18] Nonetheless, given legal uncertainties, online Islamic e-merchants should specify the method of acceptance as well as when and how the acceptance should take place. Such provisioning will enable the customers of online Islamic banking to retain their prerogative to accept or reject the offer.

It is a normal practice in online transactions that an offeree give a counter-offer just by providing any qualification or variation to the offer. If accepted, under the principles of Islamic law, it would supersede the terms of the original offer. Online Islamic e-merchants may design their Web site in such a way as to allow customers to add or remove any term(s) from the standard terms posted online. This is a matter of policy and has no bearing on *sharī≤a* principles except where such qualification or variation made to the offer constitutes a new offer to be accepted by the offeror.

As for *khīyār al-majlis*, particularly for Scholars who subscribe to this notion, it continues up to the time of receipt of the acceptance by the offeror. If he has opened and read his electronic mail containing the acceptance, then the right to *khīyār al-majlis* is deemed to expire. That is, to some extent, based upon the principle of *khīyār al-majlis* as already established in contracts effected through telex, fax, and the like. The option or *khīyār* to revoke a contract ceases to apply once the offeror has received the acceptance by the offeree.[19] In the case of electronic contracts, the *majlis* or session of the contract ends upon the receipt of this acceptance.

C. Subject Matter of Web Contracts, with Special Reference to Islamic Banking Instruments

As for deposits in Islamic banking, the underlying contract of both saving and current accounts is the *wa∞ī≤a*.[20] No serious problem exists whether one makes a deposit offline or online. The same applies to *mu∞āraba* contracts, which form the basis of Islamic investment accounts. Here, the investor submits an acceptance to all terms of an investment account, such as periods of investment, type of project, ratio of profit sharing, etc., via electronic mail. The investment could also be made through credit card or other similar facilities as will be discussed later. Writers find no critical issue as far as online deposits and investments are concerned. The only exception would be in the case of special and specific investment accounts. Here, the investor has the right to negotiate on the ratio as well as the project of investment. Therefore, the web should be designed in such a way the prospective investor has the opportunity to negotiate both the ratio and the project into which the investment will be channeled.

Within the financing sector, Islamic banking institutions normally offer instruments and products in the form of a partnership within trading or leasing or a combination of both. In other words, Islamic banks are supposed to assume the role of actual trader, vendor, lessor, or partner as the case may be. Therefore, in performing these business tasks, critical problems may exist that are relevant for both offline and online banking activities. These include defects of the goods, transfer of ownership and its attached risk (risk incidental to ownership), delivery risk, possession before the second sale (*al-qab∞*), etc.

IV. Consideration in a Web Contract

As in traditional contracts, a valid contract requires that parties agree on the consideration that is being exchanged for the subject matter of the contract. This would normally involve payment. For a Web contract, payment could be effected either through credit card or financial electronic commerce payments or electronic funds transfer as the case may be. Many writers on online banking and Islamic financial institutions have stressed the security aspect of using these instruments for payment purposes. Islamic law furthermore is concerned with the method of payment. As in some cases, the payment must be effected through a spot transaction, otherwise, this could trigger the *sharī≤a* prohibitions like buying currencies for currencies or buying *ribāwī* or usurious items on credit.[21]

V. Contractual Capacity in Web Contracts

Due to the present faceless nature of the Internet, an e-merchant is not easily able to verify the identity of online customers. In many circumstances, the verification of identity or some other quality of the contracting parties can be of significance. Of major concern is contracts entered into with minors. Under Islamic law, a contract made with a minor can be generally void or voidable, as the case may be.[22] For some Islamic financial institutions, depending on their *sharī≤a* advisory council's perspectives, restrictions such as taking deposits from certain individuals and/or companies are unacceptable.

Having said this, online Islamic bankers should be encouraged to incorporate into their web pages an express declaration on the criteria required to satisfy age requirements as well as other relevant information. If the customer has acted upon this declaration and has later found out that the conditional requirements pertaining to the contractual capacity were not satisfied, then the Islamic banks are entitled to recall the facility. This is simply based on the principle of utmost good faith and on the ®*adīth* that parties to a contract are bound by their own conditions or stipulations, so as long as the stipulations do not render what is impermissible permissible and vice versa.[23]

VI. The Purchase of Real Property via an Electronic Contract

Islamic banking is actively involved in financing real property, be it residential homes, small businesses, and land sales. Questions arise as to how real property transactions are affected when conducted through the Internet. Most states require all transactions pertaining to land and real property to be executed according to strict statutory regulations. Online Islamic bankers should also comply with all these statutory procedures, otherwise, the transaction can be deemed illegal. Nevertheless, property acquisition laws will need to be further relaxed in order to allow for transactions via the Internet.

VII. Product Defects and the Right to Revoke the Contract

In offline Islamic banking transactions, many practitioners still perceive Islamic banking products as purely financial instruments. Many instruments are therefore detached from the actual transaction, be it the trade or the lease. Moreover, focus is on compliance with banking statutes and guidelines rather than on the substantive laws of trading or leasing. These challenges are intensified in the case of online banking. Here, customers will now purchase an asset or take a lease on an asset without an actual physical examination and inspection of it, even before signing the contract. Issues of fitness, merchantable quality, and goods corresponding to their description are a new challenge to verify with online Islamic transactions.

At present, contracts for the sale of goods in Malaysia are generally governed by the Sale of Goods Act of 1957 (referred to hereafter as "the Act"). In addition to the express terms and conditions of a sale of goods contract, the Act provides that certain conditions and warranties with respect to goods sold are implied into the contract. These implied terms arise automatically by operation of law. These terms, which are contained within traditional sale transactions, will equally be implied into electronic contracts. These implied terms are as follows:

1. That the seller has a right to sell the goods, that the goods should be free from encumbrances and that the buyer should enjoy quiet possession of them;
2. That where the goods are sold by description, they should correspond with that description;
3. That the goods should be of satisfactory quality (i.e., the standard that a reasonable person would regard as satisfactory, taking into account any description of the goods, the price and all other relevant factors);
4. That the goods should be fit for the buyer's purpose where he makes that known to the seller; and
5. That where the goods are sold by sample, the goods should correspond with the sample.

All of these implied terms (except for those related to freedom from encumbrances and quiet enjoyment) are regarded as conditions. This means that if the goods are defective in any manner that is inconsistent with these implied terms, the buyer is entitled to reject the goods and terminate the contract. The buyer may also choose to accept the goods and simply claim damages with respect to the breach instead.[24]

Islamic law's perspective on breach of explicit and implicit conditions and warranties, particularly within the case of online transactions, requires a closer look. The corresponding legal term in the *sharī'a* for mistake is *al-kha≤a'* or *al-ghala≤*. While defects in any of the essential elements render a contract void *ab initio*, a non-substantial mistake does not lead to the same result. Instead, the law prescribes the right of options for the suffering party. Mistake or *al-kha≤a'* is actually a wrong presumption made by the parties as to certain facts of the contract. It occurs when parties to a contract wrongly presume a fact that is contrary to factors indicated in the offer and in the acceptance.[25] This presumption may be of a hidden will or expressly indicated by a manifest will. Another definition of mistake is *ghala≤*. It means the contracting parties presume that the subject matter of the contract consists of specific attributes or of a specific nature. Whereas, here, the actual subject matter is different either in type or in its attributes.[26]

Islamic law recognizes five types of mistake. This paper will focus only on three, as they are more pertinent to the question of online sale transactions. The first is mistake as to the subject matter. It takes place when a contract is concluded on a subject matter that is not agreed to or intended upon by the parties. They, however, only know this error after concluding the contract.[27] A mistake with regards to the kind of the subject matter would render the contract void.[28] On the other hand, a mistake as to the attribute of the subject matter renders the contract voidable but not necessarily void.[29] Thus, the buyer is given the right to revoke as prescribed in Article 310 of the *Mejelle*. "When the seller has sold a property of some good quality, if that property turns out to be without that quality the buyer has an option. If he wishes the sale to be annulled, and if he wishes, he accepts the thing sold for the whole price named. This is called option on account of description (*khīyār al-waÆf*)."

The third category would be mistake as to value, which is always associated with flagrant misrepresentation (*ghabn fā®ish*).[30] Mistake as to value takes place when the contracting parties are unaware of the real price and value of the subject matter. The contract is defective on the ground that if they had known of the true price, they would never have concluded the contract. Ibn Nujaym opined that when a seller fraudulently misrepresents the price of a thing (subject matter) and the buyer purchases the thing, and where it varies considerably from its real price, the buyer has the right to return the item.[31]

VIII. CHOICE OF LAW

Choice of law revolves around what legal principles a dispute resolution forum will apply to resolve the case at hand. Generally speaking, a country that claims jurisdiction does not necessarily have to apply its own laws to that case. The parties to a contract may decide to apply another state's laws instead of that of the state. However, in a typical online transaction, the customer is in one jurisdiction and the e-merchant in another. The payment for the product is made by way of electronic cash issued by a virtual bank situated in a third jurisdiction and most likely, the product actually sold is manufactured in a fourth jurisdiction. So which is the jurisdiction that has the closest connection with the online contract? This is one vexing question that no one single national legislator is able to resolve. The most practical approach however is for the online Islamic e-merchant to elect and to specify the choice of governing law in the online contract itself. Viability and feasibility of Islamic law principles governing online cross-border transactions are very much uncertain, at least in this point in time. As a suggestion, parties to the contract could agree to settle disputes by arbitration or by amicable settlement (*Æul®*). It avoids resorting to the court where conflicts over jurisdiction and governing law would never end. Though, rules and regulations relating to arbitration and amicable settlements would have to comply with Islam.

IX. METHODS OF PAYMENT

Conventional payment instruments such as cash, bank drafts and bills of exchange, are obviously not suitable for the speed required in e-commerce purchases. There is a wide range of payment systems currently deployed in retail transactions on the Web. Some systems are suitable for high value transactions, while other systems are more suited to low value transactions. Examples of payment systems presently in use on Web retail transactions include credit cards, charge cards, debit cards, electronic cash and electronic checks. They are basically designed as electronic analogs of various forms of payment backed by a bank or financial institution.

It appears that Islamic law has no objection to these forms of payment as they do not contradict any known *sharī^ca* principles. As previously said, the *sharī^ca* is technology neutral. The only reservation would be transactions where the *sharī^ca* has insisted on spot payment, such as in the case of foreign currency exchange and sale of *salam*.[32] The other relevant issue is the aspect of security. Credit card details can be exposed to parties not related to the contract. Among the security measures that have been developed so far is the use of encryption technology to encode information prior to its release onto the Internet. Most PC browsers are fitted with the Secure Socket Layer ("SSL") protocol to authenticate the server system and encrypt the data stream automatically.[33] Another is the use of electronic cash.[34]

X. THE RIGHTS AND LIABILITIES OF ISLAMIC BANKING PORTALS

It is anticipated that the various Islamic banking portals will assist both customers and product providers in completing their transaction, be it in-house financing, vehicle financing, Islamic insurance, investments in certain funds, investment in the stock market, and the like. Their function is merely to introduce products relevant to the needs and desires of online customers. The actual seller, lessor, or partner as the case may be is the financial institution that signed the agreement with the customer.

Are portal and service provider companies liable for any defect and misrepresentation? The answer to this question depends largely on the nature of the contract between these portals and the financial institutions. Should there be an agency contract between the two, then these portals are equally liable for any fraud or misrepresentation as discussed earlier. However, should financial institutions engage Islamic portals just as an advertiser, then there is no liability to these portals should there be any fraud or misrepresentation. It is therefore advisable for Islamic banking portals to incorporate an exclusion clause in the contract to the effect that the advertiser is and shall not be liable for damage caused by defective goods advertised on their web pages.

XI. CONFIDENTIALITY AND PROTECTION OF PERSONAL INFORMATION

Many countries provide laws to protect confidential information and trade secrets. The general law of confidence protects information that is transmitted under an obligation of confidence from unauthorized disclosure or use. Information that should not generally be in the public domain, particularly in an e-commerce context, are employee or customer medical records or credit card numbers, technical details of industrial processes, business ideas, customer lists, and price lists. Obligations of confidence can arise independently of, and parallel to, any contract, as long as the information was communicated under an express requirement of confidentiality or in circumstances that would reasonably give rise to such an obligation.

Islamic law would also protect the privacy of a transaction and its parties. An online Islamic e-merchant is likely to possess some confidential information. They should therefore have an information management policy in place. For example, security measures such as employee access controls, express confidentiality clauses in employee contracts, corporate firewalls, offline Internet data storage, regular security and system audits, and the use of encryption technology. Safeguarding from negligent disclosure also minimizes potential liability.

XII. METHODS OF INCORPORATION OF TERMS

It has been observed that most online contracts are pre-drafted standard form contracts, offered on a "take-it-or-leave-it" basis. Although this approach would be prima facie acceptable within the *sharīᶜa*, it is however questionable in many countries. They stipulate that a party is not bound by standard terms of a contract unless sufficient steps have been taken to bring the terms to their attention.

There are various techniques for designing Web sites to maximize the chances that a court will find that the online customer was aware of the online terms and conditions and that true acceptance of them did occur. Terms and conditions should be clearly sign-posted, be ready for print, and be available to customers for future reference.

Some common methods of displaying terms and conditions online are as follows:[35]

1. Reference to terms without a hypertext link by merely including a statement, such as, "This contract is subject to the terms and conditions of this company." This method may be the simplest form from the perspective of an e-merchant but will probably fail the reasonable notice requirement. Customers are unlikely to be aware of terms that were not made accessible for their viewing.
2. Reference to terms with a hypertext link, where a reference statement may be linked to another web page containing the standard terms. This method achieves some legal credibility and may satisfy the reasonable notice requirement for usual terms, but possibly not the more onerous ones.
3. Display of terms in a dialogue box. At the final stage of an order (e.g. after a review of the order), the customer is made to scroll through the terms set out in a dialogue box before clicking on the "Submit and I accept the above terms" button.

As far as Islamic law is concerned, the last method appears to be the most satisfactory. The customer is forced to review the terms (or acknowledge having reviewed the terms) and then must agree to the terms through some positive action (like the "click"). The purpose of insisting on this method is to provide greater transparency to the customer. Customers will understand that these terms form the legal part of the online contract. In Islamic law, any agreement must be *gharār*-free as well as mistake-free. Hence, the onus is on the Islamic e-merchant to provide the most detailed information about the transaction.

XIII. CONCLUSION

Electronic and online banking, Islamic or conventional, has similar requirements to that of offline banking. There are great similarities to most principles of law. However, both do differ in the manner in which these principles are satisfied. This is not surprising, as the nature of communications between the bank and the customer as in e-banking, is faceless and relatively quick. This paper has highlighted a few issues deemed to be relevant to Islamic electronic banking activities. It has equally argued in favor of certain legal principles to which operators of online Islamic banking should adhere. The legal and *sharīᶜa* issues discussed were not meant to be exhaustive. New issues will continue to emerge both in proportion to technical knowledge of online banking and to technical developments in information technology.

[1] According to a source, there are five Islamic banking portals operating from their respective Web sites: i.e., iHilal.com (Dubai), online.com (Jersey), riba-free.com (London), IslamiQ (Kuala Lumpur and London), and Muslim eFinancials, Inc. (McLean, Virginia). See Islamic Banker 54 (July 2000).

[2] It is worth noting that the *ʿilla* or the *ratio decidendi* of the formation of a valid contract in Islamic law is the connection of both offer and acceptance, instead of the consent itself, as the consent (*ri∞ā'*) or mutual consent (*≤ara∞ī*) is an attribute that is not evident and not constant; thus it did not qualify to be the basis of the ruling.

For details, see al-Shawkani. *Irshad al-Fuhul ila Tahqiq al-ßaqq min 'Ilm al-Usūl*. pp. 2-7-208.; Bakar, Mohd. Daud. "A Note on *Qiyas* and *Ratio Decidendi*." IIUM Law Journal 4 (1994). pp. 79-80.

[3] See the decision of the International Islamic Academy of *Fiqh* (no. 52). *Majallah Majma' al-Fiqh al-Islami* 6(2) (1990).

[4] See Ibn Taymiyyah. *Majmu' al-Fatawa* 29. p. 16; al-Shirazi. *al-Muhadhdhab* 1. p. 258; Ibn Qudamah. *al-Mughni* 6. p. 354; al-Kasani. *Badai' al-Sanai'* 5. p. 635.

[5] Online transactions could involve the sale of goods and services, or a direct online transfer of information. The latter kind of transaction uses the Internet as the medium of communication as well as the medium of exchange.

[6] Article 101, *Majallah al-Ahkam al-ʿAdliyyah*. The translation is taken from Hooper, C.A. The Civil Law of Palestine and Trans-Jordan 1. Jerusalem: Azriel Printing Works, 1933. p. 31.

[7] According to English common law, this principle is well established in Pharmaceutical Society of Great Britain v. Boots Cash Chemists (Southern) Ltd. [1953].

[8] Al-Dasuqi. *Hashiyah al-Dasuqi* 3. p. 4.

[9] Musa, Muhammad Yusuf. *al-Amwal wa Nazariyyat al-'Aqd*. Cairo: Dar al-Fikr al-Arabi, 1953. p. 258. According to the author, the doctrine of the unity of the session of contract is meant for the interest of the contracting parties, but this view has been rejected by some Western Islamicists. See Rayner, S.E. The Theory of Contracts in Islamic Law. London: Graham & Trotman, 1991. p. 107; Owsia, Parviz. Formation of Contract: A Comparative Study Under English, French, Islamic, and Iranian Law. London: Graham & Trotman, 1994. p. 475.

[10] Al-Kasani, *supra* 7. p. 138.

[11] Ibid.

[12] Ibn al-Humam. *al-Fath al-Qadir* 7. p. 138.

[13] This is in line with the decision of the International Islamic Academy of *Fiqh*, 1990.

[14] Ibn 'Abidin. *Radd al-Muhtar* 4. 1252 H, vol. 4, p. 29; al-Kasani, *supra* 5. p. 137.

[15] Malik. *al-Muwatta'*. Cairo: 1310. With commentary by al-Zurqani, vol. 3, p. 136.

[16] See al-Zuhayli. *al-Fiqh al-Islami* 4. pp. 108-109; Shammam, Muhammad. "Research Paper" in *Majallah Majma' al-Fiqh al-Islami* 2(6) (1990). p. 916. Under common law principles, an acceptance sent by mail is deemed effective upon mailing.

[17] Ibn al-Humam, *supra* 5. p. 274; *al-Fatawa al-Hindiyyah* 3. p. 3.

[18] Al-Sanhuri. *Masadir al-ßaqq* 2. p. 56.

[19] al-Qaradaghi, 'Ali Mahy al-Din. "Research Paper" in *Majallah Majma' al-Fiqh al-Islami* 2(6) (1990). p. 949.

[20] The reference is made to Islamic banking practice in Malaysia.

[21] See *Sharīʿa* Standard on Dealing in Currencies, prepared by the Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain, 2000. pp. 15-16.

[22] See al-Jaziri. *al-Fiqh 'ala al-Madhahib al-'Arba'ah* 2. p. 143.

[23] Al-Tirmidhi. *Sunan al-Tirmidhi (Kitab al-Ahkam)* 4. p. 584.

[24] Vohrah, Beatrix and Wu Min Aun. The Commercial Law of Malaysia. Kuala Lumpur: Longman, 2000. pp. 194-196.

[25] Al-Sabuni. *al-Madkhal li Dirasat al-Tashri' al-Islami* 2. Damascus: Matba'ah Riyad, 1974. p. 167.

[26] Madkur. *al-Fiqh al-Islami: al-Amwal wa al-Huquq wa al-'Uqud* 2. Beirut: Dar al-'Ilm li al-Malayin, 1983. p. 570.

[27] al-'Aisawi, Ahmad. *al-Madhkal fi al-Fiqh al-Islami*. Cairo: Dar al-Ta'lif, 1985. p. 525

[28] Al-Suyuti. *al-Ashbah w al-Naza'ir*. p. 341.

[29] Al-Shalabi. *al-Madkhal*. pp. 584-586.

[30] Article 65 of the Mejelle defined *ghabn fā®ish* as excessive deception in value of goods sold, not according to market price.

[31] Ibn Nujaym. *al-Ashbah wa al-Naza'ir*. p. 85.

[32] See the decision of The International Islamic Academy of *Fiqh* in *Majallah Majma' al-Fiqh al-Islami* 2(6) (1990). p. 1268. Mention should be made that the issuance and operation of both debit and charge cards is permissible. The position of the credit card is questionable, however, as it is based on interest. See *Sharīʿa* Standard on Debit Card, Charge Card, and Credit Card, prepared by the Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain, 2000, p. 35.

[33] Your Guide to e-Commerce Law in Singapore. Singapore: Drew & Napier, 2000. p. 51.
[34] Ibid.
[35] Ibid. pp. 9-10.

Sharīʿa Guidelines

A Look at the Differences and Their Impact on Performance

Laurent Chappuis*

ABSTRACT

This paper aims to take a closer look at the main differences in *sharīʿa* guidelines currently in effect, and to gauge the impact these can have on performance. In order to simplify the process, and due to the lack of transparency still prevalent in this segment of the investment industry, the scope of the investigation is limited to the two sets of guidelines applied by the major global Islamic indices: the FTSE Global Islamic Index and the Dow Jones Islamic Market Index. Also pointed out are the differences, in terms of regional and sector allocations, that the *sharīʿa* guidelines create vs. traditional global indices, and the impact that the *sharīʿa* guidelines have had on the returns achieved since 1998. Finally, this paper identifies the companies whose exclusion from the universe of Islamic investments is having the largest impact.

I. INTRODUCTION

When it comes to comparing the performances of Islamic equity funds, every fund manager is quick to point out that in order for the comparison to be valid, it is first necessary to determine whether the *sharīʿa* guidelines of the funds under review are similar. This is the reason that it is quite useful to look at what the current *sharīʿa* guidelines are and then to ascertain their impact on the regional and sector allocations of Islamic funds as well as on the two all-important factors: performance and risk.

II. CURRENT *SHARĪʿA* GUIDELINES

The *sharīʿa* guidelines currently being applied by the largest Islamic fund managers are examined first. Given the fact that, apart from a few notable exceptions, information about Islamic funds is difficult to obtain, the parameters listed on the Web site of Dow Jones Indexes, at http://indexes.dowjones.com/djimi/imparameters.html, are used in place of more direct sources of information. Under *sharīʿa* guidelines, the following business sectors are excluded from the universe of permitted investment: alcohol, tobacco, pork-related products, financial services, arms manufacturing, gaming, and pornography.

Although very little differences exist between various *sharīʿa* boards regarding prohibited sectors, the same cannot be said when it comes to the financial ratios that must be applied for screening potential as well as existing investments. Not only do *sharīʿa* boards differ on the types of screens that need to be applied, they also disagree on the definition as well as on the level of the ratios falling into the same category. The only type of ratio being applied by every *sharīʿa* board is the one concerning the leverage of a company. The standard definition and level for this ratio, the specifications that are gaining ground in the industry and that have been chosen by both the Dow Jones Islamic Market Index and the FTSE Global Islamic Index, is that total debts divided by total assets must be lower than one-third. However, the following leverage ratios are also used: total debts divided by equity must be lower than 30% or 33%; and loans plus cash divided by total assets must be lower than 50%.

The second most common type of financial screen deals with the level of interest income received by any given company. Three different definitions and levels are being used:

1. Non-operating interest income divided by operating income must be lower than 9%.
2. Interest income divided by total revenue must be lower than or equal to 15%.
3. The three-year average of interest income divided by total income must be lower than or equal to 10%.

Finally, a third financial screen that sometimes is required concerns short-term liquidity. It is also defined in three ways:

* Vice President and Head of Islamic Equities, Pictet & Cie, Banquiers, Geneva, Switzerland.

1. Accounts receivable divided by assets must be lower than 47%.
2. Accounts receivable divided by assets must be lower than or equal to 50%.
3. Accounts receivable divided by market value must be lower than or equal to 50%.

III. PERFORMANCE IMPACTS

This paper initially intended to compare the impact that the different *sharīʿa* guidelines applied by the Dow Jones Islamic Market Index and the FTSE Global Islamic Index are having on regional and sector allocations as well as on performance. Unfortunately, inasmuch as the constituents of the former index result from the screening of the traditional Dow Jones index as well as from a selection within their Islamic investment universe, it is not possible to determine the source of the differences. The divergences in allocations and performance could be a result of screens or of stock selection; it is impossible to tell which.

Nonetheless, it is interesting to list the following differences. The table below spells out the regional allocations (comprising the regional blocks of the Americas, Europe and Africa, and Asia/Pacific) and sector allocations (distributed among energy, utilities, transportation, consumer goods and services, healthcare, capital goods, basic industries, industrials, and miscellaneous) for the Dow Jones Islamic Market Index and the FTSE Global Islamic Index as of March 15, 2000. The last sector, industrials, accounts for 11% in the Dow Jones Islamic Market Index but has no counterpart in the sector breakdown of the FTSE Global Islamic Index; likewise, transportation is a component of the FTSE Global Islamic Index but not separately present in the Dow Jones Islamic Market Index.

TABLE 1. REGIONAL AND SECTOR ALLOCATIONS: DJIM AND FTSE GLOBAL ISLAMIC INDEXES

	Dow Jones Islamic Market Index	FTSE Global Islamic Index
Regional Allocation		
Americas	69%	62%
Europe and Africa	18%	26%
Asia/Pacific	13%	12%
Sector Allocation		
Energy	9.56%	9.01%
Utilities	13.43%	7.16%
Transportation	n/a	1.13%
Consumer goods and services	14.00%	28.34%
Healthcare	13.63%	15.06%
Capital goods	34.09%	33.42%
Basic industries	4.23%	4.11%
Industrials	11.01%	n/a
Miscellaneous	0.05%	1.76%

It is also useful to compare the performances of the two indices over the past three years. Their performance in 1998 is theoretical because both indices were launched at the start of 1999. In all three years, despite the differences of the indices in regional and sector allocations, their returns are quite similar, with the exception of 1999, but even then, the difference in returns was only 323 basis points.

TABLE 2. RELATIVE PERFORMANCE: DJIM AND FTSE GLOBAL ISLAMIC INDEXES

Year	Dow Jones Islamic Market Index	FTSE Global Islamic Index	DJIM – FTSE Difference (basis points)
1998	25.91%	25.57%	34
1999	29.22%	32.45%	–323
2000	–18.60%	–18.37%	–23

IV. THE *SHARĪʿA* VS. TRADITIONAL INDEXES

Fortunately for the purposes of this paper, one is able to determine the impact of *sharīʿa* guidelines on the returns achieved vis-à-vis a traditional index. Given the fact that no judgment is involved in the screening and re-balancing process of the FTSE Global Islamic Index, we need only compare the regional and sector allocations, the risks, and the returns between that index and the FTSE World Index in order to have an idea of the changes caused by the implementation of the index's *sharīʿa* guidelines. These guidelines screen only for leverage, by requiring that total debts divided by total assets be lower than one third. As shown in the table below, the FTSE Global Islamic Index and the FTSE World Index contain a number of differences with respect to regional and sector allocation.

TABLE 3. REGIONAL AND SECTOR ALLOCATIONS: FTSE GLOBAL ISLAMIC AND WORLD INDEXES

	FTSE Global Islamic Index	FTSE World Index
Regional Allocation		
Americas	62%	57%
Europe and Africa	26%	29%
Asia/Pacific	12%	14%
Sector Allocation		
Financials	0%	19.63%
Energy	9.01%	5.58%
Utilities	7.16%	11.22%
Transportation	1.13%	1.17%
Consumer goods and services	28.34%	22.72%
Healthcare	15.06%	9.88%
Capital goods	33.42%	24.26%
Basic industries	4.11%	3.75%
Miscellaneous	1.76%	1.78%

TABLE 4. RELATIVE PERFORMANCE: FTSE GLOBAL ISLAMIC AND WORLD INDEXES

Year	FTSE Global Islamic Index	FTSE World Index	Islamic – World Difference (basis points)
1998	25.57%	20.94%	463
1999	32.45%	24.17%	828
2000	–18.37%	–12.23%	–614

The returns achieved by these indices over the last three years are displayed in the following table. It has thus been demonstrated that Islamic investors can earn better returns than traditional investors and that the differences can be substantial, as in 1999 the Islamic index outperformed the traditional index by 828 basis points. However, as exemplified by the year 2000, the Islamic index is by no means guaranteed to outperform, and there will be years in which traditional indices will do better than Islamic ones. It is also to be noted that the FTSE Global Islamic Index is riskier than the FTSE World Index. The standard deviation of the Islamic index is 15.6%, while that of the traditional index is 14.9%. There is a tracking error of 3.5% for the Islamic index vs. the traditional index. This higher risk is mainly explained by differences in sector exposure, differences that stem directly from the *sharīʿa* guidelines applied to the Islamic index.

On the company level, six firms have a weighting greater than 0.5% in the FTSE World Index but are excluded from the FTSE Global Islamic Index: General Electric (weight 2.3%), Vodafone (1.03%), Citigroup (1%), IBM (0.88%), AIG (0.82%), and HSBC (0.53%). The FTSE Global Islamic Index in turn has 15 concerns with a weight of more than 0.5% compared to the FTSE World Index. They are: Cisco Systems (+ 1.54%), Intel (+1.43%), Microsoft (+1.29%), Exxon Mobil (+ 0.96%), Pfizer (+ 0.91%), Oracle (+ 0.78%), Wal-Mart (+ 0.78%), Nortel (+ 0.76%), BP (+ 0.69%), Sun Microsystems (+0.66%), EMC (+ 0.66%), Nokia (+ 0.64%), Merck (+ 0.56%), Toyota (+ 0.56%), and Coca-Cola (+ 0.52%).

V. CONCLUSION

In light of this information, one can draw a number of conclusions. First, Islamic investors can obtain good absolute returns while complying with their religious beliefs. They can also achieve superior relative returns. However, they are taking greater risks than traditional investors. Being an Islamic investor implies three investment biases. On regional allocation, Islamic investors have higher exposure than traditional investors to the United States. On sector allocation, they have greater exposure to the technology and pharmaceutical industries. Finally, FTSE Global Islamic Index differs from the FTSE World Index with respect to individual companies' weightings within the index.

Changing Perspectives in *Sharīʿa* Supervision

Yusuf Talal DeLorenzo*

ABSTRACT

As Islamic alternatives are developed for a variety of financial services, *sharīʿa* supervision finds itself increasingly challenged. The need for *sharīʿa* supervision to keep abreast of technological change is a part of that challenge. The development of the Internet facilitates the role of *sharīʿa* supervision as consumer advocate to ensure that financial products are ®*alāl*, and as consumer educator to increase awareness of Islamic financial alternatives. Technology also allows *sharīʿa* supervision to promote competition, transparency, and accountability, benefiting consumers and businesses alike. Another challenge facing *sharīʿa* supervision is to harness its capacity to promote socially responsible investing. Proactive *sharīʿa* supervision can bring attention and respect to firms by encouraging social responsibility while simultaneously fulfilling the spiritual, financial, and social rewards of investors.

I. INTRODUCTION

As the Islamic financial industry evolves, the role of *sharīʿa* supervision evolves with it. Thus, as Islamic finance moves into new markets, offering new financial alternatives to new sets of consumers, *sharīʿa* supervisors turn their attention to new issues. This is clearly as it should be, when we look at *sharīʿa* supervision as a sort of religious and ethical audit. However, if we look at *sharīʿa* supervision as a form of consumer advocacy, then there will certainly be instances when it is *sharīʿa* supervision that will lead Islamic financial institutions to turn their attention to new issues.

II. INDUSTRY DEVELOPMENT

The Islamic financial industry is a developing industry. For that matter, nowadays, what industry is not? But Islamic finance is essentially alternative finance and, as it develops new products and moves into new markets, it finds itself confronted by new sets of circumstances, many of which present *sharīʿa* supervision with new issues. This paper briefly speaks of how, as Islamic alternatives are developed for a variety of financial services, *sharīʿa* supervision finds itself increasingly challenged.

A significant element in the challenges to come, and in meeting those challenges, is technology. Let's begin with the World Wide Web. The opportunities offered to business through the Web are still somewhere out beyond imagination. Otherwise, why should those technology stocks continue to attract so much attention? In the past year alone, a number of significant Islamic institutions have established a presence on the Web. From a *sharīʿa* supervision standpoint, many positive developments have taken place as a result, and many more appear to be on the way. For example, in the matter of portfolio selection and screening, it is now a relatively easy matter for *sharīʿa* supervisors to find relevant information on virtually any security traded on any exchange in the world. Likewise, the all-important auditing function has been made considerably easier by brokerages that offer their customers online access to their portfolio accounts. Many of these are offered in real time, or near about. Obviously, the challenge for *sharīʿa* supervision is to keep abreast of the technology, and to learn how to put it to use. Remarkably, in some instances, the challenge is to convince management that it needs to provide its *sharīʿa* supervision with access to this technology.

III. *SHARĪʿA* SUPERVISION AS CONSUMER ADVOCACY

If we understand *sharīʿa* supervision as consumer advocacy, we may expect that supervision to urge the use of the Web for purposes related to transparency, and to the correlate of consumer advocacy, which is consumer education.

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* Independent *Sharīʿa* Consultant, Ashburn, Va. The following is the text of DeLorenzo's Keynote Speech on the *Sharīʿa* at the Fourth Harvard University Forum on Islamic Finance.

What is meant when we speak of *sharīʿa* supervision as consumer advocacy? By taking every possible step to ensure that an Islamic financial product is ®*alāl*, the services performed by *sharīʿa* supervisors are directed toward the investor. Undoubtedly, as a result of these efforts, Islamic financial institutions and their management will also benefit. But the primary beneficiary is the Muslim consumer, who can rest assured that his/her money is being put to use in ways that accord with the teachings of Islam and its message for all of humanity. At the same time, of course, *sharīʿa* supervisors act as advisors to management. While the scope for cooperation there is enormous, we are speaking here of their role as consumer advocates.

So, while the functions of *sharīʿa* supervision may be compared to those of an independent financial auditor, in the sense that it is concerned with regulatory compliance, there is a further and far more vital aspect to the role of *sharīʿa* supervision. By assuming responsibility for the *sharīʿa* compliance of an Islamic financial institution, including its policies and practices, *sharīʿa* supervision places itself in a position of directly representing the religious interests of the investor.

Promoting the use of technology for purposes of compliance and transparency is one way that *sharīʿa* supervision represents consumer interests. When it is said that the correlate of consumer advocacy is consumer education, reference is made to the world of possibilities for enhancing Muslim consumer awareness of, and appreciation for, Islamic financial products. The effort at Dow Jones University, on the Internet, to promote understanding of Islamic finance through the course offered on the "Principles of Islamic Investing," is certainly a positive development. However, every institution offering Islamic financial services needs to concern itself, to one degree or another, with issues of consumer education. Obviously, the chief concern there will be to provide information about the institution's own products. Consumers need to know that Islamic financial alternatives exist. They need to know that these alternatives are viable, from both a religious viewpoint and a practical one. And they need to know that these are competitive and worthy of their trust. These are the basics of such an education. Of course, there is much more that can be done.

IV. THE SOCIAL REWARDS OF ISLAMIC INVESTING

Another of the challenges for *sharīʿa* supervision as consumer advocacy, particularly in today's increasingly retail environment, comes from a focus on Islamic investing that includes three classes of rewards: spiritual, financial, and social. At present, there is very little appreciation for the social rewards of Islamic investing; and here lies another challenge to *sharīʿa* supervision, and to management as well.

"*Sharīʿa* Supervision of Islamic Mutual Funds," the author's other paper in this volume, discusses socially responsible investing at some length. But suffice it here to point out that Islamic finance has an opportunity, through attention to social issues, to develop a great deal of respect and appreciation for itself, for Islam, and for Muslims. By interpreting the Qur'anic imperative to enjoin good and prohibit wrong, *sharīʿa* supervision can contribute significantly to socially responsible initiatives to work for the environment, promote human rights, encourage diversity, and generally bring about greater appreciation for corporate ethics. Moreover, through proper use of the processes of corporate democracy, issues of specific concern to the Muslim community, and to the *umma* as a whole, may be highlighted and addressed in a positive manner. By undertaking these sorts of initiatives, Islamic finance may ally itself to the growing mainstream movement for socially responsible investing, and thus position itself as a positive influence on the society of the future. Responsible and enlightened *sharīʿa* supervision will have an immense role to play in bringing all of this about.

V. FUTURE DIRECTIONS

Thus, in regard to the future of *sharīʿa* supervision, it is possible to discern a direction. There can be no doubting the importance of understanding the role, or the different functions, of *sharīʿa* supervision. Obviously, the better a task is understood, the better it will be performed. But, in addition to a definition, there must also be an objective. Knowing what something is equates to only one half of knowledge about that something. In order to understand it fully, you must also know where it is going and why. With Islamic finance heading into retail markets, *sharīʿa* supervision will expand its responsibilities to include consumer advocacy and all that that entails.

Let us consider this from different perspectives. In a service-oriented market that is driven by competition, the firms with the better services will have the most success. *Sharīʿa* supervision that engages in consumer education enhances service. It is also better business because it promotes competition, accountability, and transparency—call this the business perspective. Businesses will recognize that it is to their advantage to have *sharīʿa* supervision that is sensitive to consumer needs.

Likewise, in a market with the potential, through the various channels of corporate democracy, to effect change in the ways that corporations do business, the Islamic financial institutions, and particularly the mutual funds that work those channels effectively, will be the ones that gain the most respect from Muslim investors. Proactive *sharīᶜa* supervision will bring appreciation and respect. We can call this the social perspective. From this perspective, no Muslim can fail to recognize that effective *sharīᶜa* supervision can play an important role in society.

Finally, in a market where the mandate from consumers is that transactions and returns must be ®*alāl*, the sort of *sharīᶜa* supervision that is responsive to the needs of consumers, and takes advantage of every technological advance to improve itself, is therefore the most reliable supervision. If we call this the religious perspective, then from this viewpoint, too, it is clearly to everyone's advantage to have efficient, professional, and forward-looking *sharīᶜa* supervision.

VI. CONCLUSION

The continued attention to the *sharīᶜa* and the appreciation of its importance to Islamic finance demonstrated at the Harvard University Forum on Islamic Finance is beneficial, as there are many issues to be dealt with, and many remain unresolved. Forums such as this are ideal for the exchange of ideas between scholars, practitioners, and concerned professionals. At a theoretical level, at least, the identification of problems and issues is the first step toward solving them. In this context, one is reminded of a quote by Imam Muhammad ibn Idris al-Shafii. He said, "A good question may be accounted one half of knowledge."

Sharīʿa Supervision of Islamic Mutual Funds

Yusuf Talal DeLorenzo*

ABSTRACT

This paper seeks to identify and discuss issues related to the *sharīʿa* supervision of Islamic mutual funds within the context of the variety of *sharīʿa*-compliant alternatives that are now, or will soon be, available to Muslims in need of financial services, including banking, insurance, consumer finance, and investments. In its analysis of the issues, the paper will explain the vital relationship of professional *sharīʿa* supervision to the credibility and success of Islamic mutual funds and to the entire Islamic financial sector. To ensure profitability, prudence dictates that investors seek out professionally managed Islamic mutual funds that combine performance with accountability and transparency. This paper demonstrates that, in order to ensure that profits from funds are ®*alāl*, investors must be satisfied that the funds are supervised and audited by competent *sharīʿa* professionals.

I. INTRODUCTION

Islamic mutual funds presently represent one of the fastest growing sectors within the Islamic financial industry. As *sharīʿa* supervision is an integral part of the industry, its place in relation to Islamic mutual funds is certainly no less important. The intention of this paper is to discuss in a general way the variety of functions performed by *sharīʿa* supervision and their importance. In doing so, observations about the industry and suggestions for a better future will be offered.

II. THE CURRENT STATE OF *SHARĪʿA* SUPERVISION

It is a matter of concern that a significant number of managed Islamic equity funds function without *sharīʿa* supervision of any sort. In fact, according to the data available on the ninety or so Islamic mutual funds, less than one half actually retain their own *sharīʿa* supervisory boards.[1] This is an alarming circumstance that, for reasons that will be discussed in this paper, needs to be remedied. Ideally, if management is slow to address the issue, then the remedy will come from the investors themselves. In fact, as Muslim investors grow in number and sophistication, they expect more from the professionals who manage their money. Then, in terms of performance—always the bottom line—and in terms of customer service, and in terms of *sharīʿa* compliance, Muslims have already begun to expect more and more from their funds. In terms of *sharīʿa* supervision, a great deal can be expected.

Particularly now, with the opening of retail markets to middle-class Muslim investors, Islamic mutual funds find themselves if not in direct competition, then at least subject to direct comparison, with the host of conventional mutual funds available to consumers. Today, funds offer all manner of services to investors, from virtual office space on their Web sites, to real-time performance updates, to regular reports, to the ability to customize a portfolio by using a personal identification number and selecting new fund options online or over an automated phone system. In short, the mutual fund industry has progressed from its beginnings as almost a closed sort of country club operation that catered to a financial elite, to its present service-oriented state that is driven by competition. Our new generation of Islamic equity funds is a part of this market, and certainly subject to many of the trends that move it. It is for this reason that, by way of example, the Azzad/Dow Jones Islamic Index Fund offers its investors a host of online facilities, in addition to regular reports by management, independent auditors, and a *Sharīʿa* Supervisory Board. Then, with standards of service, accountability and transparency rising to keep pace with the market, and with sophistication and expectations on the rise among Islamic investors, Islamic funds that fail to upgrade will certainly be bested by funds that succeed in doing so. Moreover, when retail Islamic funds begin to offer so much to their clients, investors in the other Islamic funds, institutions and high-net-worth individuals will not fail to take notice and, ultimately, either move their assets or insist that management take measures to give them more value for their money.

* Independent *Sharīʿa* Consultant, Ashburn, Va.

There are, however, instances of Islamic funds that have found other ways to see to the *sharīʿa* supervision of their businesses. For example, some funds have retained the services of a single *sharīʿa* supervisor. The author finds nothing wrong with such an arrangement, especially if the fund is set up to track an Islamic index like one of indexes from the Dow Jones Islamic Market Indexes family. Obviously, such an index fund will require less *sharīʿa* supervision for its portfolio than an actively managed portfolio because its investable universe will already have been screened by the *Sharīʿa* Board of the index provider. Then, with the active support and cooperation of management, a single *sharīʿa* supervisor should suffice to ensure *sharīʿa* compliance and assume responsibility for the other aspects of *sharīʿa* supervision. Even so, the presence of a full board would undoubtedly be more assuring to investors, and quite possibly more effective as well.[2]

Another way that an Islamic fund may ensure *sharīʿa* supervision without retaining the services of a *Sharīʿa* Supervisory Board is for it to appoint a *sharīʿa* scholar to the fund's Board of Trustees. Then the scholar may either chair a subcommittee or work alone to supervise the fund for *sharīʿa* compliance and oversee the other *sharīʿa*-related matters. Thus, while the ideal situation will always be for a fund to retain the services of a full *Sharīʿa* Supervisory Board, with three or more members, there are other ways of accomplishing the requisite *sharīʿa* supervision.

In this context, however, I would like to point out a serious misunderstanding that appears to have been repeated by a number of different Islamic mutual funds, though very likely with the best of intentions. This misunderstanding is based on the assumption that a fund licensed by an index provider with a *Sharīʿa* Supervisory Board of its own will not require *sharīʿa* supervision of any sort: not in the form of a board, and not in the form of a single supervisor. Writing in a recent issue of New Horizon, a Muslim financial professional observed,

> The arrival of the Dow Jones Islamic Market Index is seen as a cure all for banking houses who wish to broaden their success in placing equity funds with wealthy Muslims. The requirement, however, that they must still contract a *Sharīʿa* Board of their own to supervise their own behavior does not appear to be widely understood.[3]

Obviously, an Islamic mutual fund will become a licensee to an index provider with its own *Sharīʿa* Supervisory Board for the reason that the fund wants assurance for its investors that its choice of stocks will be *sharīʿa*-compliant. However, there is a great deal more to *sharīʿa* supervision than the review of stock choices from a *sharīʿa* perspective. Then, even if the fund is licensed to an index like the Dow Jones Islamic Market Index, it will still require *sharīʿa* supervision and advice. This paper shall attempt to explain why this is so by examining a number of different areas in which the participation of a *sharīʿa* scholar is essential.[4] It will also speak of the need for proactive involvement in fund affairs by *sharīʿa* supervisor(s) of the fund. Finally, it will make some recommendations on the future of *sharīʿa* supervision that, it is believed, will add value to every Islamic mutual fund.

III. CONSUMER ADVOCACY

It is of primary importance to understand *sharīʿa* supervision as consumer advocacy. By taking every possible step to ensure that an Islamic mutual fund represents a ®*alāl* investment for Muslims, the services performed by *sharīʿa* supervisors are directed toward the investor. Undoubtedly, as a result of these efforts, the fund and its management will also benefit. But the primary beneficiary is the Muslim investor who can rest assured that his/her money is being put to use in ways that accord with the teachings of Islam and its message for all of humankind. So, while the functions of a *sharīʿa* supervisor may be compared to those of an independent financial auditor, in the sense that regulatory compliance is ensured, there is a further and far more vital aspect to the role of a *sharīʿa* supervisor. By assuming responsibility for the *sharīʿa* compliance of a fund, including its components and its management, the *sharīʿa* supervisor places himself in a position of directly representing the religious interests of the investor. In discussing the different aspects of *sharīʿa* supervision, it will become clear that a *sharīʿa* supervisor functions in many different ways as a consumer advocate with both religious and fiduciary responsibilities. By performing these functions, the *sharīʿa* supervisor adds significant value to the fund(s) with which he works.

It has already been stated that there is far more to the *sharīʿa* supervision of an Islamic mutual fund than the screening and selection of equities. Let us now examine some of the different *sharīʿa* supervisory functions that are inseparable from the success of an Islamic mutual fund. One of the most important of these functions has to do with purification, which actually takes place at two different levels: at a fiscal level and at a moral level.

IV. PORTFOLIO PURIFICATION: FISCAL AND MORAL

It should not be necessary to explain that *zakāt* and purification are two entirely different, though not unrelated, matters. After all, the literal meaning of *zakāt*, which will be discussed later in this paper, is "purification." But the purification intended for discussion here is the cleansing from an investment portfolio of impure elements.

Many Muslims are familiar with the practice of "purifying" their checking accounts, for example, by simply donating the amounts listed as "interest earned" to charity. Thus, our concern from a *sharīʿa* perspective is with amounts of money earned by the corporations in which our Islamic mutual fund has invested, money earned by means deemed unacceptable by *sharīʿa* principles and teachings. Such "impure" earnings must be quantified and then purified.

Of course, the assumption here is that these are stocks that have cleared the various screens for *sharīʿa* compliance. Thus, the sources of such income might include non-operating income from interest-bearing investments, or earnings from prohibited business activities that are beyond the scope of a company's primary business. Oftentimes, such earnings will result from corporate diversification and new acquisitions. Whatever their source, the fact remains that even *sharīʿa*-compliant equities will often yield small percentages of income that is considered impure by *sharīʿa* standards, and that must then be purified.

The responsibility of the *sharīʿa* supervisor in this regard is to ensure that all such income is calculated by the fund, and that a corresponding percentage is deducted from the earnings, passed on to investors through dividends, thereby ensuring that these are free of impurities and completely ®*alāl*.[5] The methodologies for calculation may differ from fund to fund, or from one *Sharīʿa* Supervisory Board to another, where scholars, for whatever reasons, have preferences in the matter. This, however, is of secondary importance. Of primary importance is that the fund is actually committed to and regularly engaged in such purification. On behalf of the investor, then, it is the *sharīʿa* supervisor who will ensure that purification takes place, and that it takes place in a manner that accords with Islamic law.

The tangible results of such fiscal purification are that amounts of money begin to pile up. Generally speaking, it is recommended that funds sweep these amounts into separate accounts. With the advice and counsel of the fund's *Sharīʿa* Supervisory Board, these amounts may be distributed among suitable charities, or a charitable fund may be established for the purpose; again, under the supervision of the *sharīʿa* scholars.

Of course, it is certainly possible that the matter of purification be left entirely to the individual investor. Nonetheless, when we are speaking of adding value to a fund, it is clear that the fund's performance of this function will relieve the investor of the responsibility, and the considerable time and effort required to perform it. In fact, it is clear that this is a service that is much more effectively performed by the fund itself, particularly when the calculation process, including the collection of relevant data, is not a simple matter for those not equipped to undertake it.

The second half of the purification equation is what is termed "moral purification," and it is no less important than the fiscal purification of earnings. When speaking of fiscal purification, the thing that comes immediately to mind is that we are dealing with an amount of money that has been earned by means we find unacceptable, and is therefore in need of purification. So, in our haste to put aside the offending percentage, we often overlook our moral and religious responsibility in the matter. This responsibility is perhaps best understood in the context of the Qur'anic concept of "enjoining the right and prohibiting what is wrong."[6]

The ways to discharge this particular responsibility are varied. But modern corporate democracy has provided Muslim investors with every opportunity to share with management their views and sentiments with regard to corporate practice and policy. By law, in fact, publicly owned corporations are required to hold annual meetings for their shareholders, and these provide opportunities for Muslim investors, or for the *sharīʿa* supervisors who look after their interests, to voice their concerns to management as vocally and as directly as they feel necessary. Of course, it is impractical to suppose that *sharīʿa* supervisors will attend every annual meeting of every holding in the fund's portfolio. But it is still possible to participate in the process of corporate governance by means of proxies and absentee ballots. It is likewise possible, at any time, for shareholders to raise issues with management, and to initiate positive change, by means of corporate shareholder resolutions. When a fund with substantial holdings brings up an issue, management will surely listen.

In an Islamic fund's strategy of proactive engagement with companies, the participation of *sharīʿa* scholars is essential. It is essential, in the first place, to ensure that the fund be concerned with moral purification on behalf of its investors. And it is essential, thereafter, to ensure that issues of importance to Muslims, from an Islamic perspective, are represented accurately and effectively to the management of major corporations. As Islamic mutual funds grow larger, and begin to hold larger and larger blocks of shares, the attention they receive from corporations

will grow proportionately. It is of all the more importance, then, that Muslims represent their way of life in the best and most effective manner possible.

V. PORTFOLIO SELECTION: SCREENING STOCKS

Undoubtedly, one of the most important functions of a *Sharīʿa* Supervisory Board is its scrutiny of equities for compliance with established, *sharīʿa*-based criteria. Much has been written on this subject in recent years, and much more remains to be written.[7] For the purposes of this paper, however, suffice it to say that if an Islamic fund is not licensed to an Islamic index with a full *Sharīʿa* Supervisory Board, then it will undoubtedly require the services of a *Sharīʿa* Supervisory Board to oversee its choice of investments. Such choices cannot be made on the basis of software, or by simply applying the published criteria of another fund, or index. So, when an Islamic equity fund is licensed to such an index, it may at least rest assured that the stocks it invests in will accord with the guidelines for prudent Islamic investing. Even so, it will still require *sharīʿa* supervision.

While what has now become common knowledge in regard to the *sharīʿa* screening of equities will not be repeated here, one should bear in mind that beyond the quantitative screening of securities is the highly subjective matter of ethics, and what is socially responsible. Again, from the perspective of enjoining the good and prohibiting what is wrong, it is the responsibility of *Sharīʿa* Supervisory Boards to work on these issues, even after a fund has been licensed to an investable universe through an index. Muslim investors, with their spiritual, cultural, and family ties to what is politely termed the developing world, are more intimately concerned with, and sensitive to, the practices and policies of multinationals.

A company's ethics, unlike its primary business and capital structure, are highly subjective and not easily quantified. In considering issues of this nature, it is important that the fund's *Sharīʿa* Supervisory Board work closely with management on policies and guidelines that will adequately cover these issues. Islamic investing has much in common with the modern forms of investing known as ethical investing, socially responsible investing, faith investing, and green investing. Each of these investment sectors, or subsectors, has much of value to contribute; and each has something in common with the teachings of Islam. It is therefore important for *Sharīʿa* Supervisory Boards to keep abreast of what is happening in these areas. The Internet is an excellent tool for the purpose of research into these forms of investing, the organizations that support and implement their principles, and the issues that concern them. Perhaps the most encouraging thing for Muslim investors to note about the funds that have grown up around these concepts is that they have been very successful, and that they are the fastest growing sector of the market.[8] Given the affinities shared by these groups and Muslim investors, it is important that Islamic funds begin to build bridges. In this effort, the participation of *Sharīʿa* Supervisory Boards will be all-important.

VI. PORTFOLIO MONITORING

Beyond selecting stocks is the equally important task of monitoring stocks. In the business world, there is very little that remains the same. A company with non-operating interest income of less than 5% for the present quarter may show earnings in excess of 15% for the next. Obviously, vigilance is required in these matters to ensure that all of the fund's holdings remain within the limits of the prescribed *sharīʿa* filters. Again, when a fund is licensed to an index, information of this nature will be passed on by the index provider as a matter of course. In such cases, the responsibility of the *sharīʿa* supervisor will be to verify the removal of the security from the fund's portfolio. In the case, however, that the fund is not licensed or otherwise positioned to receive such information, even more vigilance is required.

Fund management will generally assign this responsibility to their portfolio managers or research analysts. The author's own experience to date with portfolio managers is that they are very diligent about these matters. Even so, it is the responsibility of *sharīʿa* supervisors to ensure that this sort of vigilance is maintained. Very recently, specialized software has been developed that allows management, and *sharīʿa* supervisors, to track portfolios with ease. Such software, when connected to the Internet, will also provide real-time access to portfolios, as well as a host of third-party information. To the author's knowledge, very few Islamic funds have actually provided their *Sharīʿa* Supervisory Boards with this sort of access. Here again, though, the funds that do so will have a competitive edge.[9] In the future, Allah willing, every Islamic fund will have this facility. In fact, work is underway on even more sophisticated software. By the time this paper is published, it is expected that the beta versions will be up and running. In the final analysis, however, no matter how powerful the search engine or how seamless the links in the software, the expertise of *sharīʿa* supervisors will be required to make the final call. The software will identify the problem, the *Sharīʿa* Supervisory Board will solve it.

VII. MONITORING MANAGEMENT

The *sharīʿa* supervisory function includes vigilance in relation to the management of the Islamic equity fund as well. Among the most important issues in this regard is the fund's cash-to-assets ratio. Fund or portfolio managers may keep a large cash portion on hand if, for example, they are bearish on the market, or if they are unable to find attractive securities to buy, or, in the case of an index fund, if they are temporarily unable to purchase the stocks needed to match the index. Of course, the reason for the concern of the *Sharīʿa* Supervisory Board under these circumstances is the possibility that idle cash will lead to interest.

Likewise, *Sharīʿa* Supervisory Boards must be especially vigilant when, owing to adverse market conditions, management decides to assume temporary defensive positions. These may occur as the result of political, economic, or a host of other reasons. The important thing, however, is that the Board ensure that the strategy not include recourse to the conventional, knee-jerk strategies of moving into high-quality, short-term securities and money market instruments, or commercial or agency paper, or T-bills, or CDs. At such times, it will be best for management to convene a meeting of the *Sharīʿa* Supervisory Board, or at least to confer with the members either individually or by whatever other means, for the purpose of discussing to what lengths the fund may go. Obviously, when such situations occur, it is the expertise of the portfolio managers and analysts that will determine the defensive strategy. It is the *Sharīʿa* Supervisory Board, however, that will determine whether or not that strategy is a lawful one from a *sharīʿa* perspective.

Another thing that *sharīʿa* supervision will watch for is the purchase of equities on margin. While managers are aware that such purchases are not permitted, oftentimes their brokers are not. It is for this reason that *sharīʿa* supervisors must be on guard for such seemingly innocent mistakes.

In monitoring management, as in monitoring the portfolio, the use of software is particularly helpful. Obviously, this is the trend of the future. In mentioning this, these remarks are directed to both the management of Islamic equity funds and to the members of the various *Sharīʿa* Supervisory Boards. In the future, one may expect that a further qualification for *Sharīʿa* Supervisory Board members will be computer literacy.[10]

As a sort of a footnote to this section, the author should like to discuss another matter of consequence. Everyone recognizes the need for a working relationship between the members of the *Sharīʿa* Supervisory Board and the management of the fund. What people often fail to realize, however, is that relationships between the Board and the portfolio managers, the brokers, the accountants, and the auditors are equally important. When the fund management is openly Muslim, and makes its preferences and practices known to those with whom it works (portfolio managers, brokers, analysts, etc.), there is clearly less likelihood on the part of those colleagues of lapses leading to non-compliance with *sharīʿa* precepts. Even so, the possibility remains. And when fund management is non-Muslim, the likelihood is greater. Thus, in both cases, it is important to establish relationships between these business associates and the *Sharīʿa* Supervisory Board. Perhaps the best way to accomplish this is to simply introduce the members of the *Sharīʿa* Supervisory Board to the business colleagues of the fund. A short face-to-face meeting for the purpose of getting acquainted is all that is required. Thereafter, if any issues arise, these may be discussed in a manner befitting professionals who have actually made each other's acquaintance and share a genuine interest in the success of the fund. Such face-to-face meetings can easily be scheduled around an annual meeting of the *Sharīʿa* Supervisory Board, for example, and may even take place at a lunch or a dinner.

In this regard, it might be helpful to relate an example from personal experience. When Azzad's *Sharīʿa* Supervisory Board decided that a certain fund needed to liquidate its position in a certain stock, the decision was passed by management to its broker and the stocks were sold. Moreover, the accountants were instructed to sweep the profits from dividends and capital gains into the fund's charitable account. In a matter of days, the fund's auditors contacted management to question the liquidation of such a lucrative equity, and the justification for separating its earnings. At the request of management, the author spoke on the phone with the auditor, who agreed that the author should subsequently inform the auditor's firm in writing of the action the fund had requested, and the reasons for it. Thus, a potentially confusing and time-consuming situation was settled in a simple and straightforward manner. It went as smoothly as it did because a relationship of collegiality had been established, so that there was nothing awkward or hesitant about the exchanges that occurred between the auditor and the firm's *sharīʿa* representative. Similar relationships have led to the author's receiving tips from portfolio managers concerning peripheral involvement in prohibited business on the part of certain firms whose stock was held by funds that the author supervises.

VIII. MONITORING FEES

Certainly, from the perspective of the individual investor, one of the most important of all the different functions performed by a *Sharīʿa* Supervisory Board is its ensuring that the consumer is made aware of the fund's fees and how these are structured. Here again, the *Sharīʿa* Supervisory Board finds itself in the role of consumer advocate. While there is generally no formal channel for communication (other than quarterly or annual reports) between the Board and those who invest in the Islamic fund, the responsibility in this regard is not so much consumer education as it is a matter of the Board's satisfying itself of two essential matters. Firstly, that the fee structure is a reasonable one and, secondly, that the fees are clearly stated in the fund's literature and otherwise communicated without ambiguity to investors.

As the market for Islamic mutual funds grows, investment professionals (and even conventional brokers) will become familiar with the various offerings, and will explain all of the nuances and differences between them to their clients. At the present time, however, most Muslim investors approach Islamic funds directly, and purely on the basis of their understanding that the product offered is ®*alāl* and will yield ®*alāl* results only. Under such circumstances, it is very important that Islamic funds clearly state their fees, especially when the middle-class Muslim investor may be less inclined to be meticulous on the matter.[11] Then, while the author is confident that there is no real danger of unscrupulous practices on the part of funds, the real concern is that investors fully understand what sorts of fees they are expected to pay. For example, even in the United States, where the regulatory atmosphere is so strict, the annual expense ratio, or annual fee, does not appear on the client statements of most conventional funds. As a result, most consumers are not even aware of it. So, if people invest in a no-load fund, and then sees no mention of fees on their client statements, they might very well suppose that they are paying nothing to their funds.

Even aside from the annual fees and the different sorts of loads, funds will generally charge fees for a number of other services. For example, investors who move money between funds in the same family of funds (from a growth to an income fund, for example) may generally do so without any additional load. There may, however, be a fee for doing so, as well as a tax liability. It should be the responsibility of the Islamic fund to provide investors with a clear picture of their responsibilities in these instances. Such a "schedule of fees" should also include information on breakpoints or volume discounts, on the investors' rights of accumulation, on surrender fees (contingent deferred sales charges), on the facilities accorded by the fund for letters of intent (including the terms of retroactive collection in the event that the LOI is not fulfilled), and on special items like performance incentives and thresholds. The concern of the *Sharīʿa* Supervisory Board in these matters is simply that the investor be apprised of factors that may be of significance to him/her when investing Islamically. By looking out for the interests of the consumer in this manner, the *Sharīʿa* Supervisory Board is actually adding value to the fund. This is because when all the fees are carefully spelled out for investors, there is far less chance of unpleasant surprises and the resulting ill will that might be generated by even the simplest of misunderstandings. In today's service-oriented markets, this should be more than obvious.

IX. MONITORING FUND DOCUMENTATION

Perhaps more than monitoring, this function of a *Sharīʿa* Supervisory Board is actually one of assisting management in the preparation of filings for regulatory agencies such as the Securities and Exchange Commission, subscription agreements, private placement memoranda, fund prospectuses, and the like. Obviously, in the preparation of such documentation, references will have to be made to the *sharīʿa* and its interpretations. For this reason, it is essential that the expertise of *sharīʿa* scholars be accommodated. It is clearly of inestimable importance that the documents that define the Islamic mutual fund and the ways it works be in complete consonance with *sharīʿa* precepts. The only way to ensure this is to have the *Sharīʿa* Supervisory Board involved in the drafting and review of all pertinent legal and business documentation.

In fact, this paper will go one step further and suggest that *sharīʿa* supervision be extended to include marketing materials, such as brochures, advertisements, Web sites, and even multimedia presentations. In all of these, reference of one sort or another is sure to be made to the *sharīʿa* and the Islamic nature of the fund. In order to warrant that all such references are made correctly, especially in view of the fact that these will be made public, the involvement of the *Sharīʿa* Supervisory Board is essential.

X. MONITORING THE INDUSTRY

As academics, the members of *Sharīᶜa* Supervisory Boards will naturally keep abreast of scholarship in their respective fields and specializations. As professionals, it is equally essential that they remain informed of developments in the industries they supervise. In order to comprehend fully the sorts of issues that require the attention of *Sharīᶜa* Supervisory Boards, it is important to understand the issues in the broader context of the marketplace in general. From this perspective, the attention brought to bear on the issues by the Board will certainly be more pertinent, with the result that the Board's decisions will be more informed and ultimately of more value to the investor. This is not to say that *Sharīᶜa* Supervisory Boards should tell management how to run their business. Rather, a Board that is sensitive to the business environment is an effective Board.

In order to maintain this edge, *Sharīᶜa* Supervisory Board members need to understand the stock market and its various indicators. They also need to be able to use the tools that will allow them to follow the stock market and the factors that influence it. Thus, at the level of fund and sector performance, the Dow Jones Islamic Market Indexes and the Financial Times/TII Indices are indispensable tools. Specialized Web sites like Failaka.com, IslamiQ.com, and Muslim-investor.com are important sources of information about the Islamic investing sector, as are a handful of specialized publications such as *New Horizon*, *The Islamic Banker*, and others. Finally, at the level of the mutual fund industry in general, the sources of information are seemingly limitless, whether in print, online, or over the airwaves. Finally, academic and professional forums, such as the Harvard University Forum on Islamic Finance, may have much to contribute to this important aspect of *sharīᶜa* supervision.

XI. PRODUCT DEVELOPMENT

While the issue of product development is more commonly associated with Islamic banks, there is nonetheless a certain amount of scope for it in Islamic mutual funds as well. With the goal of mitigating risk through portfolio diversification, an Islamic fund might consider turning to markets other than the stock market, or to target other asset classes, such as real estate investment trusts (REITs). The fund may also want to do something different as part of a defensive strategy for a bearish market, or as a way to manage short-term liquidity. Whatever the case, there will be a clear need for the expert advice and assistance of a *Sharīᶜa* Supervisory Board.

XII. *ZAKĀT*

The assumption might easily be made that if Islamic mutual funds are active in purification, then they should surely be doing something about *zakāt*. This, however, is not the case. The matter of *zakāt* is complicated by any number of factors that lie outside the control of Islamic funds (and, for that matter, Islamic banks and other financial institutions as well). Since these factors are particular to the circumstances of each investor, the matter of *zakāt* is best left to the investors themselves. In this regard, one can refer to the *fatwā* of the Islamic Bank of Jordan, which effectively explains the reasons that the matter of *zakāt* should be left to the individual Muslim investor or depositor.[12]

Even when the matter is left to the individual, the fund may consider requesting its *Sharīᶜa* Supervisory Board to prepare guidelines for the calculation of *zakāt* on profits earned through investments in funds. These guidelines might then be published in brochure form and mailed to investors, or posted on the fund's Web page as an extra service to its investors. As there is still considerable debate on the details of *zakāt* to be paid on such investments, attention to the matter on the part of *Sharīᶜa* Supervisory Boards may indeed help bring about a needed consensus on several outstanding issues.

XIII. REGULAR REPORTS

Finally, one of the most important functions of a *Sharīᶜa* Supervisory Board is to prepare reports on the status of the fund it supervises. Such reports are best issued quarterly and should address issues of *sharīᶜa*-compliance in the portfolio and on the part of management. Likewise, the reports should keep investors informed of the purification process and the charitable ways in which purification money has been put to use by the fund. Other issues of relevance to the supervision of the fund might also be mentioned in the reports, such as new software that enables the Board to easily monitor the fund's portfolios, to screen stocks for *sharīᶜa*-compliance, and so on. In addition, the Board may use the reports to communicate the ways in which it is addressing issues related to socially responsible investing and the business ethics and practices of corporations. Finally, as the goal of these reports is to

promote transparency and full disclosure, they should always be prepared in a straightforward manner. If shortcomings have occurred, they must be mentioned, along with the steps taken to remedy the situation.

XIV. Conclusion

Throughout this paper, I have alluded to what the future might bring. All such references, I believe, have been made with a degree of optimism. No one doubts that there is a sizeable, and as yet untapped, market for Islamic financial products and services, especially in the United States and Europe, and in Muslim-majority countries with prosperous middle classes. When I consider this market, I see a religious community that is in many ways just as comfortable, and at ease, with the modern world as it is with its own Islamic heritage. The politics of the modern world have provided haven, and its economics have provided comfort. At the same time, Muslims are inextricably tied to Islam. My concern, as an advocate for this community, is that we receive the value that we deserve, not only that we get what we pay for, while the tenets of our religion are respected, not only in the sense of compliance, but in the sense of honor and esteem as well.

It will not be out of place, in our discussion of the future of *Sharīʿa* Supervisory Boards, to mention here the need for impartiality and independence. In the same way that independent auditors are brought in to review the finances of a business, *Sharīʿa* Supervisory Boards review compliance with *sharīʿa* precepts. Independent audits are understood as ways to gain and maintain the trust of investors and consumers. Independent *sharīʿa* supervision is the best way to gain and maintain the trust of Muslim investors and consumers.

The call goes out, from time to time, for the establishment of a central, or a unified, *Sharīʿa* Supervisory Board that could look after the interests of every Islamic bank or financial institution. Just as often the call is ignored. (Admittedly, an attempt was made in the 1980s to establish such a central board, but for Islamic banks only.) As may be gleaned from the contents of this paper, it is simply impossible for a centralized board to effectively perform all the tasks required for the *sharīʿa* supervision of each and every Islamic financial institution. In the early 1980s, when there was only a handful of such institutions, such a notion might have seemed reasonable. But today, when Islamic mutual funds alone number nearly one hundred, the notion is highly impractical.

Not only that, but as the Islamic financial sector looks at ways to provide *sharīʿa*-compliant financial services to retail consumers, there is an increasing need for specialization among *sharīʿa* supervisory professionals. *takāful* operations, for example, while based on many of the same principles, are nonetheless quite different from banking operations. The operations of commercial banks differ considerably from those of thrifts and investment banks. In the future we can expect to see more specialized *sharīʿa* supervision, or supervision geared toward specific sectors within the Islamic financial industry as it grows in size and sophistication. Under these circumstances there is no practical future for a single, central *Sharīʿa* Supervisory Board.

To ensure that *Sharīʿa* Supervisory Boards remain current, however, it may be preferable to have a professional organization, an industry association if you will, that sets standards for everything of importance to Islamic mutual funds. Such an association might therefore be inclusive of standards and practices for *sharīʿa* boards, Islamic funds, and fund management as well. Such an industry association might also look after the interests of membership, and promote understanding and exchange through publications and regular forums. It could also establish relationships with relevant academic, commercial, and professional bodies. The industry appears to have matured to the point where such an association would be of great value to everyone involved in Islamic funds. From the perspective of a consumer advocate, I will strongly recommend the timely establishment of such an industry association.

And it is Allah who prospers and assists.

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[1] Thanks to Tariq Al-Rifai and http://www.failaka.com.

[2] Indiana University's Kelly School of Business reviewed 27 studies on board size done over 40 years, covering 20,620 firms. "Boards ranged from 6 to 22 directors, and the team concluded there is a positive link between large boards and performance. The benefit of a big board may be a greater ability to obtain critical resources ranging from raw materials to refined information." Wall Street Journal. August 24, 2000. p. 1. Then, although it is highly unlikely that the boards studied included a single *Sharīʿa* Supervisory Board, the results are nonetheless indicative of the efficacy of a working plurality. When the Qur'an encourages believers to consult those "in the know," it uses the term *ahl al-dhikr*, which is immediately understood as plural. See Qur'an 16:43.

[3] Thomas, Abdulkader. "The Islamic Perspective: Making Your Money Work." New Horizon 100 (July 2000). London: Institute of Islamic Banking and Insurance. p. 11.

[4] Likewise, I consider it folly for an Islamic financial institution to name what is essentially an academic body as its *Sharīʿa* Supervisory Board. This is like naming the National Association of Certified Public Accountants as your auditors. The

name is impressive, the cumulative experience is staggering, but practically speaking the results will be zero. Institutions that attempt to obfuscate the issue of *sharī`a* supervision by appointing this academy or that council as their *sharī`a* supervisors have missed the point. They are also doing themselves and their investors a major disservice. *Sharī`a* supervision requires the commitment of time and resources. An informal arrangement for a part-time effort is far from satisfactory.

[5] It might be noted here that a company may suffer an operating loss and still declare a dividend, i.e., earnings per share may sometimes total less than the dividend per share. In such cases, a company will draw on reserves to pay the dividends. Obviously, under such circumstances, dividend purification will be rendered meaningless. Even so, *sharī`a* scholars have devised a number of methods for purification when this happens. My purpose in this paper is not to discuss the details of how these things may be accomplished, but how *Sharī`a* supervision is needed to focus on what needs to be accomplished.

[6] See, for example, 3:104, 110, 114, and 7:157, and 9:71, and elsewhere.

[7] I believe that the *sharī`a* filters established by the *Sharī`a* Supervisory Board of the Dow Jones Islamic Market Indexes represent the industry standard today. Nonetheless, that Board is careful to point out that its recommendations on the matter should be understood as interim tolerance parameters. Thus, scholarship on the issues is ongoing. As an entire paper might very easily be devoted to this subject alone, I have thought it sufficient here merely to allude to it.

[8] Social Investment Forum. 1999 Trends Report: Responsible Investing in the United States. p. 3.

[9] In fact, I recently had the pleasure of informing investors in the Azzad Growth Fund of this development and how it further ensures the efficiency of our Board and, in turn, the ®*alāl* nature of the fund's earnings.

[10] It is a sign of the times that I am now able to carry, on the hard drive of my laptop, the equivalent of hundreds of volumes, in Arabic, on subjects like *fiqh*, *usūl*, *tafsīr*, ®*adīth*, and the other classical Islamic disciplines. I hope that by this time next year, Allah willing, my own work in four volumes, A Compendium of Legal Opinions on the Operations of Islamic Banks, will be available on CD-ROM.

[11] From a *sharī`a* perspective, it is essential that contracts remain free of ambiguity, or *gharār*, especially of the sort that may lead to disputes and even litigation.

[12] *al Fatawa al Shar`iyah li al Bank al Islami al Urduni* 2. pp. 13-15.

Purification of Islamic Equity Funds

Methodology and Sharīᶜa *Foundation*

Mohamed Ali Elgari*

ABSTRACT

One of the fundamental *sharīᶜa* aspects in Islamic funds is purification, which simply means cleansing the investor's returns from income whose source is questionable from a *sharīᶜa* point of view. To some *sharīᶜa* scholars, the entire permissibility of an Islamic fund hinges on purification. This paper will expound on the *sharīᶜa* foundation of the concept of purification and on the basis for applying it as part of an equity investment program. It will illustrate the main formulae used by fund managers for this purpose and will also reflect on the differences of opinion among *sharīᶜa* scholars on who should implement such purification.

I. INTRODUCTION

The basic model of a publicly traded limited-liability company is a contemporary one dating back to no more than 100 years in Muslim countries. This form of company presents a momentous departure from the simple form of partnership. Such a model has never been rejected by contemporary *sharīᶜa* scholars who see in it a modern form of the *Anan* company, well known in Islamic jurisprudence.[1]

Except for a minor dissension, the majority of today's *sharīᶜa* scholars accept company shares as exemplifying an undivided ownership over the assets of the company as well as the basic transferability of ownership through purchase and sale of company shares (negotiability). Up to the 1980s, the prototype of a public company on which all the jurisprudence was applied to, was one free from every prohibited activity or questionable source of income, including borrowing and lending on the basis of interest. However, the business environment and the state of economic affairs in the contemporary world made such model unreachable and non-existent, even within Muslim countries, due to the problem of *ribā*. It may not be impossible for a company to refrain from prohibited activities such as production of ®*arām* goods. However, it is not possible for a modern corporation to survive without any access to capital and money markets as well as basic banking services. Even companies that maintain large liquid assets can hardly do without a regular overdraft account with the local bank. In most cases this is not the only facility such companies need and cannot arrange on an Islamic basis. Such transactions were based on interest that purported to borrow on the basis of *ribā*. Unfortunately Islamic banks were yet to develop a substitute for regular overdraft accounts. This effectively meant that public companies, regardless of how dedicated their management was to the *sharīᶜa*, were unable to fully refrain from interest-based transactions.

Many Muslims started shunning equities all together as this appeared to them to be the best thing to do from a religious point of view.

In 1991, the OIC *Fiqh* Academy made a monumental and decisive ruling on "what is a company share" and what exactly is the objective of the sale contract when such share is sold.[2] Scholars were now able to revisit the issue related to investing in companies that were not *so pure*. Such issue is now articulated in a manner that affords a *sharīᶜa* discourse.

In the last few years, *sharīᶜa* scholars succeeded in developing an equity investment program that was implemented by professional investment managers, of which, purification was a pivotal element. Islamic equity funds were born.[3] Today, the market for such funds is sizable. According to the author's estimation, it may have already passed the $20 billion mark worldwide, affording two market indexes (and a third on the way).

While the study of the *sharīᶜa* basis for Islamic equity funds is important, it is the subject of a different paper. This paper takes such aspects as a given and concentrates on the issue of purification.

II. THE MEANING OF PURIFICATION

Purification simply means deducting from one's investment those earnings the source of which is not acceptable from a *sharīᶜa* point of view. In the case of equity investment, this refers primarily to interest earnings

* Associate Professor, King Abdulaziz University, Jeddah, Saudi Arabia.

and incidental income from other non-permissible sources of income to the investee company such as a sale of alcoholic beverages or pork. Estimating the earnings from sale of pork and alcoholic beverages is not easy and interestingly quite arduous. For example, a company is a going concern. It is a living entity with far-reaching enterprises and widely stretched activities. From an accounting and financial point of view, it is also very complex. It is a far cry from the single partnership of the *Anan* form of company. Therefore, estimating income is a formidable task, requiring an excellent knowledge of accounting and corporate finance as well as an exceptional ability to handle *sharīʿa* issues. This is a combination that is not always within reach.

III. THE *SHARĪʿA* BASIS FOR PURIFICATION

From an increasing number of *sharīʿa* scholars and the Muslim public at large, Islamic equity investment programs gain more and more acceptance everyday. Although, the opinion is still held by some that the *sharīʿa* basis for such programs are speculative to say the least. Nevertheless, no part of these programs is on a more solid ground from a *sharīʿa* point of view, than that of purification. This is because the issue of purification is not new. It finds a clear *sharīʿa* foundation exemplified within the classical annals of *fiqh* and statements of major learned scholars of the early centuries. Their understanding of the texts (Qur'an and Sunna) epitomized the principles for such procedures

However, articulating these *sharīʿa* principles into a formal procedure for purification in portfolio investments is quite a formidable task and one with a number of unsettled issues, as will be described below.

IV. THE ISSUES

A. What is to be purified?

1. Dividends

There are those who think that non-permissible earnings of a company (such as interest) will transpire into an investor's returns only if such investor collects a direct receipt from the company in the form of a dividend. Hence, what is to be purified is only that part. As according to this viewpoint, return derived from capital gain, as most of the returns accruing to equity investors, need no purification. Capital gain is a market element, the argument goes. The main consequence of this approach is that no cleansing will need to be applied if the dividend is distributed, even if the company did earn interest income.

2. Capital Gains

Others differentiate between investing in a single company and being a subscriber to an investment fund. While it makes sense to only purify dividend incomes in the first case, in the second, the fund itself should be treated as a company, where the investment units are akin to company shares. In this case, the investment returns one derives from such fund (which is primarily capital gain) must all be purified as they are not dissimilar to company shares and dividends. No capital gain is realized from the sale of such fund units, and hence any income is similar to a dividend. A third view holds that the increase in share prices in the market (capital gain) is a complex phenomenon. Such an increase can be attributed to multifarious factors from which cash and debt securities (the source of interest earnings) cannot be excluded. Hence, even capital gain ought to be purified.

3. Assets or Liabilities

According to current thinking, only the company assets need to be purified. An Islamic equity investment program is based on, among other considerations, the *sharīʿa* maxim, "*Li-al-kathīr ®ukm al-kull*," or, "The rule is based on the majority, not the minority." Since the bulk of sources of funds for the company comes from permissible sources (two-thirds), the minority source is ignored and hence should have no consequences to purification. However, there are those who believe that the above mentioned maxim permits us to invest only in the company and that composition of the liability side should be considered for purification. In this case, we need to assign a portion of the income of the company to the debt source of funds and dispose of it.

B. Net or Gross

A Company deposits some money in a time deposit, or holds government bonds and earns interest on them. This interest will be part of that company's income for the year. But, it remains to be determined whether such interest earnings should be net income or just revenue. In other words, when we transpose the interest earnings of a company to the return on investment received by a participant in an equity fund, we need to relate such interest

earnings to either net income or the revenue of the Investee Company. It appears that income is not a very reliable element, whereas, revenue is less influenced by such factors. By counting interest as revenue we indirectly allow charging operational expenses to such source of income, like any other source. This is not the case when we relate interest to net income.

C. Purification vs. Screening

It is important to distinguish the method of handling interest and all incidental non-permissible earnings in the screening phase of the Islamic investment program to that of the purification phase. There is no basis in the *sharīʿa* for saying that 5% is acceptable while 6% is not. In other words, screens that permit investing in a company if its interest earnings are 5% or less of its income are clearly founded on expedience, not conformity to the *sharīʿa*. Due to this point many *sharīʿa* boards are now moving to a stricter criterion. It is different at the purification stage, as all interest earnings must be dispensed with.

D. Deduct or Inform?

Investors in most equity investment funds are advised on a quarterly basis the percentage of their investment that they need to dispose of in order to purify their return. It is the duty of every subscriber to purify on his or her own. In other funds, such burden is entrusted to the fund manager. He is not only required to calculate but also to dispose off the tainted amounts. The first method is clearly more practicable. Since no deduction from the net asset value of the portfolio is taken, the fund appears more profitable. Furthermore, this attracts strict Muslim investors (who would be keen to dispose off this amount every quarter), and those who are non-practicing or non-Muslims to invest in the fund.

Some *sharīʿa* scholars, on the other hand, think that an equity fund will not be truly Islamic unless all returns to investors are "pure." In this case, the manager must deduct such amount and dispose of it to charity.

In the author's personal view, money itself is neither pure nor tainted. Such things can only take place in the "*dhimma*."[4] If one earns impermissible income, he will be cleared if he disposes of the same from other sources. In the final analysis, those who subscribe to the fund with the intention of earning pure and clean return will purify.

V. METHODS OF PURIFICATION

We have deducted in the practice of Islamic equity fund management several methods of purification, which will be presented below. Each method is based upon assumptions the purposes of which are to embody *sharīʿa* requirements into a formula that lends itself readily for implementation by fund managers. All the methods presented here are already in practice, and are used by one or more fund managers. However, these are probably not the only methods, albeit the most common.

In each methodology, a formula is set-up to find factor P through which interest income can be estimated.

A. First Method

Let us assume that we have a portfolio of company shares. On January 1 (t_1) we have investee companies (c) each earning interest equal to í.

Hence, we have interest income equal to:

$$í_{c1} + \ldots. + í_{cn} = a$$

Let us assume that the net operating income for any company in the portfolio is y.

Hence, the total net operating income for the portfolio is equal to:

$$y_{c1} + —— + y_{cn} = b$$

Let us assume that the net asset value of the fund on Jan 1 is equal to $NAV_{t1.}$

Then calculate Z, which equals $NAV_{t2} – NAV_{t1.}$

The purification factor P will then equal ZH = P.

$$\text{Then} \quad H = \frac{a}{b}$$

Hence for every dollar invested, the investor must multiply by P and donate this amount to charity.

If for example, P = .007 and the investors Z = $2000 then he must dispose of the amount of $14.00

B. Second Method

Let us assume that we have n companies in the portfolio: $C_1, C_2 \ldots C_n$

Then calculate dividend yield (d) where d equals = $\frac{\text{dividend}}{\text{market value}}$ = d

Therefore, the annual portfolio dividend yield will be = $d_{c1} + d_{c2} + \ldots + d_{cn}$

Calculate interest income ratio for each company (í) which equals = $\frac{\text{interest income}}{\text{net operating income}}$

for the portfolio it will be = $í_{c1} + í_{c2} + \ldots + í_{cn}$

Hence, purification factor is = (d) (í) = P

This means that for every dollar invested, the amount of $P must be donated annually to charity.

C. Third Method

Let us assume that reported interest income for each company in the portfolio is X. We will then have X_1 to X_n where 1 and n denotes investee companies.

Let us assume that T is equal to each company's tax rate and that there is a tax rate for each investee company.

A equals the percentage of the total company shares owned by the fund.

M equals the number of months the share is held in the portfolio. Then we have interest income in the portfolio ip equals S X (1 – T) (X) (a) (M).

$$\sum x\ (I - T)\ (X)\ (A)\ (M)$$

VI. CONCLUSION

The concept of purification is the *sharī'a* scholars' answer to the problems faced by public companies prior to the 1990s. At that time, a company had to be free from the outset of every prohibited activity or questionable source of income, including borrowing and lending on the basis of interest. Today, purification of equity investments is simply made by cleansing the investors' returns from income whose source is questionable from a *sharī'a* point of view. To some *sharī'a* scholars, the entire permissibility of an Islamic fund hinges on purification. Islamic equity funds were born from this purification process, creating a sizeable market. Yet the process of purification itself is difficult and has led to a variety of approaches and opinions.

Disagreements proliferate as to what actually must be purified. Some argue that the dividend is what needs to be purified, others point to capital gains, while a third group believes that the company's assets and liabilities need to be purified. Moreover, disagreements exist over whether interest earnings should be considered as part of net income or revenue.

This paper expounds on the *sharī'a* foundation of the concept of purification and its application, particularly as part of an equity investment program. Three common methods of Islamic equity fund purification were discussed, each method with its followers and critics.

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[1] Of course, some argue that such acceptance was not the product of rigorous scholarship but was mostly based on *istis®āb al-®āl*.

[2] *Fiqh* Academy session of the Year 1412 H.

[3] There are now over 55 public Islamic equity funds worldwide and two Islamic market indexes.

[4] If one becomes obliged from payment of *zakāt*, for instance, it suffices if he pays the due amount from funds other than the one on which *zakāt* is due.

The Regulation of Risk in Islamic Law, the Common Law, and Federal Regulatory Law

Mohammad Fadel[*]

ABSTRACT

Executory contracts require assumptions regarding future states of the world about which contracting parties lack perfect information. This ignorance creates obstacles that can prevent parties from reaching efficient agreements, even where both parties are behaving rationally, when the future turns out radically different from the scenario anticipated by the parties themselves; moreover, opportunities for strategic behavior arise, which, if not mitigated, will deter parties from entering otherwise efficient agreements. Legal systems develop special rules regulating the limits of contractual rights and obligations in the face of these circumstances because there is an inevitable tension between ex ante efficiency and ex post efficiency. The different approaches taken by various legal systems can thus be understood as attempts to balance the conflicting goals of ex ante and ex post efficiency. Using this paradigm, some of the limitations that Islamic law places on the autonomy of contracting parties will be explained. As a useful comparison, the manner in which the common law traditionally dealt with some of these issues, especially derivative contracts, as well as the modern approach taken by federal regulators in the last quarter of the 20th century and going forward, will also be touched upon.

I. INTRODUCTION: THE NATURE OF LEGAL REGIMES AND LEGAL DECISION-MAKING

Analysis of legal rules requires attention to more than the content of particular rules of decision; one must also give due attention to the decision-making structure within which rules are applied, in order to obtain a fuller understanding of the purposes of legal rules. Accordingly, a brief description will be given of what are taken to be the most salient features of the three regimes that are the subject of this paper—Islamic law, American common law, and federal regulatory law.

A. Islamic Law

Islamic law is revealed law in origin, but is in fact a product of the interpretive labors of jurists who work using a case-by-case method of decision-making. One commentator has described Islamic law as a "jurists' law," to describe the fundamental role legal experts played in Islamic law's historical evolution. While jurists may be specialists in questions relating to the interpretation of legal texts, as well as procedural and evidentiary features of the legal system they administer, they are categorically *not* experts with respect to empirical questions of fact, although legal rules will often contain implicit within them empirical presumptions regarding the state of the external social world.

B. Common Law

When one speaks of the common law legal tradition, one generally has in mind the body of legal rules that originates in the decisions of the English law courts. While the common law originated in England, it is used in all parts of the English-speaking world. Generally, contract law, property law, tort law, and, to a lesser extent, criminal law, in the various subfederal jurisdictions, i.e., states and territories, that make up the United States, are products of the common law tradition, except where it has been changed by positive legislation.

Common law decision-making is similar to Islamic law in that the rules are made by legal specialists on a case-by-case basis. It differs in that the legal specialists making these decisions are sitting judges, whereas in the case of Islamic law, the legal specialist is usually a legal scholar who is usually not sitting on the bench. Thus, while in a common law system *stare decisis*, or precedent, is the chief means of creating legal stability, in Islamic law it is the judge's duty to practice *taqlīd* of an established jurist that accomplishes this result. Islamic law differs from common law in that the latter is explicitly pragmatic in ways that Islamic law, as a religiously inspired legal system, cannot claim to be.[1] Furthermore, common law rules are always subject to repeal, revocation, and reform by

[*] Clerk, U.S. Court of Appeals for the Fourth Circuit, Baltimore, Md.

positive legislation of the sovereign within existing constitutional constraints, whereas Islamic law has tended to claim a type of independence from the positive lawmaking powers of the sovereign.[2]

Common law rules are commonly associated with the concept of "private law," emphasizing its concern with the interests of the private persons involved in the regulated conduct, e.g., trade. In this respect it is also similar to Islamic law, whose main concern is not the regulation of an individual's relationship with the state, but rather with the relationship of one individual to another. Thus, both systems rely overwhelmingly on *private ordering* rather than on centralized, top-down regulation.

C. Federal Regulatory Law

The impetus behind the creation of modern federal regulatory law was the perception that judges, exercising their common law responsibilities of adjudicating disputes on a case-by-case basis, were not capable of formulating coherent responses to the ever-increasing complexity of modern social and economic life.[3] Accordingly, responsibility for the development of federal regulatory law has been assigned to expert agencies (bureaucracies) created by positive legislation of the U.S. Congress. Examples of such expert agencies in the financial field include the Securities and Exchange Commission and the Commodity and Futures Trading Commission, created, respectively, by the Security and Exchange Act of 1934 and the Commodity Exchange Act of 1936, as amended in 1974.

An interesting feature of federal regulatory law is its tendency to displace many common law doctrines based on an assumption that private ordering sometimes fails to achieve public welfare. At times, this requires a contraction of common law rights, e.g., placing limitations on the right to contract as in labor law, while at other times public welfare is deemed to require affording private individuals greater freedom to enter cooperative agreements than the common law saw fit, e.g., trading in derivatives.

Regulatory law contrasts most strongly with common law and Islamic law in two respects. The first is its reliance on technical experts rather than generalist judges or legal experts to establish the appropriate legal rules. The second is that the obligations of regulatory law run primarily to the government and only secondarily to other persons. In contrast to private agreements, then, where only the parties to an agreement could seek its enforcement, the government always has standing to enforce its regulatory regime, even in situations where the regulated parties would rather do without the benefit of the regulatory protection.

II. The Legal Status of Speculation

Significantly, all three regimes are in agreement that restrictions must be placed on financial "speculation," although each system's restrictions are different. The fact that each regime's technical solution to the problem of financial speculation differs should not obscure their fundamental agreement that significant restrictions on transactions whose value derive largely from the occurrence or non-occurrence of specified contingencies are necessary for the enhancement of social welfare. What requires explanation is why each system draws its lines differently, although in principle all seek the same result—prohibition of trading that reduces social welfare while allowing trading that increases it.[4]

A. Islamic Law's Approach to the Regulation of Speculation

Islamic law's approach to financial speculation is derived from the paradigmatic contract of exchange in Islamic law—the law of sales. Accordingly, we must begin first with a doctrinal review of the elements of a valid sale, second, with the legal consequences of an invalid sale, and finally, with the remedies that apply to an invalid sale.

1. The Islamic Contract of Sale

A sale is defined as "*ᶜaqd muᶜāwa∞a*," which means, literally, a commitment of mutual exchange. The essential requirements of this contract are consent and actual exchange of property. These requirements have their basis in verses of the Qur'an that prohibit "devouring the property of others unjustly (*akl amwāl al-nās bi-al-bā≤il*)."[5] A valid sale, according to the jurists, requires that each party deliver a price, known as a *thaman*, and accept in exchange property, known as a *muthamman*. Consider the following example: Buyer pays Seller $10,000 for a car. The $10,000 is the *thaman* that Buyer gives Seller in order to receive the car, which is the Buyer's *muthamman*. From Seller's perspective, the car is the *thaman* that Seller gives to Buyer in order to receive the $10,000, which is Seller's *muthamman*. Because of the prohibition against sales involving material uncertainty (*al-nahī ᶜan bayᶜ al-gharār*), both the *thaman* and the *muthamman* must be known with reasonable certainty at the time of the transaction. If there is uncertainty in either of these, the sale will be invalid, either on the theory that consent

is vitiated by the indeterminacy of the value of the exchanged property, or that the uncertainty leads to one party's devouring the property of another falsely.

Consider the following contract between a goldsmith and a sweeper for the purchase of the dust generated in the goldsmith's workshop. The sweeper is interested in purchasing the dust because it contains gold fragments that he intends to recover through the expenditure of labor. Because the quantity of the recoverable gold in the dust is unknown, however, jurists hold this trade to be invalid. The standard remedy in this situation is for the sweeper to return the dust to the goldsmith, and for the goldsmith to return the purchase price to the sweeper. If, however, the sweeper has already recovered the gold from the dust, the sweeper is entitled to a wage not exceeding the value of the recovered gold. The minority position is that he receives a market wage for his labor, even if it exceeds the value of the recovered gold.

The salient features of this remedy can be reduced to the following observations. First, an invalid sale does not transfer title to the property that is exchanged. Second, as a consequence of the first, the parties hold the exchanged property on behalf of its actual owner, viz., Islamic law imposes a constructive trust on the parties to an invalid sale, and requires them to restore the property in their possession to its rightful owner.[6]

To conclude, a valid contract of exchange in Islamic law requires mutuality of exchange, whereby each party delivers property and receives property. If an exchange is valid, title is transferred, but an invalid sale will not transfer title. Instead, the parties will hold the properties exchanged until they can be returned to their legal owner.

2. Risk of Loss (*∞amān*)

Risk of loss, i.e., casualty, in Islamic law is generally a function of either legal ownership or possession of the res. As a general matter, Islamic law frowns upon any agreement whose result is to separate ownership from possession. Nevertheless, it occurs, especially as a result of an invalid sale, in which case risk of loss will pass by possession, although title does not. Because risk of loss is either a function of legal ownership or possession, as a general matter, parties are not allowed to stipulate by contract which party will bear the risk of loss if their agreement contradicts the established rules allocating which party bears this risk. The only exception known to this author occurs in the sale of goods not present at the time of the contract (*bayᶜ al-ghā'ib*). In this case the parties can determine, by agreement, which party will bear the risk of loss until delivery is completed.

Because risk of loss is deemed to be a characteristic either of legal ownership or possession, "risk of loss" as such is not deemed property that can be exchanged for other property. When this fact is combined with the structure of the Islamic law of sales that requires mutuality of exchange, it is easy to understand why Islamic law declares trades of risk to be invalid. Take an insurance contract. At T_1, A, the insured, pays a premium to B, the insurer, in exchange for B's promise to protect A against certain losses should a predetermined contingency occur. A pays a *thaman* in the form of premiums but does not receive a *muthamman*, at least not immediately, in return. Likewise, B receives a *muthamman* but does not immediately deliver a *thaman* to A. After the parties enter into the insurance contract, one of two scenarios is possible. In the first scenario, the specified contingency occurs and B compensates A for his loss. From the perspective of the jurists, the money delivered from B to A is A's *muthamman* that he receives in exchange for the premiums that he had already paid. Similarly, the money B pays A in this scenario is the *thaman* that B paid in order to receive A's *muthamman* (premiums). Accordingly, they conclude that this exchange is invalid: first, because it involves *ribā* (the deferred exchange of money); and second, because of uncertainty in the *thaman* and the *muthamman*. Recall that the promise to indemnify against a loss cannot serve as the *muthamman* that would complete the exchange because it is not property that can be delivered to the insured.

In the second scenario, the term of the insurance contract is completed without the occurrence of the specified contingency. In this case, according to the jurists, there simply has been no exchange: although the insured has delivered property to the insurer in the form of premiums, the insured has never delivered any property (*muthamman*) to the insured in return. Likewise, the insurer has received property (*muthamman*) without paying a price (*thaman*) in exchange. Accordingly, the trade fails because it entails "consuming the property of another unjustly (*akl amwāl al-nās bi-al-bā≤il*)." In the view of the jurists, it is unjust for the insurer to keep the property of the insured without ever giving him property in return.

3. Financial Surety (*al-damān bi-juᶜl*)

The rules of sale apply not only to preclude casualty insurance; they also invalidate surety agreements in which the surety is compensated for agreeing to serve as the guarantor. This transaction is known to the jurists as a "surety with compensation." In this case, A, the merchant-debtor, pays B, the guarantor, X, in exchange for B's promise to pay C, the creditor, should A default. As a result of B's promise, C agrees to sell A, the merchant-debtor, goods on credit. In this transaction, one of two possibilities can occur. In the first scenario, A pays C the amount owed. In this case, B, the guarantor, has received a *thaman*, X, but never delivered any property to A in return. The

mere promise to pay C in the event of A's inability or unwillingness to pay his debt, as was the case in the discussion of risk of loss above, is not deemed to be "property" that can serve as the *muthamman* necessary to render the exchange valid. Consequently, the agreement is condemned because it results in B's consuming A's property unjustly.

In the second scenario, A does not pay C, forcing B to pay C. Because A is now indebted to B in the amount he paid to C, and B is entitled to collect that debt from A, B will receive two payments from A: first, the fee to serve as guarantor; and then second, the amount of the debt that B paid on behalf of A. According to the jurists, in this situation, the money B paid to C is a loan (*salaf*) from B to A. The amount A paid to B in exchange for his willingness to guaranty A's debt is thus a profit (*naf*^{c}) that accrues to B as a result of the loan extended on his behalf to pay C. Thus, the arrangement stands condemned as an instance of *salaf jarra manfa*^{c}*a* (a loan that generates a profit).

4. Options to Buy (*bay*^{c} *al-*^{c}*urbūn*)

In this contract, the Buyer agrees to give the Seller an amount of money in exchange for the Seller's promise not to sell the specified property to another person for a specified period of time. The parties further agree that if the Buyer does not complete the purchase, the Seller keeps the Buyer's down payment. This agreement is also invalid for it contemplates allowing the Seller to take property from the Buyer without giving the Buyer any property in return. In other words, the jurists also deem it an instance of "*akl amwāl al-nās bi-al-bā≤il*."

5. Derivatives

The author is not aware of a discussion by medieval Muslim jurists of agreements that resemble modern derivatives. Nevertheless, it is clear that application of the established rules would render derivative contracts unenforceable. In a plain-vanilla derivatives contract, the parties agree to exchange cash flows at a specified time or times based on the price of an underlying asset at the time of performance. For example, an oil refinery might agree with an oil company to take delivery of 100,000 barrels of oil on January 1, 2001, at a price of $25 per barrel. Instead of the refinery's taking delivery on the delivery date, however, the parties agree that they will settle their performance obligations simply by paying the difference between the contract price and the spot price on the day of delivery. Thus, if the price of oil on the spot market is $26, the oil company will simply pay the refiner $100,000. If the price of oil on the date of delivery is $24, however, the refiner will pay the oil company $100,000. In neither case, however, is there an actual exchange of property. Instead, one party will receive money but not give anything in return. Accordingly, it would be invalid because it would be an instance of "*akl amwāl al-nās bi-al-bā≤il*." Again, the promise of the counter-party to pay money in the event that the price moves in the opposite direction is not "property," and, accordingly, cannot save the contract from the perspective of Muslim jurists.

6. Conclusion

The requirement, derived from the law of sales, that property (*^{c}iwa∞*) be mutually exchanged permeates the Islamic law of exchange. Indeed, the sine qua non of a lawful exchange is that both parties receive property whose material characteristics, e.g., price, quality, and quantity, are ascertainable at the time of the contract. Islamic law's "property" requirement is much narrower than the common law's requirement of a "consideration," defined simply as "a performance or a return promise [that] is bargained for." The "performance" may consist either in "an act other than a promise, or a forbearance, or the creation, modification or destruction of a legal relation." *Restatement* (*Second*) *of Contracts*, § 71. Islamic law's requirement that property exchange hands, when applied rigorously, renders invalid numerous contracts deemed valid at common law.

At a formal level, Islamic law refuses to enforce contracts that include significant speculative elements because there is no mutual exchange of property. Instead, only one side receives property, while the other's receipt of property is contingent on the occurrence of an event in the future. Empirically, this strict position is based upon an irrefutable presumption that the absence of an actual exchange of property reduces the welfare of the contracting parties.

B. The Common Law's Approach to Speculative Contracts

Although the common law's concept of consideration is considerably wider in scope than Islamic law's concept of *^{c}iwa∞*, there were, nevertheless, significant restrictions placed on parties' freedom of contract in the name of forbidding gambling. Just as Islamic law refused to enforce contracts on the ground that to do so would entail "the consumption of property unjustly (*akl amwāl al-nās bi-al-bā≤il*)," so too the common law traditionally refused to enforce wagering agreements[7] because, were they to be enforced, "the consideration received would not

be commensurate with the detriment imposed on one side."[8] In this context, the common law's treatment of insurance contracts and derivatives is enlightening.

1. The Common Law and Insurance

Because insurance contains a speculative element, it can easily be condemned as a type of gambling. Indeed, the early common law refused to enforce insurance contracts for precisely this reason. Even with the common law's acceptance of insurance, however, important restrictions were placed on the contract so as to insure that the insurance contract could not be used as a vehicle for speculation. The first requirement was that of an "insurable interest." Thus, before a court would enforce an insurance contract, the policyholder had to demonstrate that he would suffer a significant economic detriment should the insured property be destroyed. Under this doctrine, only the owner of the insured property, or the financier holding a lien on the property, could purchase insurance on the property. Insurance contracts taken out on the property of a third party, however, lack an insurable interest in the insured property, and accordingly cannot be enforced. Where an insurable interest exists, the common law reasoned that the purpose of the contract is not to speculate on future contingencies with the hope of profiting thereby, but only to protect one's property in the event of an accident. Where there is no insurable interest, on the other hand, the only purpose for entering into the contract would be to profit from future contingencies, i.e., gambling.[9]

In addition to the insurable interest requirement, the common law placed a second restriction on insurance to lessen the possibility that it would be used as a vehicle for speculation—the "indemnification principle." Under this doctrine, a policyholder cannot recover under an insurance contract any amount that exceeds his interest in the economic value of the insured asset.[10] The owner of an insured automobile may recover the market value of his car upon its destruction, but not twice that amount, even if he has purchased two policies. Thus, at common law, "insurance policies are to compensate for losses suffered—not to generate profits."[11]

2. The Common Law and "Difference" Contracts

At common law, a contract for the future delivery of a commodity—a forward contract—was valid, but only if the parties actually contemplated actual delivery of the commodity.[12] The requirement that the parties contemplate actual delivery was instituted to preclude enforcement of contracts whose sole object was to speculate on the future prices of commodities. These contracts were condemned as "difference contracts." A "difference" is a contract that takes the form of a legitimate forward contract, but in fact is one in which the parties do not intend to settle the contract by delivery of a commodity. Rather, the parties intend to settle in cash based on the difference between the contract price and the spot price on the date of delivery specified by the contract.[13]

Courts recognized two exceptions to the rule prohibiting difference contracts. The first was where it could be shown that the contract served a legitimate hedging function.[14] A party seeking to enforce the contract would have to show that, at the time he entered the contract, he held an economic interest in a commodity that would be injured by the very same event that allowed him to profit on the contract. In this case, although the contract was a difference contract, it was enforced because it served only to indemnify against a loss, and was not a source of speculative profit.[15]

The second exception was where the contract was executed in an organized futures market, regardless of the actual intention of the parties to the contract.[16] Here, the reasoning used to justify enforcement was slightly different. The courts began with the premise that organized futures markets are organized for the needs of producers and consumers, primarily to allow them to hedge price risks efficiently.[17] Accordingly, the practice in those markets for counter-parties to offset their delivery obligations by entering into another contract is the legal equivalent of delivery.[18] Thus, in the case of exchange-traded futures contracts, there was an irrebutable presumption that the parties contemplated actual delivery,[19] whereas in the case of private futures contracts, the contract could only be enforced if the parties contemplated actual delivery, or one of the parties was hedging an actual economic interest.[20]

3. Conclusion

The common law, like Islamic law, was suspicious of speculative contracts, condemning them as gambling or wagers. Insurance contracts, although they contain speculative elements, were allowed where the insured had an interest in the property covered by the contract of insurance, but on the condition that he could recover only the value of his loss. Accordingly, insurance contracts were excluded from the definition of gambling because the insured could not profit from the contract. Likewise, the common law was suspicious of futures contracts, allowing them only where the parties contemplated actual delivery of the commodities or one of the parties could show a legitimate hedging purpose for the contract. Otherwise, the contract was deemed unenforceable as a difference contract.

C. The Commodity Exchange Act and the Federal Regulation of Speculative Contracts

The Commodity Exchange Act of 1936 (CEA) was passed, at least in part, to fight what the United States Congress deemed to be the harmful effects of "excessive speculation" in commodity prices. In 1974, Congress established the Commodity Futures Trading Commission (CFTC or the Commission) to administer the CEA. Since that time, the CFTC has enjoyed exclusive jurisdiction over enforcement of the Act. The heart of the CEA is that any "contract for the purchase or sale of a commodity for future delivery" be "conducted on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity." Conversely, any contract for the purchase or sale of a commodity for future delivery that is not conducted on a legally recognized organized exchange is unlawful, and may generate criminal penalties.[21]

The United States Congress believed that organized trading in futures contracts was "affected with a national interest" because "[t]he prices involved in such transactions are generally quoted and disseminated throughout the United States… as a basis for determining prices.… Such transactions are utilized by… [persons] engaged in handling commodities and the products and byproducts thereof… as a means of hedging themselves against possible losses through fluctuations in price." In other words, organized futures markets furthered social welfare in two important ways. The first was by enhancing the accuracy of future pricing information, thereby allowing producers and consumers of commodities to plan future business decisions more reliably, a function known as *price discovery*. The second was to allow producers and consumers to hedge their market risks more efficiently.

Trading in futures contracts was not without harmful side effects, however, as "the transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of… the national interest therein."[22] The Commission, in designing the substantive rules that are to govern exchange-traded futures, is required to make a determination whether futures trading in a particular commodity will promote the goals of price discovery and hedging while at the same time warding off the evils of "excessive speculation." Thus, before a futures contract can be legally traded on a board of trade, the advocate of a futures contract must demonstrate to the Commission that the contract is a response to a genuine market need for more efficient price discovery and/or hedging. Thus, even under the CEA, a futures contract is presumptively unlawful.[23]

Recently, however, with the rise of the market in privately-traded over-the-counter derivatives (OTC derivatives), the regulatory framework of the CEA has come under attack as overly restrictive. In response to this criticism, the United States Congress passed the Futures Trading Practices Act of 1992.[24] The 1992 legislation authorized the Commission to "exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to" the CEA's prohibition against trade in off-exchange futures contracts.[25] The Commission used this power in the early 1990s to exempt both swaps and hybrid instruments from the CEA's prohibition against off-exchange sales of futures contracts.[26] In contrast to the approach of the CEA, under this exemption such contracts are given a presumption of legality, so long as the contracting parties meet certain objective criteria, i.e., are "appropriate persons."[27] Partially as a result of this exemption, the market in OTC derivatives has exploded. It remains to be seen whether the decision to deregulate the OTC derivatives market will in fact serve the public interest.

III. CONCLUSION

With the exception of the recent decision by the Commodity Futures Trading Commission in 1992 to exempt certain "appropriate persons" from engaging in off-exchange futures contracts, Islamic law, the common law, and federal regulatory law (the CEA) all agree that speculation must be restricted. The difference is not so much in principle, but rather in technique. In Islamic law, there are certain categorical rules about the nature of property that substantially limit the ability of parties to engage in purely speculative contracts. On the other hand, these rules are clearly overbroad insofar as they will also deny enforcement to contracts where the speculative element is secondary to a valid commercial goal. Islamic law, however, solves the overbreadth problem of its rules on contract formation on the remedial side—because contractual rights can be enforced only by the parties to the contract themselves, so long as the parties are satisfied with the trade, no one can force them to undo their trade. In effect, this regulatory strategy may be a reflection of a perceived institutional inability to distinguish between contracts whose speculative elements are material and those that are not. Thus, in the event of a dispute, the court will simply not intervene to enforce a contract where the court cannot be *certain* that the speculative element is either *immaterial*, or *unavoidable*. Common law, on the other hand, appears to place more confidence in the fact-finding ability of judges to distinguish between contracts that are welfare enhancing and those that are simply tools for gambling. Because both systems depend upon a case-by-case method of decision-making, however, the difference between the legal rules of the two regimes might be a reflection of the greater experience common law

judges have had with contracts such as insurance than Muslim jurists have. The same skepticism toward speculative contracts is also reflected in the CEA, with the difference that it vests authority to distinguish between "valuable" speculation and "mere" speculation in an expert agency, the Commodity Futures Trading Commission. The Commission's decision to exempt "appropriate persons" from limitations on speculation that apply to "normal" persons can also be viewed as simply a decision that "appropriate persons" are better positioned to distinguish between welfare-enhancing contracts containing speculative elements and those contracts that are simply vehicles for speculation. Thus, for "appropriate persons," modern American law establishes a conclusive presumption that their speculative contracts are not gambling, but rather further a legitimate business purpose.

The question Muslim jurists need to confront, then, is whether the traditional rules of Islamic law remain the most efficient means available to distinguish between those speculative contracts that are gambling, and therefore should be denied enforcement, and those that increase social welfare, and should, therefore, be enforced. In exploring this question, valuable lessons can be learned from other legal systems, including the common law and modern federal regulatory law.

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[1] This difference should not be exaggerated. Modern legal historians tend to criticize the early common law as having been excessively formalistic at the expense of the pragmatic policy interests served by the law. It has only been in the last century that one can say that the pragmatic trend in the common law has triumphed over formalism.

[2] This difference also may be more apparent than real when one takes into account the Islamic legal doctrine of *siyāsa shar^{c}iyya*. Under this doctrine, the government is allowed to promulgate rules of decision that differ from the formal rules of the jurists, within the one constraint that the government's rule does not command disobedience to God.

[3] The reasons for this perception were many. First, judges as legal specialists were not perceived to have the adequate expertise to understand the complex changes in the economic life of the United States; consequently, there was fear that their decisions would be erroneous. Second, because of the peculiar structure of the American federal system, combined with the structure of stare decisis, there was the perceived threat that a business could face up to fifty different legal rules. Federal regulation had the perceived advantage of providing businesses with one set of rules with which to comply.

[4] There can be no dispute that Muslim jurists perceive their rules as welfare enhancing: al-Sawi, in commenting on the goals of the law of sales, states that its purpose is "to allow [one] to acquire, by means of agreement, that which is in the possession of another, and [as a result] conflict, violence, theft, betrayal, and cheating are reduced, as well as [leading to benefits] other than these."

[5] Qur'an 2:188 provides, "And do not consume one another's property [using means that are] unjust, and then go before judges so as to consume property of others sinfully, knowing [the property is not yours]." Qur'an 4:29 provides, "O you who believe! Do not consume one another's property unjustly, [but instead use legitimate means of] trade with mutual consent."

[6] If a material post-exchange event occurs, known as *fawāt*, the obligation is usually transformed into a duty to compensate the other party for the monetary value of his property.

[7] 7 Samuel Williston, A Treatise on the Law of Contracts § 17:1 at 542 (4th ed. 1997) ("Wagers and gaming transactions, except where authorized by statute, are generally held illegal.") [hereinafter Williston on Contracts]; id., § 17:8 at 611 ("In this country, by legislation and judicial decision, the hostility to wagers of every nature has been marked. Wagers are inconsistent with the established interests of society, are in conflict with the morals of the age, and, as such, are generally void as against public policy.").

[8] Id., § 17:1 at 542.

[9] Id., § 17:5 at 576 ("The requirement of an insurable interest in insured property is for the purpose of preventing the use of insurance as a means of wagering.").

[10] "[O]nce . . . an insurable interest exists, the [insurance] policy is a wagering contract only if the interest of the insured is grossly disproportionate to the value set by the parties." Id., § 17:5 at 576-77.

[11] Stout, Lynn A. Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives. 48 Duke L.J. 701, 725 (1999).

[12] A forward contract is permissible according to Muslim jurists so long as the buyer pays at least some of the purchase price at the time of contracting. This contract is known as *bay^{c} salam*.

[13] "The generally accepted doctrine in this country is . . . that a contract for the sale of goods to be delivered at a future day is valid, even thought the seller has not the goods, nor any other means of getting them than to go into the market and buy them; but such a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price is to be paid by the buyer; and, if under guise of such a contract, the real intent be merely to speculate in the rise or fall of prices, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void." Irwin v. Williar, 110 U.S. 499, 508-09 (1884).

[14] Stout at 718-19.

[15] "The traditional difference between hedging and gambling is that the hedger has a legitimate interest to protect *apart* from the hedging transaction, while the gambler has no interest except in the transactions, depending on the rise and fall of the market." (Emphasis added). Williston on Contracts § 17:10 at 627.

[16] Stout at 720.

[17] "There is no doubt that the large part of those [futures] contracts is made for serious business purposes. Hedging, for instance, as it is called, is a means by which collectors and exporters of grains or other products, and manufacturers who make contracts in advance for the sale of their goods, secure themselves against the fluctuations of the market by counter-contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture. . . . It seems to us an extraordinary and unlikely proposition that the dealings which give its character to the great market for future sales in this country are to be regarded as mere wagers . . . . A set-off is in legal effect a delivery. We speak only of the contracts made in the pits [of organized exchanges], because in them the members are principals." Board of Trade of Chicago v. Christie Grain & Stock Co., 198 U.S. 236, 249-50 (1905).

[18] It should be noted that with respect to exchange-traded futures contracts, a legal obligation to make delivery (if one is long on the commodity) and to accept delivery (if one is short on the commodity) exists in the absence of an offsetting transaction.

[19] "Where it is shown that the transactions were actually executed according to the rules of a legitimate exchange as required by statute, the contract is valid as against the argument that it is a mere gamble." 7 Williston on Contracts § 17:12 at 635-36.

[20] The treatment of exchange-traded futures contracts stands in sharp contrast to the prohibition of so-called "bucket shop" operations. "Bucket shops" allowed persons to enter into "sham 'purchases and sales' . . . where no delivery is *ever* made or expected." (Emphasis added). There is no doubt that, under American law, these contracts are "gambling. This is because the parties cannot, under the guise of a contract that has the appearance of validity, make a valid contract where the real intention is merely to speculate on the rise and fall of the market without any purpose that any property shall be delivered or received, but with the understanding that, at the appointed time, the account is to be adjusted by paying or receiving the difference between the contract and the current price." Id., § 17:12 at 633-35.

[21] "[I]t shall be unlawful for any person to offer to enter into . . . any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery . . . unless such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity." § 4(a), CEA.

[22] Section 3 of the Commodity Exchange Act.

[23] See generally, Revised Guideline on Economic and Public Interest Requirements for Contract Market Designation, Comm. Fut. L. Rep. ¶ 6147, 6073.

[24] Act of October 28, 1992 (Futures Trading Practices Act of 1992), effective October 28, 1992, Sec. 502(a), P.L. 102-546, 106 Stat. 3590, 3629-3631.

[25] Section 4(c)(1), CEA.

[26] *Exemption for Certain Swap Agreements*, 58 Fed. Reg. 5587 (1993) (to be codified at 17 C.F.R. Part 35); *Regulation of Hybrid Instruments*, 58 Fed. Reg. 5580 (1993) (to be codified at 17 C.F.R. Part 34).

[27] These include, *inter alia*, (1) banks or trust companies; (2) savings associations or credit unions; (3) insurance companies; (4) investment companies; (5) commodity pools (provided that is not formed solely for the purpose of entering into a swap agreement); (6) a corporation or other entity (provided that it is not formed solely for the purpose of entering into a swap agreement), if it has total assets exceeding $10,000,000, or if its obligations pursuant to the swap agreement are backed by a corporation or other business entity whose assets exceed $10,000,000, or if its obligations are backed by any other eligible swap participant, or if it has a net worth of $1,000,000 and enters into the swap in its line of business, or if it has a net worth of $1,000,000 and enters into the swap agreement to manage the risk of an asset or liability it owns or incurs or is reasonably likely to be owned or incurred in the course of its business; (7) an employee benefit plan subject to ERISA whose total assets exceed $5,000,000 or whose investment decisions are made by a bank, insurance company, investment advisor, or commodity trading advisor; (8) any governmental entity or subdivision thereof; (9) a broker-dealer, unless she is a natural person or proprietorship, in which case she must also independently satisfy the requirements of both those categories; (10) a futures commission merchant acting on its own behalf, provided that it independently meets the requirements either of a natural person or a business entity; and (10) any natural person with a net worth exceeding $10,000,000. 17 C.F.R. § 35.1 (2).

Corporate Debt and Islam

Shaikh Abdul Hamid*

ABSTRACT

Corporate debt is a very important source of capital for businesses. Whereas the market value of equities worldwide amounts to about $23.1 trillion today, corporate bonds outstanding amount to roughly 442% of that. Short-term debt is also a significant part of corporate capital worldwide. The use of debt by companies is pervasive. Islam prohibits the use of interest-bearing debt. This apparently puts companies needing capital in some difficulty. Investors desiring to invest in stocks often find very attractive companies that use debt. However, some Islamic jurists have permitted Muslims to invest in companies with a certain level of debt. This paper explores the benefits of debt, as well its harmful effects. It seeks to show that debt, like wine, has some benefits, but that its harmful effects outweigh its benefits.

I. INTRODUCTION

Debt is a very important source of capital for businesses worldwide. Whereas the total market value of publicly traded equities in developed markets in 1998 was $23.1 trillion,[1] the size of the major bond markets in the beginning of 1998 was $24.1 trillion. Of this amount, approximately 60% were government bonds, 29% was comprised of corporate debt of various types, and 11% was composed of eurobonds. Thus corporate debt and eurobonds amounted to approximately $9.8 trillion, or about 42% of the equity market of $23.1 trillion. The amount of short- and intermediate-term bank borrowing is hard to determine. But taken together, corporate debt would amount to a sizable share of corporate capital. In other words, the use of debt by companies is pervasive.

Islam prohibits the use of interest-bearing debt. This would create difficulty for Muslim-owned companies that need capital. They would not be able to raise debt capital.

This would also create difficulty for practicing Muslim investors. They are not in a position to invest in stocks of companies that use debt. However, some Islamic jurists have permitted Muslims to invest in companies with certain levels of debt.

This paper explores the benefits of debt, as well as its harmful effects. It seeks to show that debt has some benefits, but its harmful effects outweigh these benefits. (This may be akin to the Qur'anic saying that there is some benefit in wine, but its harmful effects outweigh the benefit.)

The first section of the paper uses a hypothetical example and shows the benefit of debt and its harmful effect. The second section looks at the historical experience with respect to relationship between recessions and business failures. The third section is an empirical study on the effect of debt on corporate performances of over 2,500 publicly traded U.S. companies. The reason for using U.S. companies is that data on such companies is more readily available at no cost. The final section makes some tentative conclusions.

II. DEBT, TAXES, AND RETURN ON EQUITY: SOME BASICS

Exhibit 1 shows hypothetical partial income statements for two firms. Both firms have the same asset size. Firm U is unlevered; that is to say, it has no debt (it is all-equity financed). Firm L is levered (or leveraged), which means it uses debt. It is 50% equity and 50% debt financed. By using debt (leverage), Firm L seeks to magnify its returns. If it borrows at, say, a before-tax interest cost of 10% and invests in projects to earn a higher return on its investment. If it earns, say 20% on the investment, it pays an interest cost of 10%; though it has earned 20% return, it does not pay interest of more than 10%. Shareholders benefit as a result. They get what is left after paying the 10% interest. This magnifies the return on equity (ROE) of the shareholders; as residual owners, the return on investment above the interest cost accrues to the shareholders.

In Exhibit 1, forecasts for earnings before interest and taxes (EBIT) are shown for two firms for three possible future scenarios over the next one year: bad, average and good. Both firms are assumed to be equally strong operationally. Hence they are expected to produce the same EBIT under a particular scenario. Interest on the

* Assistant Professor of Finance, New Hampshire College, Manchester, N.H.

debt of Firm L is assumed to be 10%. Firm U does not have interest expenses. Hence, its earnings before taxes (EBT, which is earnings before interest and taxes minus interest expense) is higher than that of Firm L (its interest expense reduces its taxable income). Thus, Firm U pays more taxes than Firm L, $1,600 vs. $1,200. However, because Firm L has to pay interest, its expected net income is reduced to $1,800 vs. $2,400 for Firm U. But the lower net income for Firm L translates to higher ROE (net income/equity) because the equity base for Firm L is half that of Firm U. The lower equity increases ROE.

The higher ROE of Firm L is not because it is operationally superior to Firm U. Both firms have the same basic earning power (BEP) since operationally, they are equally strong. However, Firm L manages to increase its ROE 50% higher. The expected ROE of Firm L is 18% and that of Firm U is 12%. This increase is because of the use of debt, as the interest on debt is tax deductible. So the higher ROE of Firm L is because of the financing decision. It has nothing to do with operational decisions or the efficient use of resources.

However, debt is not an unmixed blessing; it can also magnify ROE downwards. If EBIT of a company is less than the interest expense, it still has to pay interest. Income will thus be negative, as will ROE. Thus, debt cuts both ways. If a company cannot pay interest to its creditors, it may be forced into bankruptcy. But if a company is all-equity financed, and its net income is negative, it does not have to pay dividends to shareholders. Even when the net income is positive, the company may not pay any dividend; it may want to reinvest all or part of its net income into attractive projects that will boost the stock price.

The risk inherent in debt is reflected in the standard deviation of the ROEs under the three scenarios for each firm. The expected ROE of Firm L is 50% higher than that of Firm U, but the standard deviation of the ROE is two times that of Firm U, 4.24% vs. 2.12%. Thus higher ROE comes with higher risk.

Companies that use debt stand to benefit from higher expected ROE, but at the same time, they are exposed to higher risk: the risk of being forced into bankruptcy.

III. Recessions and Business Failures

Firms do well or poorly as a result of company specific factors, industry specific factors, and market-wide factors. It is easy to gauge the effect of market-wide factors on firms. One way to gauge the risk of firms with high debt is to analyze if business failure rates increase in times of recessions. In a recession, the downturn causes firm revenues to fall. A firm with high debt may run out of cash flow and find it difficult to make interest payments. This can cause a firm to seek bankruptcy protection. In many such cases, firms may go out of business. We would thus expect to find high rates of business failure in times of recessions.

Exhibit 2 shows business failure rates from 1927 to 1997, a 71-year period that experienced 12 recessions lasting from 6 months to 43 months. A recession is defined as the period from peak to trough of a business cycle. The 12 recessions cover a month to 12 months of 26 years. The duration of the recession in each of these 26 years is shown in the last column of Exhibit 2. Except for 6 years, in each of the other 20 recession years, failure rate was higher than in the preceding year (the failure rates in these 20 recession years are noted in **bold**). Of the 6 exception years, one recession lasted a month, and two lasted two months each. The failure rates are per 10,000 businesses, and include failures due to bankruptcy, death of owner, closure due to retirement of owner, etc. It is more likely that the increase in failures in recession years is due to bankruptcy than any other factor.

Exhibit 3 graphically displays part of the data in Exhibit 2: failure rates (Y-axis) are plotted against the years 1950 to 1997 (X-axis). Recession periods are shaded. The graph tells us that business failures have generally increased during every one of the eight recessions that occurred in the 48-year period. After nearly every recession, failure rates decreased. Businesses with debt thus have a higher risk of failure during recession than if they had no debt, given the extra financial risk that they bear.

What is apparent from the above analysis is that debt increases ROE, but it also increases the risk to shareholders. In good years, debt can magnify ROE. But good times cannot last forever. Even in a resource-abundant and technologically advanced country like the U.S., 26 out of 71 years since 1927 were partially or wholly affected by recession. The incidence of recession is likely to be greater in less well-endowed countries of the world.

In bad years, shareholders' equity is at stake. When a company goes bankrupt and its assets are sold, creditors (banks, bondholders, etc.) get their share first, and are only then followed by the claims of preferred stock holders. Common stockholders finish last.

Another problem with debt is the moral hazard issue that it raises. Owners may raise significant debt capital and put in little money of their own. Since they have little stake in the business, they may be induced to take a great deal of risk. If the business succeeds, they cut it big, since they have to pay a fixed interest cost. If they fail in their enterprise, their loss is small. If the risky venture pays off, they win handsomely.

IV. EXPERIMENTAL DESIGN

One of the previous sections shows that debt has value because interest on debt is tax deductible. This translates to lower taxes for the government, higher income for shareholders, and consequently higher returns. The higher potential return has a cost: higher risk. A firm that does not have debt faces only business risk. When it borrows, financial risk (risk of bankruptcy and financial distress) is added to the business risk.

This means that Muslim investors who shy away from investing in companies with debt would invest in companies that should have lower financial risk and consequently lower total risk, and hence lower returns. This may also mean that they are depriving themselves from investing in companies with better performance. The intent of this section is to test this.

Four measures of corporate performance are used:

1. Return on equity (ROE)
2. 5-year compound average revenue growth rate
3. 5-year compounded average stock price growth rate
4. 5-year total compounded return

Companies were screened based on debt/equity ranges and data on ROE of screened companies were obtained using the Internet site http://www.marketguide.com. The return on equity (ROE) of a company is defined as net income for the most recent fiscal year divided by shareholders' equity on the company's balance sheet. (Shareholders' equity is assets minus liabilities). The number is expressed as a percentage.

Companies were screened based on debt/equity ranges and data on the other 3 performance measures was obtained using the Internet site: http://www.hoovers.com.[2] Hoovers.com defines these 3 performance measures as follows:

- The 5-year compound revenue growth rate measures a company's sales growth rate over time. Sales for the five most recent fiscal years are used to calculate a compound average based on a linear regression.
- The 5-year compound average stock price growth rate measures the appreciation (or depreciation) of a company's stock price over time. The five data points used are the closing stock price for the most recent business day and the closing stock price for that same day (or the nearest previous business day) for each of the past five years. These five numbers are used to calculate a compound average based on a linear regression.
- The 5-year total return is the 5-year period price change plus dividends paid during the past 5 years, divided by the stock's price at the beginning of the period. The 5-year period is the 5 years previous to the most recent day on which the stock traded. The number is expressed as a percentage.

The data were collected in early to mid-2000 from these Internet sites.

First, I screened companies that have no long-term debt (debt-to-equity ratio of 0) and obtained the ROE for each company. Then I screened companies that have debt/equity ratio in the range of 1% to 10% and obtained their ROEs. In this way I screened companies falling in various debt ranges. The debt ranges that I took are 0%, 1% to 10%, 11% to 20%, 21% to 30% and so on in increments of 10%, until 91% to 100%. Beyond this point the increment chosen was 20%. I stopped with debt/equity ratio of 200%. (Many companies with debt/equity ratios greater than 200% are banks, which in any case are impermissible for Muslims.) Thus we have 16 categories based on debt/equity. I obtained the ROE for each company. Then I tested to see if the ROEs of a particular debt/equity range are significantly different from ROEs of the other 15 debt/equity ranges. The number of companies in each of the 16 categories of companies and the result of statistical test for differences in ROEs appears in Exhibit 4A.

The Kruskal-Wallis test is used to test for difference in performance measures. It is a non-parametric test, which is appropriate when the data is not normally distributed, which is generally the case with market data. The test performs test for differences among several population medians.

Once again I use the 16 debt/equity ranges to screen companies and obtain data for the other three performance measures for each company:

- 5-year compound average revenue growth rate
- 5-year compounded average stock price growth rate
- 5-year total compounded return

Data on these three performance measures are obtained simultaneously for each of the screened companies. Initially companies were screened based on the 16 categories of debt/equity ranges and data was obtained simultaneously for ROE and the above 3 performance measures. The number of companies in each category came out significantly less than when ROE is excluded. Hence companies were first screened based on debt/equity ranges and data on ROE was obtained, and then again screened based on debt/equity ranges and data were obtained on the other 3 performance measures.

Then the Kruskal-Wallis statistical test was conducted to analyze if significant difference in 5-year compound average revenue growth rates existed in the 16 categories of companies. Thus I check to see if there is a significant difference in the 5-year compound average revenue growth rates of one category of companies (within a given debt range) compared to the other categories of companies. Exhibit 5 shows the output of the Kruskal-Wallis tests. I do similar tests to analyze differences in 5-year compounded average stock price growth rates (Exhibit 6) and then 5-year total compounded returns (Exhibit 7) of the 16 categories of companies. The total number of companies in the 16 categories is 2967.

V. ANALYSES OF RESULTS

A. Test for Difference in ROE

The Kruskal-Wallis test for difference in the medians of the 16 categories of companies is presented in Table 4A. The exhibit shows the number of companies in each category. The total number of companies in all categories is 5740. The p-value of 0.00 shows that there is a significant difference in the medians. Companies with debt/equity of 0.81 to 0.90 have the highest average rank. Companies within debt ranges of 1.01 to 1.20 and 1.21 to 1.40 have the second and third average rankings. Generally speaking, companies with higher debt have higher average rankings; companies with lower debt have higher average rankings. Companies with higher debt appear to have higher ROE. Companies in the last category (debt/equity ratio of 1.81 to 2.00) with an average ranking of 13 are an exception.

Descriptive statistics of the ROE data for the 5740 companies (Exhibit 4B) show that there are outliers as large as +25,480% and –54,237%. All the mean ROE values of the 16 categories of companies are negative; it is more than –15% for 12 of the 15 categories of companies. When the smallest 5% and largest 5% ROE values are trimmed from the sample, and then mean values are computed, the means are more meaningful; only 2 categories of companies have mean ROE less than –15%; companies in categories 10 through 13 (debt/equity ratios ranging from 0.81 to 1.40) have mean values that are low positive or close to 0. The median values of all are positive with one exception (Category 2: debt/equity ratio of 0.01 to 0.10).

Next, I exclude companies that have ROE outside ±2,000% to get rid of outliers. This eliminates 22 companies. Then the Kruskal-Wallis test is conducted on the remaining 5,718 companies. Exhibit 4B presents the output. The first three rankings do not change. Another 8 rankings also do not change.

Another nonparametric alternative, Mood's Median Test, is more robust than Kruskal-Wallis Test against outliers (though less efficient for data from many distributions). It performs a nonparametric analysis of a one-way layout. The test assumes that the data are independent random samples from distributions of the same shape. Mood's Median Test is highly robust against outliers and errors in data. Exhibit 4D shows the output of Mood's Median Test on the full sample of 5,740 companies. The p-value of 0.00 shows that significant differences exist in the medians of the 16 categories of companies. Hence it is apparent that companies with higher debt have higher ROE.

B. Test for Difference in 5-Year Compound Average Revenue Growth Rates

The test is on the difference in medians of five-year compound average revenue growth rates of the 16 categories of companies with various debt levels. The median five-year compound average revenue growth rates of companies with 0 debt is 9.69% (Exhibit 5A). The exhibit also shows medians of the other 15 categories of companies. The p-value of 0.05 shows that at the 5% significance level there are differences in the medians of the 16 categories of companies. Companies with higher levels of debt exhibit higher five-year compound average revenue growth rates. The company with the highest average rank has a debt level of 1.01–1.20. The six categories of companies with the highest debt/equity ranges (from 0.91–1.00 to 1.81–2.00) share the first six ranks among them, which means that they experienced higher revenue growth rates.

This result is hard to explain, but there may be two factors at play here:

1. These companies are from certain industries, which have grown in the last five years at higher rates than others.
2. Companies with higher debt are under pressure to service their debt (make interest and principal payments) and are therefore more aggressive in achieving higher sales and hence achieve higher revenue growth rates.

Exhibit 5B shows output from Mood's Median Test for difference in five-year compound average revenue growth rates. As mentioned earlier, the Mood's Median Test is more robust against outliers. The result is interesting. The p-value of 0.72 shows that there is no significant difference in the medians of the 16 categories of companies. So, the outcome on test for difference in five-year compound average revenue growth rates is inconclusive: the Kruskal-Wallis Test showing significant difference whereas the Mood's Median Test showing no significant difference.

C. Test for Difference in 5-Year Compounded Average Stock Price Growth Rates

The output of Kruskal-Wallis test for difference in the medians of 5-year compounded average stock price growth rates of the 16 categories of companies is shown in Exhibit 6. The p-value of 0.32 shows that there are no significant difference in the medians of the 16 categories of companies. Companies with debt level of 21%–30% have the highest ranking. The median value is 10.2%. Companies with debt between 31%–40% have the next ranking with a median value of 6.36%. Rankings of the other categories is scattered. No clear-cut pattern emerges. If higher debt theoretically should lead to higher ROE, then that should have an impact on stock price. But this test on the 5-year compounded average stock price growth rates does not exhibit any pattern.

The Mood's Median Test was also done on this data set (the output is not shown as exhibit). It produced a p-value of 0.29 implying no significant difference.

D. Test for Differences in 5-Year Total Compounded Return

The p-value of 0.35 in Exhibit 5 shows that there are no significant differences in the medians of the 16 categories of companies based on 5-year total compounded return. Companies with debt level of 21%–30% had the highest ranking (median = 68.16%); companies with debt of 1%–10% have the next ranking. Overall, companies with lower debt have higher 5-year total compounded return.

The Mood's Median Test for this data set (the output is not shown as exhibit) produced a p-value of 0.60 implying no significant difference.

VI. CONCLUSION

Since interest on debt is tax-deductible, debt has value. Theoretically, this translates to higher ROE and therefore higher returns for equity holders. But it also implies that equity holders have to bear higher risk. I find that companies with higher debt have experienced higher ROE. I also find that companies with higher debt have experienced higher five-year compound average revenue growth rates. However, significance tests on these results are mixed. They are significant based on one test, and not significant based on another. It must also be noted that higher compound average revenue growth rates did not necessarily translate to higher 5-year compounded average stock price growth rates or higher 5-year total compounded returns for equity holders of companies with high debt.

[1] The U.S. stock market accounted for 53% of this.

[2] The database at http://www.hoovers.com screens and provides data for companies with ROE greater than or equal to 0%. Hence, http://www.marketguide.com was used for screening and obtaining ROE data. However, marketguide.com does not have data on 5-year performance measures, so hoovers.com was used to get data on the other three performance measures.

EXHIBIT 1. PARTIAL INCOME STATEMENTS FOR A LEVERED AND AN UNLEVERED FIRM

Both firms have same asset size. Firm U is financed only by equity (hence the term unlevered); Firm L is 50% equity- and 50% debt-financed (hence levered). Forecasts for earnings before interest and taxes (EBIT) are shown for each firm under three possible scenarios: bad, average, and good. The rate of interest (INT) on debt is 10%. EBT is earnings before taxes; BEP is basic earning power; ROE is return on equity. Both firms have the same BEP; operationally, they are equally strong. Firm L has a higher expected ROE because interest on debt is tax deductible. However, the risk of ROE (variability, as measured by σ [standard deviation]) is also higher for Firm L.

	Firm U (unlevered)			**Firm L (levered)**		
Assets		$20,000			$20,000	
Equity		$20,000			$20,000	
Debt		$0			$0	
Scenario	**Bad**	**Average**	**Good**	**Bad**	**Average**	**Good**
Probability	0.25	0.50	0.25	0.25	0.50	0.25
EBIT	$3,000	$4,000	$5,000	$3,000	$4,000	$5,000
INT (10%)	$ –	$ –	$ –	$1,000	$1,000	$1,000
EBT	$3,000	$4,000	$5,000	$2,000	$3,000	$4,000
Taxes (40%)	$1,200	$1,600	$2,000	$800	$1,200	$1,600
Net Income (NI)	$1,800	$2,400	$3,000	$1,200	$1,800	$2,400
BEP (EBIT/Assets)	15%	20%	25%	15%	20%	25%
ROE (NI/Equity)	9%	12%	15%	12%	18%	24%

$E(ROE_U) = 0.25(9\%) + 0.5(12\%) + 0.25(25\%) = 12\%$ = Expected ROE of Firm U

$E(ROE_L) = 0.25(12\%) + 0.5(18\%) + 0.25(24\%) = 18\%$ = Expected ROE of Firm L

$\sigma_{ROE_{(Unlevered)}} = 2.12\%$ = Standard deviation of the ROE of Firm U

$\sigma_{ROE_{(Levered)}} = 4.24\%$ = Standard deviation of the ROE of Firm L

EXHIBIT 2. FAILURE RATES PER 10,000 BUSINESSES, 1927–1997

Year	Failure Rate	Duration (months)	Year	Failure Rate	Duration (months)
1927	106		1963	56	
1928	109		1964	53	
1929	104	5	1965	53	
1930	122	**12**	1966	52	
1931	133	**12**	1967	49	
1932	154	**12**	1968	39	
1933	100	2	1969	37	1
1934	61		1970	44	**10**
1935	62		1971	42	
1936	48		1972	38	
1937	46	8	1973	36	2
1938	61	**5**	1974	38	**12**
1939	70		1975	43	**2**
1940	63		1976	35	
1941	55		1977	28	
1942	45		1978	24	
1943	16		1979	28	
1944	7		1980	42	**6**
1945	4	8	1981	61	**6**
1946	5		1982	88	**12**
1947	14		1983	110	
1948	20	**2**	1984	107	
1949	34	**9**	1985	115	
1950	34		1986	120	
1951	31		1987	102	
1952	29		1988	98	
1953	33	**6**	1989	65	
1954	42	**6**	1990	74	**6**
1955	42		1991	107	**2**
1956	48		1992	110	
1957	52	**5**	1997	109	
1958	56	**3**	1994	86	
1959	52		1995	82	
1960	57	**9**	1996	80	
1961	64	**1**	1997	88	
1962	61				

Note: recession years are in bold.

EXHIBIT 3. BUSINESS FAILURES, 1950–1997

Shaded periods represent recessions.

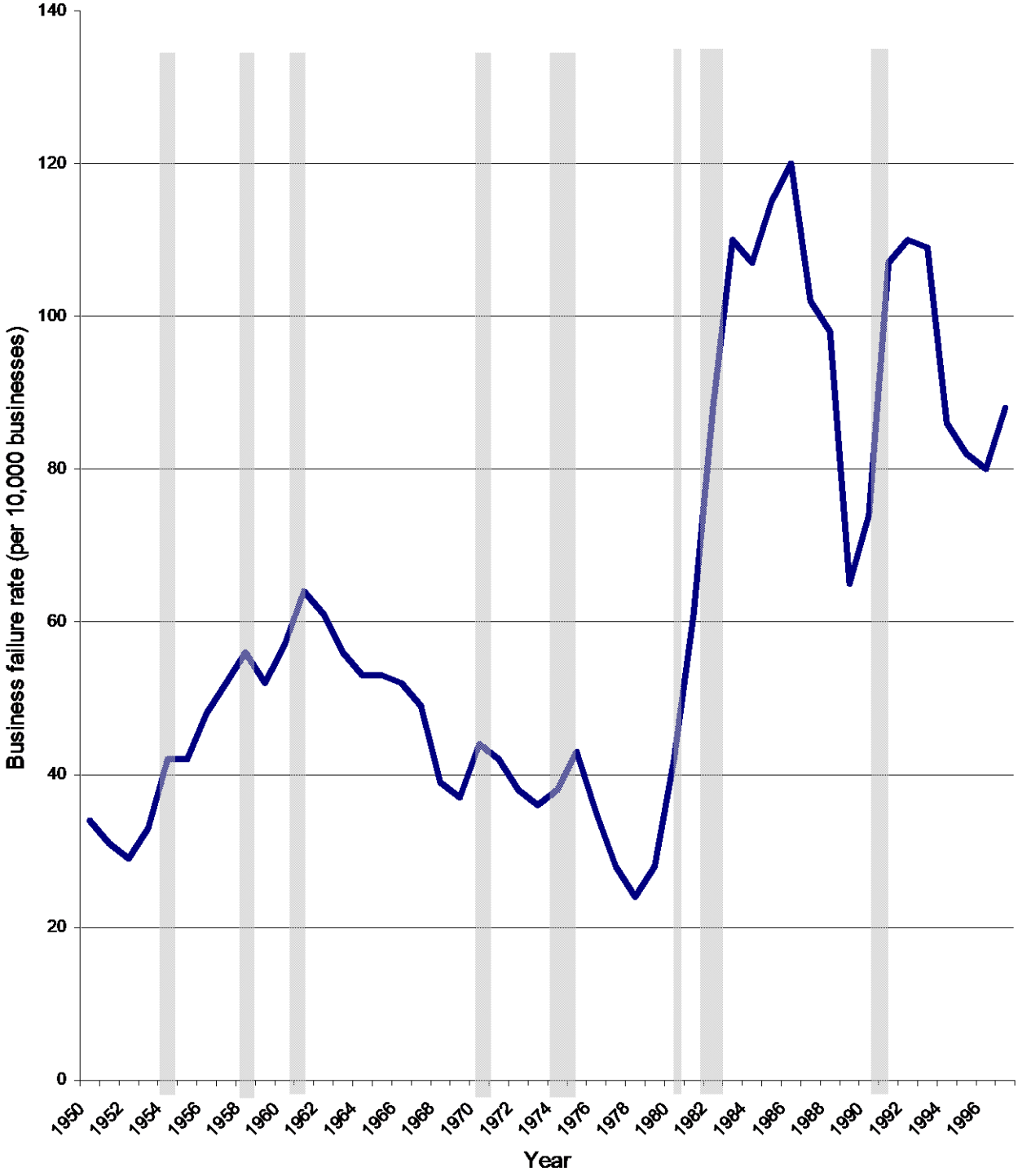

EXHIBIT 4A. KRUSKAL-WALLIS TEST OF DIFFERENCES IN THE MEDIANS OF RETURN ON EQUITY (ROE) OF COMPANIES IN 16 DEBT/EQUITY RANGES (FULL SAMPLE)

Category	Debt	Number of Observations	Median	Average Rank	Z-Value	Rank
1	0.00 – 0.00	1268	0	2659.3	–5.14	15
2	0.01 – 0.10	880	–1.7	2510.6	–7	16
3	0.11 – 0.20	479	1.47	2717.3	–2.11	14
4	0.21 – 0.30	400	5.19	2933.3	0.79	12
5	0.31 – 0.40	340	6.11	3068	2.27	7
6	0.41 – 0.50	268	4.98	2986.5	1.17	11
7	0.51 – 0.60	292	7.7	3161.9	3.08	4
8	0.61 – 0.70	232	5.61	2955.3	0.8	10
9	0.71 – 0.80	205	7.23	3102.8	2.04	6
10	0.81 – 0.90	212	9.63	3388.4	4.64	1
11	0.91 – 1.00	211	8.47	3149.1	2.49	5
12	1.01 – 1.20	304	8.34	3207.8	3.65	2
13	1.21 – 1.40	221	8.63	3199.1	3.01	3
14	1.41 – 1.60	179	6.79	3010.8	1.15	9
15	1.61 – 1.80	139	7.67	3059.2	1.36	8
16	1.81 – 2.00	110	2.54	2752.9	–0.75	13
Whole sample		5740		2870.5		

H = 138.19 df = 15 p = 0.00
H = 138.19 df = 15 p = 0.00 (adjusted for ties)

EXHIBIT 4B. DESCRIPTIVE STATISTICS FOR ROES OF 16 CATEGORIES OF FIRMS

Category	Number of Observations	Mean	Median	TrMean[1]	Std.Dev.[2]	SEMean[3]	Min.	Max.	Q1[4]	Q3[4]
1	1268	–16.3	0.0	–17.2	734.3	20.6	–2872.0	25479.8	–39.5	14.2
2	880	–166.3	–1.7	–22.5	2363.7	79.7	–54236.7	13255.2	–48.5	13.0
3	479	–31.84	1.47	–12.24	141.00	6.44	–1563.23	563.06	–24.69	13.45
4	400	–53.2	5.2	–7.4	466.6	23.3	–8350.9	210.6	–14.9	15.2
5	340	–34.8	6.1	–3.0	273.0	14.8	–3168.1	824.1	–10.6	16.3
6	268	–54.2	5.0	–1.2	720.1	44.0	–11724.7	117.8	–8.9	13.6
7	292	–13.75	7.70	–0.95	97.39	5.70	–641.03	589.52	–6.56	15.46
8	232	–24.91	5.61	–3.19	146.90	9.64	–1676.07	58.07	–6.78	13.15
9	205	–14.21	7.23	–4.64	122.42	8.55	–723.57	1128.17	–9.18	15.36
10	212	–95.4	9.6	5.4	1395.2	95.8	–20284.4	476.3	–0.8	17.0
11	211	–28.2	8.5	–0.0	253.9	17.5	–3532.2	154.2	–2.6	14.1
12	304	–11.49	8.34	2.48	106.62	6.12	–1296.10	269.67	–3.82	15.58
13	221	–2.54	8.63	1.20	55.60	3.74	–279.93	432.53	–5.98	14.42
14	179	–24.0	6.8	–4.3	152.9	11.4	–1490.0	175.9	–10.4	13.9
15	139	–17.25	7.67	–4.70	94.84	8.04	–688.39	265.22	–18.72	15.31
16	110	–23.09	2.54	–13.27	77.74	7.41	–421.41	122.12	–35.21	13.91

EXHIBIT 4C. KRUSKAL-WALLIS TEST OF DIFFERENCES IN THE MEDIANS OF RETURN ON EQUITY (ROE) OF COMPANIES IN 16 DEBT/EQUITY RANGES

(22 companies with ROE outside ±2,000% are excluded as outliers)

Category	Debt	Number of Observations	Median	Average Rank	Z-Value	Rank
1	0.00 – 0.00	1266	0.00	2640.0	–5.36	15
2	0.01 – 0.10	869	–1.40	2510.0	–6.78	16
3	0.11 – 0.20	479	1.47	2698.3	–2.23	14
4	0.21 – 0.30	397	5.22	2936.4	0.96	11
5	0.31 – 0.40	337	6.19	3076.2	2.48	7
6	0.41 – 0.50	267	4.99	2978.7	1.21	10
7	0.51 – 0.60	292	7.70	3142.9	3.01	5
8	0.61 – 0.70	232	5.61	2936.3	0.72	12
9	0.71 – 0.80	205	7.23	3083.8	1.98	6
10	0.81 – 0.90	211	9.65	3385.5	4.72	1
11	0.91 – 1.00	210	8.52	3145.1	2.55	4
12	1.01 – 1.20	304	8.34	3188.8	3.57	2
13	1.21 – 1.40	221	8.63	3180.1	2.94	3
14	1.41 – 1.60	179	6.79	2991.8	1.09	9
15	1.61 – 1.80	139	7.67	3040.2	1.31	8
16	1.81 – 2.00	110	2.54	2733.9	–0.81	13
Whole sample		5718		2859.5		

H = 138.19 df = 15 p = 0.00
H = 138.19 df = 15 p = 0.00 (adjusted for ties)

EXHIBIT 4D. MOOD'S MEDIAN TEST OF DIFFERENCES IN THE ROE OF COMPANIES IN 16 DEBT/EQUITY RANGES

Category	Debt	N<=	N>	Median	Q3–Q1
1	0.00 – 0.00	731	537	0	53.7
2	0.01 – 0.10	521	359	–1.7	61.5
3	0.11 – 0.20	263	216	1.5	38.1
4	0.21 – 0.30	193	207	5.2	30.1
5	0.31 – 0.40	156	184	6.1	26.8
6	0.41 – 0.50	124	144	5	22.5
7	0.51 – 0.60	118	174	7.7	22
8	0.61 – 0.70	109	123	5.6	19.9
9	0.71 – 0.80	88	117	7.2	24.5
10	0.81 – 0.90	77	135	9.6	17.8
11	0.91 – 1.00	81	130	8.5	16.7
12	1.01 – 1.20	123	181	8.3	19.4
13	1.21 – 1.40	87	134	8.6	20.4
14	1.41 – 1.60	80	99	6.8	24.3
15	1.61 – 1.80	59	80	7.7	34
16	1.81 – 2.00	60	50	2.5	49.1
Whole sample				4.5	

Overall median = 4.5
Chi-square = 138.50 df = 15 p = 0.00

EXHIBIT 5A. KRUSKAL-WALLIS TEST OF DIFFERENCES IN THE MEDIANS OF 5-YEAR COMPOUND AVERAGE REVENUE GROWTH RATES OF COMPANIES IN 16 DEBT/EQUITY RANGES

Category	Debt	Number of Observations	Median	Average Rank	Z-Value	Rank
1	0.00 – 0.00	752	0.09690	1396.3	–3.25	16
2	0.01 – 0.10	319	0.11010	1490.8	0.15	9
3	0.11 – 0.20	230	0.10490	1460.6	–0.43	11
4	0.21 – 0.30	196	0.10530	1440.2	–0.74	14
5	0.31 – 0.40	197	0.11140	1489.8	0.1	10
6	0.41 – 0.50	153	0.09440	1425.5	–0.87	15
7	0.51 – 0.60	142	0.11170	1544.2	0.86	7
8	0.61 – 0.70	143	0.09010	1447.3	–0.53	13
9	0.71 – 0.80	107	0.09590	1458.6	–0.31	12
10	0.81 – 0.90	120	0.11155	1534.3	0.66	8
11	0.91 – 1.00	115	0.11730	1604.1	1.53	4
12	1.01 – 1.20	178	0.11900	1637.4	2.46	1
13	1.21 – 1.40	127	0.11010	1579.5	1.28	6
14	1.41 – 1.60	59	0.13840	1631.9	1.34	2
15	1.61 – 1.80	67	0.11730	1603.8	1.16	5
16	1.81 – 2.00	62	0.12485	1628.4	1.34	3
Whole sample		2967		1484.0		

H = 25.17 df = 15 p = 0.05
H = 25.17 df = 15 p = 0.05 (adjusted for ties)

EXHIBIT 5B. MOOD'S MEDIAN TEST OF DIFFERENCES IN THE 5-YEAR COMPOUND AVERAGE REVENUE GROWTH RATES OF COMPANIES IN 16 DEBT/EQUITY RANGES

Category	Debt	N<=	N>	Median	Q3–Q1
1	0.00 – 0.00	397	355	0.097	0.202
2	0.01 – 0.10	158	161	0.110	0.183
3	0.11 – 0.20	116	114	0.105	0.198
4	0.21 – 0.30	100	96	0.105	0.145
5	0.31 – 0.40	97	100	0.111	0.166
6	0.41 – 0.50	81	72	0.094	0.197
7	0.51 – 0.60	68	74	0.112	0.200
8	0.61 – 0.70	77	66	0.090	0.155
9	0.71 – 0.80	57	50	0.096	0.160
10	0.81 – 0.90	59	61	0.112	0.164
11	0.91 – 1.00	50	65	0.117	0.194
12	1.01 – 1.20	80	98	0.119	0.193
13	1.21 – 1.40	61	66	0.110	0.261
14	1.41 – 1.60	25	34	0.138	0.171
15	1.61 – 1.80	31	36	0.117	0.246
16	1.81 – 2.00	27	35	0.125	0.204

Overall median = 0.107
Chi-square = 11.39 df = 15 p = 0.72

EXHIBIT 6. KRUSKAL-WALLIS TEST OF DIFFERENCES IN THE MEDIANS OF 5-YEAR COMPOUND AVERAGE STOCK PRICE GROWTH RATES OF COMPANIES IN 16 DEBT/EQUITY RANGES

Category	Debt	Number of Observations	Median	Average Rank	Z-Value	Rank
1	0.00 – 0.00	752	0.0432	1450.6	–1.24	11
2	0.01 – 0.10	319	0.0468	1455.4	–0.63	9
3	0.11 – 0.20	230	0.0684	1507.0	0.42	6
4	0.21 – 0.30	196	0.1020	1680.4	3.32	1
5	0.31 – 0.40	197	0.0636	1540.8	0.96	2
6	0.41 – 0.50	153	0.0408	1439.4	–0.66	13
7	0.51 – 0.60	142	0.0588	1537.5	0.76	4
8	0.61 – 0.70	143	0.0492	1418.2	–0.94	15
9	0.71 – 0.80	107	0.0636	1531.7	0.59	5
10	0.81 – 0.90	120	0.0546	1454.6	–0.38	10
11	0.91 – 1.00	115	0.0468	1444.0	–0.51	12
12	1.01 – 1.20	178	0.0504	1457.1	–0.43	8
13	1.21 – 1.40	127	0.0516	1498.6	0.20	7
14	1.41 – 1.60	59	0.0432	1378.2	–0.96	16
15	1.61 – 1.80	67	0.0684	1538.9	0.53	3
16	1.81 – 2.00	62	0.0534	1426.1	–0.54	14
Whole sample		2967		1484.9		

H = 17.04 df = 15 p = 0.32
H = 17.04 df = 15 p = 0.32 (adjusted for ties)

EXHIBIT 7. KRUSKAL-WALLIS TEST OF DIFFERENCES IN THE MEDIANS OF 5-YEAR COMPOUND RETURNS OF COMPANIES IN 16 DEBT/EQUITY RANGES

Category	Debt	Number of Observations	Median	Average Rank	Z-Value	Rank
1	0.00 – 0.00	752	0.5701	1528.3	1.64	3
2	0.01 – 0.10	319	0.6515	1545.4	1.36	2
3	0.11 – 0.20	230	0.5950	1500.9	0.31	5
4	0.21 – 0.30	196	0.6816	1583.5	1.68	1
5	0.31 – 0.40	197	0.4200	1454.0	–0.51	9
6	0.41 – 0.50	153	0.3574	1456.5	–0.41	8
7	0.51 – 0.60	142	0.4997	1515.0	0.44	4
8	0.61 – 0.70	143	0.2802	1357.0	–1.82	15
9	0.71 – 0.80	107	0.5000	1481.0	–0.04	6
10	0.81 – 0.90	120	0.5204	1409.8	–0.97	11
11	0.91 – 1.00	115	0.4805	1406.9	–0.98	12
12	1.01 – 1.20	178	0.4868	1401.6	1.32	13
13	1.21 – 1.40	127	0.5191	1471.4	–0.17	7
14	1.41 – 1.60	59	0.5152	1338.7	–1.32	16
15	1.61 – 1.80	67	0.5315	1447.7	–0.35	10
16	1.81 – 2.00	62	0.4397	1370.1	–1.06	14
Whole sample		2967		1484.0		

H = 16.54 df = 15 p = 0.35
H = 16.54 df = 15 p = 0.35 (adjusted for ties)

EXHIBIT 8. SUMMARY OF STATISTICAL TESTS ON FOUR PERFORMANCE MEASURES OF 16 CATEGORIES OF COMPANIES

Performance Measure	Kruskal-Wallis Test of Medians	Mood's Median Test
Return on equity	Difference	Difference
5-year revenue growth rate	Difference	No difference
5-year stock price growth rate	No difference	No difference
5-year total compound return	No difference	No difference

Structuring Islamic Investment Funds

The Legal, Tax, and Regulatory Aspects

W. Donald Knight, Jr.[*] and Henry Thompson[†]

ABSTRACT

Numerous legal and tax questions arise when structuring and effecting Islamic investment funds that will invest in the United States. Their answers must satisfy not only U.S. legal and tax considerations, but also the principles of the *sharī*a*. The issues include the following: How can the investment fund be structured to avoid or minimize U.S. income taxation and to avoid U.S. estate and gift taxes? Will the fund be closed-ended or open-ended, and what legal steps must be taken to effect that decision? How can one assure that the offering of shares or other interests in the investment fund complies with applicable securities laws of the U.S. and the comparable laws of the non-U.S. countries where shares of the fund will be placed? In what offshore jurisdiction should the investment fund be organized, and what legal form should the fund take to secure the legal rights of the fund's investors and to assure that investors' shares will not be subject to the U.S. estate or gift tax? What approvals are required from the government of the home country of the investment fund sponsor and of the non-U.S. countries where investors will be sought? In addition to these core issues, numerous others must be addressed in the formation of a properly structured Islamic investment fund.

I. INTRODUCTION

Until the early 1990s, institutions and individuals wishing to invest capital in Islamically acceptable investment funds[1] had very few choices available to them. A high percentage of the then-offered Islamic investment funds invested in *murāba®a* transactions involving precious metals or other commodities. Few of such funds invested in investment objects physically located in the United States or other Western countries, and, as a consequence, the complex legal, tax, and other regulatory considerations arising from investing in the United States and in most other Western countries were not called into play.

In more recent years, existing and newly-established Islamic banks and other financial institutions in the Gulf area and elsewhere in the Islamic world have responded to the desire of Islamic investors for investment products that are as diversified and sophisticated—and offer the same kinds of risk/return opportunities—as investment products available to non-Islamic investors in secular Western countries. As a part of this response, Islamic financial institutions have established Islamically-acceptable investment funds aimed at investing in a wide variety of investment objects, including (a) leased equipment; (b) real estate; (c) venture capital; (d) publicly-traded shares of companies that have been screened for *sharī*a* acceptability as to the nature of their businesses and of their equity and debt structures; (e) buy-outs of mature companies; and (f) financial instruments, such as participations in Islamically-structured financings.[2]

Many of the investments by these new Islamic investment funds are located in the United States, with the result that a complex web of U.S. legal, tax, and regulatory considerations is applicable to such funds. Properly organizing an Islamic investment fund that will invest in the United States involves handling legal, tax, and regulatory considerations under (a) the laws of the United States, (b) the laws of the "home countries" of prospective investors, (c) the laws of the "home country" of the fund sponsor, and (d) the laws of the "offshore" jurisdiction where the fund will be organized. This is a complex and multi-faceted undertaking, which this paper will address only in summary form.

If the effort to structure an Islamic investment fund that will invest in U.S. investment objects is properly handled, the fund in question should operate smoothly and (assuming good investment decisions are made) should produce after-tax returns to its Islamic investors consistent with the returns targeted by the Islamic financial institution sponsoring the fund. On the other hand, if structuring the fund is not property handled, the results could be far less than satisfactory. As an example, if the U.S. tax considerations involved in establishing an Islamic investment fund are not carefully considered, the worst case result could be a U.S. federal income tax of as much as

[*] Senior Partner, King & Spalding, Atlanta, Ga.

[†] General Counsel, First Islamic Investment Bank, Manama, Bahrain.

54.5% of the *income* generated by the fund and, in the case of a natural person investor who dies while holding an interest in the fund, a U.S. estate tax at a rate of up to 55% of the value of the deceased investor's interest in the fund, which generally would include the *capital* the deceased investor invested in the fund.

As noted, this paper will provide a summary of the various legal, tax, regulatory, and practical considerations involved in structuring Islamic investment funds that will invest in U.S. investment objects. Because this is a summary of those considerations, there are numerous technical aspects that are not addressed here. Further, the authors have sought to make this paper readable—and therefore have avoided listing the "exceptions to the exceptions" of which we lawyers are so fond.

II. COMMENTS AS TO DISCUSSION OF *SHARĪ'A* PRINCIPLES

At a number of points in this paper the application of *sharī'a* principles to issues relating to structuring Islamic investment funds will be discussed. The authors are amateurs, not experts, as to *sharī'a* matters. Their knowledge of this subject has been gained by working with the *Sharī'a* Advisory Boards of various Islamic banks and other institutions in structuring Islamic investment funds and handling Islamically-acceptable transactions, as well as from discussing such matters with qualified *sharī'a* scholars. Accordingly, the authors' discussions in this paper of *sharī'a* principles and their applications to various aspects of Islamic investment funds are presented in all humility, with the foreknowledge that certain qualified *sharī'a* scholars may take issue with various aspects of these discussions.

With that cautionary note, certain general statements as to *sharī'a* principles applicable to Islamic investment funds, in addition to such basic rules as the *sharī'a* ban on making money on money, may be described as follows:

- Regardless of the form of investment, Islamic investors directly (or indirectly through a share in the investment fund vehicle) must have an ownership interest in the *assets* in which an investment fund invests or the usufruct of such assets.
- The *sharī'a* is informed by notions of fairness and equity; for example, except under limited circumstances, an investor cannot be deprived of his ownership interest in an asset by forcing him to sell that interest. Even if an investor is willing by contract to forego an interest in an asset, this may not be permitted if the interest is regarded by a *Sharī'a* Advisory Board as an "inalienable right."
- Binding bilateral agreements to buy and sell assets at a predetermined price are generally not permitted.
- Parity is required; investors must share the risks of a venture equally. Having different classes of shares in the same investment pool, with different payment priorities and liquidation preferences, is not allowed.
- Different contractual obligations and rights in an investment object cannot run concurrently. In practice, this means thinking carefully about what agreements are required in connection with an investment fund and the way in which it will invest, segregating rights and obligations among the agreements, and sequencing the agreements in a particular way. For example, in a sale-leaseback transaction, the sale agreement cannot refer to the lease, because the lease must be an independent transaction that will occur at a future time.
- Under *sharī'a* principles, guaranties are supposed to be altruistic. A guarantor is understood to be a "white knight" who helps out a needy person. Accordingly, a guarantor is not permitted to accept compensation for giving his guaranty, nor can his guaranty go beyond the basic obligation that is guaranteed.
- Transparency is favored. Fees and mark-ups taken by parties involved with a properly structured Islamic investment fund must be disclosed.

Because U.S. law and the *sharī'a* share the philosophy that what is not prohibited is permitted, it is often possible to reconcile U.S. and *sharī'a* legal requirements to give Islamic returns that are comparable to those available in the secular market. Sometimes, however, conflicts arise between U.S. and *sharī'a* requirements that cannot be resolved easily. For example, in certain financing contexts *sharī'a* principles dictate the creation of an agency relationship, but such a relationship could give rise to an undesirable U.S. tax result.

III. BASIC ISSUES: ORGANIZATION OF ISLAMIC INVESTMENT FUNDS

There are a number of fundamental questions that must be answered when contemplating the organization of an Islamic investment fund. These include:

- In which country or jurisdiction should the fund be organized?
- How should the fund be structured, taking into account both tax and commercial considerations?
- Who will be responsible for identifying and managing the investments of the fund?
- Who will provide necessary administrative support for the fund?
- Who will market the shares or units in the fund?
- To whom will shares or units in the fund be marketed, and how?
- What approvals must be obtained from government authorities in the home country of the investment fund sponsor and in the non-U.S. countries where investors will be sought (*e.g.,* approval of the applicable Ministry of Finance and/or Commerce)?

In addition to these core issues, numerous other legal matters must be addressed in the formation of a properly-structured Islamic investment fund, including legal aspects of effecting basic business decisions for the fund (for example, drafting proper and enforceable agreements with third party investment managers, financial advisors, placement agents, and others providing services to the fund).

A. Where should the fund be organized? Issues as to Offshore Jurisdiction Alternatives

For purposes of this paper, the authors will assume that the fund will invest in investment objects (such as real estate, leased equipment, and the like) physically located in the United States. We will also assume that the investors in the fund will be natural persons or institutions resident or organized in the Gulf Cooperation Council ("GCC") countries of the Middle East.[3] In many instances, investors from such "home countries" invest in funds of the type under consideration here at least in part in order not to have "all of their eggs" in the Middle Eastern "basket"—both as a matter of economic risk and of perceived political risk. For this reason, we will assume here that the fund in question will not be based or organized in any GCC country but, rather, will be an "offshore" legal entity organized outside of the investors' home countries and outside the United States, where the investment objects of the fund will be located.[4]

Once it is determined that the fund will not be based in the investors' home countries or in the United States, there are numerous "offshore" jurisdiction alternatives available to be considered, including "European" offshore fund jurisdictions (such as Luxembourg, Ireland, and the Channel Islands); Bermuda; "mainstream" Caribbean offshore jurisdictions (such as the Cayman Islands, the British Virgin Islands, and the Netherlands Antilles); and offshore jurisdictions which to some extent may be considered in the category of exotica (such as the Turks and Caicos Islands, Gibraltar, Malta, Madeira, and Cypress).[5] In the past, certain offshore jurisdictions such as the Netherlands Antilles and the British Virgin Islands enjoyed tax benefits as to investing in the United States, arising out of the application to such jurisdictions of versions of the income tax treaties between their respective "mother" countries (i.e., The Netherlands and the United Kingdom) and the United States.

As a result of termination of treaties, the enactment of the branch profits tax provisions of the U.S. Internal Revenue Code (hereafter, the "U.S. Tax Code"),[6] the U.S. Treasury Department's ongoing attack on "treaty shopping," and other factors, it is the authors' view that it is no longer advisable to choose a non-U.S. jurisdiction that has a favorable income tax treaty with the United States, organize a "letterbox" fund corporation in that treaty-favored jurisdiction, and then seek to have the fund claim the benefits of the tax treaty to which the United States and the non-U.S. jurisdiction are parties. Particularly given that conclusion, it is fair to say there is no one "correct" answer as to which offshore jurisdiction should be used as the place of organization for a fund of the type in question here. Rather, determining the place of organization for such a fund will depend on making a judgment as to a number of issues pertaining to particular jurisdictions, including:

- The overall reputation of the jurisdiction.
- The degree of proven reliability and flexibility of local company, partnership, and other commercial laws.
- The quality and level of fees of local professionals (lawyers, auditors, and others) who will be associated to form and maintain the fund.
- The quality of the local infrastructure of the jurisdiction (including availability of reliable telephone and telefax service, e-mail, convenient air travel, and the like).
- Presence in the jurisdiction of substantial and reliable banks.
- The extent of local taxes and/or other governmental fees that will be applicable to a fund organized in the jurisdiction.
- The nature and extent of local regulation of investment funds.

- The extent to which corporate and other decision-making actions of a fund must physically take place within the offshore jurisdiction.
- Whether there is a local stock exchange (assuming there is a potential for trading the shares or units of the fund in the public markets).

B. How should the fund be structured?

How the fund should be structured (i.e., as a corporation, a unit trust, a limited liability company, a limited partnership, or the like) depends in large part on the nature and location of the fund's intended investments and the tax considerations that arise from making investments of the intended kind. Certain of the tax considerations involved are discussed below in Sections 4 and 5 of this paper.

Beside tax issues, there are a number of other basic considerations in deciding how a fund should be structured. One of those issues is whether the fund will be a closed-end fund (i.e., a fund which will admit investors only once or a very limited number of times, which will have a stated duration and which will not make ongoing provision for investors to have their shares or units redeemed by the fund) or an open-end fund (i.e., a fund which will admit investors on a regular basis, will have either no stated duration or at least will be long-term in nature, and which will provide investors the opportunity to have their shares or units redeemed by the fund periodically at the then-applicable net asset value of such shares or units). A closed-end fund could take the form of a corporation, a limited liability company, a limited partnership or certain other legal forms. An open-end fund typically would be in the form of a unit trust or in the form of a corporation where applicable company law permits regular redemptions of corporate shares.

Another significant issue as to how an investment fund should be structured relates to the transferability of shares or units in the fund in question. As discussed more fully below, it is generally highly advisable to restrict the offering, issuance and transferability of shares and units in an offshore investment fund so that such shares or units cannot be offered, issued, or transferred to a "U.S. person"[7]—given that the offer, issuance, or transfer of shares or units to a U.S. person would call into play the full array of U.S. securities laws relating to registration and offering of securities. Similar securities law considerations may suggest prohibitions on the offering, issuance, or transfer of shares or units to investors resident or organized in industrialized Western countries other than the United States, most of which have securities laws of their own that would apply to the offering, issuance, or transfer of shares or units in a fund to investors resident or organized in such countries.

Going beyond securities law considerations as to the issuance or transferability of shares or units in a fund, certain types of U.S. tax planning for a fund require (for example) that related or affiliated investors cannot hold more than a specified percentage of the outstanding shares or units of the fund. Where the desired tax consequences of an investment fund depend upon prohibiting concentration of ownership in the hands of a single investor or a limited number of unrelated or related investors or upon other fund ownership rules, it obviously is desirable to restrict issuance and transferability of shares or units in the fund to investors whose ownership and/or whose relationships and affiliations with other fund investors would not cause the fund to fail to qualify for the tax results intended by its tax planners.

Beyond Islamic considerations as to a fund's investment policy, other investment considerations will dictate how a fund should be structured. For example, it is often considered desirable for a fund to be structured with restrictions on short-term trading of its intended investment objects, to be structured so that the fund will not invest more than a certain stated percentage of its capital in any one type of investment, to prohibit or limit the extent to which the fund may invest its capital in other investment funds, and the like.

C. Who will be responsible for identifying, acquiring, and managing the investments of the fund, and how will the manager be compensated?

Another major issue that must be addressed in structuring any investment fund is who will be responsible for locating desirable investments for the fund, acquiring the investments on behalf of the fund, and thereafter managing them—and how will that person or entity be compensated. If a fund is in the form of an offshore corporation, the Board of Directors of the fund corporation will, of course, have final authority as to management of the corporation, including the management of its investments. In most cases, where an investment fund has a sponsor based thousands of miles from the United States in a GCC country of the Middle East, the fund will enter into a management contract with a U.S.-based investment manager under which, subject to the overall direction of the fund's Board of Directors (or the equivalent of such a Board, in the case of a fund that is not in corporate form), the investment manager will have the obligation to identify, execute, and manage the investments of the fund.

In the case of an Islamic investment fund, the agreement between the fund and the U.S. investment manager should contain clear guidelines as to the Islamic principles that the investment manager must follow. Even

with such principles specified, there will be variation from one type of investment fund to another as to the degree of discretion that should be granted to the investment manager in actually acquiring investments for the fund. If, for example, the investment fund is aimed at investing in shares of U.S. corporations that are publicly-traded on a U.S. stock exchange or NASDAQ, the "home country" Board of Directors of the fund may be willing in the management agreement to grant the investment manager discretion to make investments on behalf of the fund, subject only to its prescribed Islamic "screens" (a) as to the type of industries in which the fund may invest and (b) as to the degree of permissible debt capitalization of investee companies. The management agreement might also contain further non-Islamic investment rules relating to the degree to which investments of the fund may be concentrated in one particular industry sector, or the like.

On the other hand, if, for example, an investment fund will invest in U.S. real estate or controlling interests in U.S. business corporations, it is highly unlikely that the fund's Board of Directors (or its equivalent in a fund not organized as a corporation) would be willing (or well advised) to give the U.S. manager authority actually to go forward with any specific investment without the detailed review and approval by the Board and by the fund's *sharī^ca* advisors of each proposed investment and of the manner in which the investment will be acquired and, perhaps, financed. This follows, not only from the complexity of real estate and "private equity" investments, but also from the fact that investments of these types typically involve more specialized *sharī^ca* concerns than the more generalized "Islamic screens" for investments in shares of publicly-traded corporations. In particular, it should be noted that the *sharī^ca* rules applicable to acquiring and holding a controlling share interest in a venture or company are markedly different from the rules applicable to acquiring a minority "portfolio" investment interest in shares of a publicly-traded company.

As to the compensation of a U.S. investment manager by an offshore Islamic investment fund, arrangements vary from one type of investment object to another. Given the highly competitive nature of "money management" in the United States, an Islamic investment fund aimed at investing in Islamically-acceptable shares of publicly-traded U.S. corporations likely could negotiate a management fee based on a quite low percentage of the market value of the fund, as in effect from time to time. Because of the special Islamic considerations involved, such a fee might be slightly higher than fees paid to U.S. money managers who manage secular mutual funds. However, it is likely that a first quality U.S. investment manager would be willing to manage an Islamic fund of a reasonable size aimed at investing in shares of U.S. publicly-traded corporations without being given an incentive fee arrangement.

By contrast, where an Islamic investment fund will invest in such investment objects as U.S. real estate or U.S. private equity situations, it is highly likely that the U.S. investment manager will propose to charge a periodic fee based on the amount of capital committed by (or to) the fund, as well as an incentive fee, which will be in the form of a percentage of the fund's realized profits. Such an incentive fee would typically be payable only after the investors have received from the fund (a) a return of all of their invested capital and (b) a specified "hurdle" rate of return on that invested capital.

In many cases, U.S. investment managers will wish to receive such an incentive fee in a way that will allow them, for U.S. tax purposes, to have this amount taxable at the more favorable, long-term U.S. capital gains tax rate applicable to natural persons, rather than receiving fee income that will be subject to taxation at higher U.S. "ordinary income" rates. Structuring incentive fee arrangements for U.S. investment managers to achieve this tax result may give rise to *sharī^ca* concerns if the incentive fee claim of the U.S. investment manager to a share of the fund's profits is (to use a typical example) in the form of a preferential partnership return having a priority over the partnership rights of the other fund investors. In some instances, *sharī^ca* advisors are willing to approve incentive fees payable to investment managers that are structured in the form of a priority capital gains partnership return to the manager, after provision for an initial, "lock step" distribution to all investors, on the theory that this structuring was done to satisfy the tax concerns of the manager and that the manager, in fact, is being paid an Islamically-acceptable profit share or fee for his/its services as a *mu∞ārib*.

D. Who will provide necessary administrative support for the fund?

Each offshore Islamic investment fund will need certain types of administrative support, including an independent auditing firm, a tax return preparer, a firm that can prepare and make all required government filings (including filings in the offshore jurisdiction that is employed as well as the United States), a reliable bank that will provide all required banking services (including Islamically-acceptable short-term investments, such as *murāba®a* investments), and a sophisticated law firm in the offshore jurisdiction accustomed to dealing with investment fund issues.

Beyond these basic administrative services, depending on the types of investments to be made by a particular fund, other services may be required. For example, in the case of an investment fund that will invest in

publicly traded securities, it will be necessary to employ a brokerage firm and a custodian to hold the securities portfolio of the fund in safe keeping. If a fund will invest in real estate, it will not only typically utilize an investment manager to source, effect, and provide overall asset management services; it will also often need to have on-site property managers at each of its properties. In such a case, an issue will be whether the fund should out-source these property management services or directly employ property managers itself.

Investment funds also will typically employ share transfer agents, both in the case of closed-end and open-end funds. Where a fund is open-end in nature, the fund likely will employ the same agent to handle redemptions of its shares when investors exercise their redemption rights, in accordance with the fund's governing instruments.

E. Who will market the shares or units in the fund?

Each investment fund sponsor will have in mind a target market of investors for shares in its fund. This certainly will be the case with sponsors of Islamic investment funds who/which will focus on institutional and private investors that are either insistent upon, or interested in, Islamically acceptable investment proposals. The shares or units of all existing Islamic investment funds known to the authors were placed privately with investors, rather than involving a public offering of such securities. It is likely that this private placement approach will continue, for the foreseeable future, for Islamic investment funds.

In a private placement of shares or units in an Islamic investment fund, the practical issue that must be faced is whether the placement effort will be undertaken solely by the fund sponsor (which generally will be an Islamic bank or other financial institution) or, in whole or in part, through the services of a third party placement agent. In either case, Islamic investment funds typically provide for investors to pay to the fund sponsor an "organization and placement fee," often in the range of 1% to 2% of the funds committed by each investor. Usually this fee is payable by the investors, in addition to the amount of capital they commit to the fund, and provision is made to allow the fund sponsor to share the fee with a third party placement agent.

Depending on the country or countries in which shares or units in an Islamic investment fund will be placed, there may be a necessity for the sponsor or placement agent to register with the local government or for the offering materials as to the fund to be approved by the local government before placement efforts are undertaken in the country in question. The requirements of local laws in these respects should be determined before any placing efforts are undertaken in a particular country.

F. To whom will shares or units in the fund be marketed and through what methods?

Securities laws and laws of similar import will strongly affect considerations regarding to whom shares or units in an investment fund will be marketed and how the placement effort should be undertaken. Speaking generally, if no shares or units in an investment fund are ever offered to U.S.-based investors, the principles of Regulation S under the U.S. Securities Act of 1933, as amended, clearly provide that the investment fund will not be required to register its shares or units with the U.S. Securities and Exchange Commission (the "SEC"). Given the complexity of making a proper registration with the SEC, this is a desirable result. Accordingly, the legal documentation under which an offshore Islamic investment fund is established generally should contain specific, strict provisions prohibiting any U.S.-based investor from acquiring any shares or units in the fund during its placement period, as well as prohibiting a post-placement transfer of shares or units from an original investor to the U.S.-based investor.

Going beyond the registration requirements of the U.S. securities laws, which, as indicated, happily can be avoided by assuring that no U.S.-based investor acquires shares in the offshore Islamic investment fund, there are other U.S. securities law considerations that are called into play. Specifically, where an offshore investment fund (even one having only non-U.S. investors) will invest in U.S. situs investment objects, employ U.S. investment managers and professionals, and have other contacts with the United States, it is not possible to say with certainty that the so-called "anti-fraud" provisions of Regulation 10-b5 under the U.S. Securities and Exchange Act of 1934, as amended, will not be applicable.[8]

This means that a well-advised sponsor of an offshore Islamic investment fund that will make investments and/or have other contacts in the United States will assure that the placement documentation for the fund is drafted to give prospective investors a very clear, "U.S. standard" description of the fund, the legal rights of investors in the fund, the nature of the investments that the fund will make, the "track record" of the fund sponsor and the fund investment manager, the risks involved in investing in the fund, conflicts of interests that may be involved as between investors and the fund sponsor and manager, the nature and amount of all fees payable to the fund sponsor and manager, and other matters that would be material to an investor in making a decision to invest in the fund. (The authors are aware that the statement made above to the effect that placement documentation for an offshore Islamic investment fund should be prepared to the level of the "U.S. standard" may be met in some quarters with

concern, concern that typically would arise from familiarity with overly-lengthy, repetitive, and complex prospectuses and other placement documentation that are sometimes seen in the U.S. securities market. In the authors' view, first quality placement documentation meeting the "U.S. standard" can be prepared and presented in a reasonable manner. Moreover, the authors' experience is that prospective investors in the Middle East appreciate professional, first quality placement documentation and, through the efforts of many involved in the Islamic investment field, have come to expect placement documentation of this quality.)

The issues presented by the U.S. securities laws when an offshore Islamic investment fund will invest in the United States, or otherwise have significant contacts there, are not the only securities law issues involved in placing interests in an Islamic investment fund with investors in GCC countries. Rather these countries in the Middle East themselves often have securities laws, or laws of similar import, which must be observed.

As a general matter, the regulatory environment regarding offering investments in the Middle East is uncertain. Areas of concern are a general lack of clarity in applicable laws as to the placement of fund investments with local investors and inconsistent enforcement of such laws. In the GCC, the Bahrain Monetary Agency is given notably high marks as a bank and investment regulator, however.

Generally, securities cannot be issued or offered for subscription or sale in the member countries of the GCC without the permission of the Ministry of Commerce or another, comparable regulatory body of the country in which the placement will occur. No explicit private placement exception exists in the laws of any of the GCC countries.

Most Middle East countries do not have a clear regulatory scheme governing the registration of the contents of fund offering documents. Moreover, no statutory antifraud provisions with clear disclosure standards are found in the laws of Middle East countries. In some countries it is a requirement that all investment offerings must be placed through licensed local entities or entities whose corporate or charter objects permit investment placement activities.

Because offshore offerings in the Middle East in many cases are subject to an uncertain legal environment, self-regulation, "staying with the herd," and monitoring the local situation closely are essential. In no case should an offering be made in a GCC country though public means, such as newspaper advertisements, public solicitations, or the like.

IV. OVERVIEW OF U.S. TAX CONSIDERATIONS: ISLAMIC INVESTMENT FUNDS INVESTING IN THE U.S.

Any investment by an offshore Islamic investment fund in U.S.-situs investment objects will call into play the U.S. tax laws. Obviously, in order to attract investors, such a fund must produce a competitive *after-tax* return to its investors. In order to do so, U.S. tax must be minimized or avoided at two stages, namely (a) while each particular U.S. investment is held by the investment fund, and (b) when that investment is sold and the sales proceeds are repatriated from the United States. The following is a very summary description of the basic U.S. income tax rules and their general application to offshore investment funds, followed in Section 5 by a more specific discussion of the application of such rules to offshore Islamic investment funds that invest in U.S.-situs leased equipment.

A. Focus on Private Sector, Non-Charitable Islamic Investors, Not Government Agency Investors or Charitable Foundation Investors

It should be noted that the tax discussion that follows addresses only the tax consequences of investments in offshore Islamic investment funds by private sector, non-charitable investors. Under U.S. law, investments in the United States by "integral parts" of non-U.S. governments and by certain "controlled entities" of non-U.S. governments are entitled to a special, limited exemption from U.S. taxation, which generally applies in the case of U.S. investments in stocks, bonds, or other securities that do not constitute "commercial activities."[9] (Examples of "integral parts of non-U.S. governments that are entitled to the indicated limited exemption from U.S. tax on their U.S. investments are the Kuwait Investment Authority and the Abu Dhabi Investment Authority.) The U.S. tax rules applicable to investments in the United States by such non-U.S. governments or their controlled entities is beyond the scope of this paper.

Also under U.S. law, properly structured non-U.S. Islamic charitable, religious, or educational foundations, bequests, trusts, or estates could enjoy a tax exemption for certain types of U.S. income they might derive from U.S. investments. As with U.S. investments by non-U.S. governments and their controlled, non-commercial entities, the U.S. tax rules governing the exemption or non-exemption from U.S. income tax applicable to U.S.-source investment income earned by such non-U.S. Islamic "charitable" entities is also beyond the scope of this paper.

B. U.S. Tax Treaties and International Tax Planning

The United States is a party to income tax treaties with a large number of other countries. Such tax treaties (often called "double taxation agreements") are generally aimed at preventing double taxation (i.e., taxation both by the United States and by the other "treaty country") (1) of income that a U.S. person may derive from sources in the other treaty county and (2) of income that a person or legal entity based in the treaty country may earn from sources within the United States. The United States does not have an income tax treaty with any GCC member country—quite likely because, while such countries typically impose a tax on income that a U.S. person or legal entity may derive from the GCC country, such countries do not have an income tax that applies to their own natural person residents or to corporations owned by them.

Income tax treaties play a major role in structuring investments in the United States by persons entitled to the benefit of such a treaty. Given that the United States does not have a treaty with any GCC member country, the only possibility for utilizing an income tax treaty in planning for an offshore investment fund owned by Islamic investors from countries in the GCC would be to organize the investment fund corporation (or another legal entity that may be utilized as the fund) in a country that does have a favorable income tax treaty with the United States. As noted above, such an effort is fraught with potentially adverse tax consequences.

For one thing, the United States has an income tax treaty only with countries that themselves have an income tax system. Obviously, it would make no sense to base an investment fund in a specific country, in an effort to avoid United States tax on the earnings of the fund—and, as a result, subject the fund's earnings to treaty country taxation that might even exceed otherwise applicable U.S. taxes. Further, even if the treaty country tax rules would allow special steps to be taken so that the treaty country's own taxes would not apply to U.S. source income earned by an investment fund based in that country, attempted utilization of the tax treaty in question between the United States and the treaty country "home" of the investment fund would be subject to challenge by the U.S. taxing authorities who, as noted above, are engaged in a war against this type of tax planning, which is typically referred to as "treaty shopping," and the tax treaty benefits would also be subject to challenge under the U.S. "branch profits tax" rules.[10]

In the authors' view, given these risks, it is much preferable to structure an offshore Islamic investment fund utilizing the opportunities available under internal U.S. tax law, rather than attempting to "treaty shop."

C. A Starting Point in Investment Fund Structure Planning: The U.S. Estate and Gift Taxes

In addition to its income tax, the United States has an estate tax and a gift tax. The estate tax applies to any "U.S. situs" assets that a non-U.S. natural person owns at the time of his death, and the gift tax applies to lifetime gifts by a non-U.S. natural person of "U.S. situs" assets. U.S. situs assets for estate tax purposes include, for example, interests in U.S. real estate, shares of U.S. corporations, and personal property (such as leased equipment) that is physically located in the United States. The U.S. gift tax does not consider intangible assets (such as shares of corporate stock) to have a U.S. situs.

The U.S. estate and gift tax rates are quite high, rising to 55% of the U.S. estate (or gift) of a non-U.S. person to the extent that the estate (or gift) has a value at the time of the person's death (or gift) of over U.S. $3 million. Moreover, as noted in Section 1, because of their application to the value of an investor's interest, the U.S. estate or gift tax generally applies to the actual *capital* invested in the United States by a non-U.S. natural person, not merely the *income* from an investment.

In the context of an offshore investment fund, the U.S. estate or gift tax could apply to a non-U.S. natural person investor's investment in the fund if the offshore fund structure were viewed by U.S. tax authorities as being "tax transparent," as could be the case with an offshore fund structured as a partnership or, potentially, as a unit trust. Fortunately, it is clear that if an offshore fund is structured as a non-U.S. corporation and appropriate corporate formalities are followed by the fund corporation,[11] the U.S. estate or gift tax will not be applicable to shares in the fund corporation held by a non-U.S. natural person investor who gives such shares away during his lifetime or owns them at the time of his death. This is the case even though all of the assets of the offshore fund corporation are located in the United States. Also, the U.S. estate tax obviously does not apply to institutional investors (such as corporations, government agencies, and the like); such entities do not "die."

Because of the potentially devastating consequences of the U.S. estate or gift tax, with very rare exceptions offshore Islamic investment funds should be structured as non-U.S. corporations or as legal entities that the U.S. tax authorities will treat as non-U.S. corporations.

D. Basic U.S. Income Tax Rules: Islamic Investment Funds Structured as Non-U.S. Corporations

Generally, U.S. income tax rules divide the income that a non-U.S. fund corporation derives from U.S. sources into two categories, namely (1) income of the offshore fund corporation derived from a U.S. "trade or

business," and (2) "passive" income (i.e., income not treated as "effectively connected" with a U.S. "trade or business" of the non-U.S. fund corporation). U.S.-source passive income for this purpose generally would include income from rents, royalties, interest, and dividends.

A non-U.S. fund corporation is subject to the regular U.S. corporate tax (now at a maximum rate of 35%) on its *net* income derived from a U.S. trade or business, with such net income being determined by deducting all ordinary and necessary expenses of the business, plus the non-cash allowable deduction for depreciation of business assets. In addition, when the after-corporate tax "earnings and profits" of the non-U.S. fund corporation are removed from the United States (or are deemed removed, under complicated rules), such after-corporate tax earnings and profits will be subject to an *additional* "branch profits" tax, at the rate of 30%. The application of the regular U.S. corporate tax at the 35% regular corporate rate *and* the application of the 30% branch profits tax on the 65% of that income remaining after the corporate tax has been paid results in a combined effective tax rate of 54.5%.

Obviously, virtually no U.S. investment could be expected to be so successful that, after application of a 54.5% tax, the remaining proceeds available to the Islamic investors would constitute an acceptable return to such investors. Plainly, then, it is essential to structure offshore Islamic investment funds so that the U.S. source income such funds derive will not be treated as effectively connected with a U.S. trade or business and subjected to this kind of double taxation.

In this context, it is obviously necessary to determine what type of activities or investments by a non-U.S. fund corporation are viewed by the U.S. tax authorities as giving rise to a U.S. "trade or business." Generally speaking, with certain notable exceptions (including an exception for trading in U.S. stocks and other securities[12]), any considerable, continuous, and regular commercial activity[13] conducted in the United States by a non-U.S. fund corporation (acting through its non-U.S. officers or its U.S. agents) run a risk of being viewed by U.S. tax authorities as constituting a U.S. "trade or business" for this purpose. Further, under the Foreign Investment in Real Property Tax Act[14] provisions of the U.S. Tax Code, any gain realized by a non-U.S. investment fund from the sale of U.S. real property held directly by the offshore fund corporation will be deemed to be income effectively connected with a U.S. trade or business of the fund.

By contrast to the described taxation of the *net* amount of "trade or business" income realized by a non-U.S. fund corporation, the *gross* amount of U.S. source "passive" income (such as rents, royalties, interest, and dividends) realized by a non-U.S. fund corporation is subject to a 30% withholding tax. This 30% tax, on its face, appears to be a significant improvement over the potential 54.5% combined regular corporate and branch profits tax that could apply to "trade or business" income. However, it should be noted that the 30% withholding tax applies to the *gross* amount of "passive" income realized by a non-U.S. fund corporation, without allowance for deductions of any expenses related to the income in question.

E. An Important Tax Planning Tool: The "Portfolio Interest" Exemption from U.S. Withholding Tax

The U.S. tax law rules contain a special provision under which interest paid from U.S. sources to a non-U.S. entity, such as an offshore fund corporation, will be completely exempt from U.S. tax if the interest meets the technical requirements necessary for it to qualify as "portfolio interest." To qualify as portfolio interest, the instruments pursuant to which the interest is paid to an non-U.S. investor generally should be structured to be registered obligations, and the non-U.S. recipient must file with the payer of the interest a specific U.S. tax form, certifying that the recipient is, in fact, a non-U.S. entity.[15]

Further, even if all formal requirements are satisfied to assure that interest being paid to a non-U.S. recipient qualifies as a tax-exempt "portfolio interest," the tax-exemption will not apply if such interest is paid to either of two categories of non-U.S. recipients. First, U.S.-source interest cannot qualify as tax-exempt "portfolio interest" if it is paid to a non-U.S. fund corporation (or other non-U.S. investor) which actually, or under complicated attribution of ownership rules, owns 10% or more of the voting stock of the U.S. corporation that pays the interest.[16] Second, interest paid from U.S.-sources to a non-U.S. bank[17] will not qualify as tax-exempt "portfolio interest" if the interest is paid pursuant to a loan made by a non-U.S. bank in the ordinary course of its banking business.

F. The Use of "Interest" in U.S. Tax Planning for Islamic Investors

Interest is generally a highly effective U.S. tax-planning tool for non-U.S. investors making U.S. investments. This follows because interest is generally a deductible expense in calculating the *net* income of a non-U.S. investor's U.S. trade or business that is subject to the U.S. corporate tax. Further, where "interest" can be structured to qualify as tax-exempt "portfolio interest," such interest can be paid out of the United States free of tax.

The obvious issue in the context of planning for Islamic investment funds is whether interest-bearing loans can ever be Islamically acceptable.[18] Based on numerous discussions that the authors have had with Islamic scholars, it appears that payments that U.S. tax authorities would characterize as "interest" for U.S. tax purposes can, under specific circumstances, be structured in a manner that is consistent with *sharīʿa* principles.

For example, assume (1) that there is a non-U.S. holding company owned by an Islamic investor that owns 100% of the shares of a U.S. corporation ("USCo"), (2) that the offshore holding company has invested U.S. $1 million in the share capital of USCo, and (3) that USCo needs an additional U.S. $1 million to expand its business. Most *sharīʿa* scholars apparently would agree that the Islamic investor could cause his non-U.S. investment company to lend the additional, required U.S. $1 million to its USCo subsidiary without violating Islamic principles. This follows because the loan in question would not place the "burden of interest" on anyone except USCo, which is wholly-owned by the Islamic investor's offshore holding company. In other words, lending "to one's self" appears to be permissible under *sharīʿa* concepts. (Obviously, in the example described here, the interest paid by USCo to the "parent" offshore investment company would be subject to the 30% U.S. withholding tax because the Islamic investor's offshore investment company owns 10% or more (actually, 100%) of the voting stock of USCo.)

Taking the example a step further, assume (1) that eleven different Islamic investors, unrelated one to another, each own a separate non-U.S. investment company and (2) that each of these eleven offshore investment companies owns 9.09% of the shares of a specific USCo. Assume further that the USCo is in need of U.S. $1 million of additional capital and that each of the eleven Islamic investor-owned offshore corporations makes a loan to USCo in principal amount equal to 9.09% of U.S. $1 million (in other words, the percentage of the overall loan made by each of the eleven offshore investment corporations is exactly the same as the percentage of the shares of USCo owned by that offshore investment corporation). In this case, none of the offshore investment corporations would own 10% or more of the voting stock USCo and, accordingly, assuming that the technical requirements for "portfolio interest" were met, interest paid by USCo to each of the offshore investment corporations should be U.S. tax-exempt.[19]

The question that arises is whether this more complicated structure would be Islamically acceptable. The authors have been advised by numerous *sharīʿa* scholars that the described structure would be viewed for *sharīʿa* purposes as acceptable "self-lending," on the theory that, because each of the offshore investment corporations would be making a loan directly in proportion to that offshore investment corporation's percentage share ownership in USCo, none of the offshore investment corporations would be placing the "burden of interest" on the ownership position of any of the other offshore investment corporations. This self-lending principle affords a number of opportunities for tax planning for non-U.S. Islamic investment funds.

The "portfolio interest" tax exemption also offers tax-planning opportunities in situations not involving self-lending from offshore Islamic investment corporations to USCos. For example, where an equipment lease provides by its terms that the lessee of the equipment will have acquired full ownership of the leased equipment if the lessee makes all of the required lease payments (and, in some cases, exercises a nominal, end-of-lease purchase option), U.S. tax authorities normally will view the equipment lease in question as being a financing, will treat part of each of the rental payments made by the lessee as "interest" for U.S. tax purposes, and will view the lessee as the "tax owner" of the equipment throughout the term of the lease. The *sharīʿa* scholars and *Sharīʿa* Advisory Boards with whom the authors have had discussions on this subject generally take the position that, if a lease is otherwise Islamically-acceptable,[20] the fact that U.S. tax authorities choose to treat part of the rental payments as "interest" for U.S. tax purposes is irrelevant. This view of such equipment leases gives rise to structuring possibilities for Islamic equipment leasing funds, as discussed in more detail in Section 5 below.

V. Overview of Tax Structures for Islamic Equipment Leasing Funds

A. The Distinction between "*Ijāra Muntahīa bi-al-Tamlīk* Leases" and "Operating Leases"

As noted above in Section 4, where an equipment lease provides by its terms that the lessee of the equipment will become the owner of the equipment at such time as the lessee has made all of the specified rental payments and, under some leases, has exercised an end-of-lease purchase option for a nominal amount or made a "bullet" payment of the unpaid acquisition cost of the equipment, U.S. tax authorities generally will view the equipment lease in question as being a financing and will treat part of each of the rental payments made by the lessee as "interest" for U.S. tax purposes. Such an equipment lease is generally referred to as an "*ijāra muntahīa bi-al-tamlīk*." As also noted above, *sharīʿa* experts with whom the authors have discussed such leases have generally taken the position that, if a lease is otherwise Islamically-acceptable, the fact the U.S. tax authorities choose to characterize part of the rental payments as "interest" for U.S. tax purposes is of no concern, insofar as the *sharīʿa* analysis of such a lease is concerned.

By contrast to *ijāra muntahīa bi-al-tamlīk* leases, under the terms of an "operating lease," another, frequently-used type of equipment lease, the lessee of the equipment does not become the owner of the equipment after the lessee has made all lease payments that are required pursuant to the terms of the lease and does not have a nominal end-of-lease option to purchase the equipment. Rather, in the case of an operating lease, the lessor remains the owner of the equipment at the end of the lease term and is then faced with the need to "re-market" the equipment, either by leasing it to the same or another lessee or by selling it in the market. In the case of an operating lease, the lessor is viewed for U.S. tax purposes as the owner of the equipment and has the right to claim a depreciation deduction each year, as well as other ordinary and necessary business expenses, arriving at the lessor's *net* income which is subject to U.S. tax.

B. A Possible Structure for an Islamic Equipment Leasing Fund Holding Only Equipment Subject to *Ijāra Muntahīa bi-al-Tamlīk* Leases

As indicated above, U.S. tax authorities generally will treat part of each rental payment under an *ijāra muntahīa bi-al-tamlīk* lease as being interest for U.S. tax purposes. Moreover, as discussed in Section 4.5 regarding "portfolio interest," interest paid to a non-U.S. person or entity that qualifies as "portfolio interest" can be paid out of the United States free of U.S. tax. Most *ijāra muntahīa bi-al-tamlīk* leases for U.S. equipment are made under a U.S. domestic "market standard" lease form which does not contain the requisite formal language necessary for the interest element of the rental payments paid under such leases to satisfy the portfolio interest rules. Normally it would not be practical to try and amend individual equipment leases in order to include within the terms of such leases the language necessary to make the interest element paid as part of the rent thereunder qualify as portfolio interest.

Accordingly, given the practical inability to amend most standard equipment leases in order to make provision so that rental payments under such leases made to an Islamic offshore investment fund corporation will be free of U.S. tax, it is necessary to interpose between the lessee and the offshore fund a structure that will cause the payments to satisfy the requirements of being treated as portfolio interest. For example, *ijāra muntahīa bi-al-tamlīk* leases having terms that do not satisfy the requirements of the portfolio interest rules could be placed in a U.S. "pass-through trust,"[21] and the pass-through trust could issue "pass-through certificates" to the offshore fund corporation, with the pass-through certificates being drafted so that their terms do satisfy the requirements of the portfolio interest rules.

An alternative may be to have the equipment leases that, by their terms, do not satisfy the portfolio interest rules, held by a "special purpose corporation" (an "SPC"). In form, the SPC would "sell" the leased equipment to the offshore fund corporation, which would then lease the equipment back to the SPC (subject to the existing end-user leases) pursuant to the terms of a "master lease." The master lease would be written so as to contain the provisions required to satisfy the portfolio interest rules. Assuming this structural arrangement is handled in a proper manner, the payments under the master lease received by the offshore fund corporation should be exempt from U.S. tax under the portfolio interest provisions.

Beside the technical requirements necessary to satisfy the portfolio interest rules, so that the interest element payable under *ijāra muntahīa bi-al-tamlīk* leases can be received by the offshore fund corporation free of U.S. tax, it is essential with a lease structure of this kind to assure that the activities of the offshore fund corporation do not give rise to a "U.S. trade or business"—because the "trade or business" tax rules of the U.S. Tax Code "trump" the portfolio interest rules. Accordingly, if the offshore fund corporation's U.S. activities are viewed by the U.S. taxing authorities as causing the offshore fund corporation to be engaged in a U.S. trade or business, the consequence will be the application of the regular U.S. corporate tax rates (current maximum: 35%) and the U.S. branch profits tax (30%), for a total tax burden to the offshore fund corporation of 54.5%—even if the leases in question and all other aspects of the transaction *in form* satisfy the portfolio interest rules. In short, the "swing" in this situation is between a 0% tax rate and a potential overall tax rate of 54.5%.

It can be strongly argued that *ijāra muntahīa bi-al-tamlīk* finance leases are "securities" within the meaning of the U.S. Treasury Regulation that holds that no U.S. trade or business will arise when an offshore corporation effects transactions in the United States "in stocks or securities" for the offshore corporation's own account. If so, an offshore fund corporation would effectively fall into the "safe harbor" from being held to be engaged in a U.S. trade or business.[22] Nonetheless, given the potential 54.5% tax rate if this "safe harbor" is not applicable, prudence dictates that steps be taken to minimize the U.S. activities of an offshore fund corporation that invests in such U.S. leases. Such steps could include (a) having the offshore fund corporation enter into a "Master Purchase Agreement" with its U.S. leased equipment "originator" under which the originator would, from time to time, present to the offshore fund corporation at the fund's office *outside the United States* a description of leased equipment that is for sale, together with details concerning the leases related to that equipment, the credit strength of the lessees, etc., and

(b) having the offshore fund corporation review the materials presented by the originator *outside the United States* and likewise communicate all decisions as to whether it will purchase the equipment from *outside the United States*.

C. A Possible Structure for an Islamic Equipment Leasing Fund Holding Only Operating-Leased Equipment

When an offshore fund corporation purchases equipment subject to an operating lease, it is clear for U.S. tax purposes that the fund is acquiring the actual, U.S. situs equipment. As a consequence, the offshore fund corporation in such case does not have any possibility of arguing, as in the case of *ijāra muntahīa bi-al-tamlīk* finance leases, that what is being purchased is a "security" that satisfies the "no U.S. trade or business" safe harbor referred to above in Section 5.2. Further, the necessary activities to maintain, insure, and, ultimately, re-market the purchased equipment will be considered activities of the offshore fund corporation that owns the equipment. This will be the case even if such activities are conducted (in the case of maintenance and insurance) by the lessee pursuant to the operating lease or (in the case of re-marketing) by a leased equipment originator acting for the offshore fund corporation.

It appears quite likely that such activities would be sufficient to cause the offshore fund corporation to be engaged in a U.S. trade or business, if it directly owns the U.S. situs equipment that is leased to third parties pursuant to operating leases. As noted above, such treatment could result in a total tax rate of 54.5% on the *net* income realized by the offshore fund corporation from payments it receives under the operating leases and proceeds realized when it sells or otherwise re-markets the leased equipment, once the operating leases have terminated.

A much better structural approach where an offshore fund corporation will acquire equipment subject to operating leases is to form a U.S. corporation (a "USCo") to hold the leased equipment. The voting common stock of the USCo (constituting, for example, 2% of the total capital stock of the USCo) would be held by a party (perhaps the fund sponsor) unrelated to the Islamic investors who own the shares of the offshore investment fund corporation. The investment fund corporation would subscribe (for example) for 98% of the capital stock of the USCo, which would be in the form of non-voting common stock of the USCo. The party holding the voting common stock of the USCo and the offshore fund corporation would also provide capital to the USCo in the form of interest-bearing, "self-lending" loans to the USCo, made pro-rata to their respective percentage interests in the capital stock of the USCo. The promissory notes issued by the USCo to reflect the self-lending would be in registered form, and the other requirements of the portfolio interest rules with respect to such loans would be satisfied.

Taking this approach, the *net* income of the USCo holding the equipment that is subject to operating leases would be taxable at the regular U.S. corporate rates (current maximum: 35%). However, in arriving at the amount of *net* income of the USCo each year, the USCo would be entitled to deduct all of its ordinary and necessary business expenses, including interest paid on the registered promissory notes (assuming these notes are structured so as to qualify as "true debt"—and not as a form of equity of USCo, and assuming that the so-called "earnings stripping" rules of the U.S. Tax Code[23] are not implicated), as well as depreciation on the leased equipment.

It would be necessary to do appropriate tax projections on the specific facts involved in a proposed fund to ascertain whether this structure would produce an acceptable after-tax return to the offshore fund corporation and its Islamic investors. However, in many cases of this type, it is likely that the U.S. corporate tax payable by the USCo while the equipment is held by it would be quite low. When the USCo sells its equipment after the operating leases have expired, the income realized by the USCo from realization of this "residual value" may bear an increased tax burden. Finally, when the USCo is completely liquidated and cash is paid out to the offshore fund corporation and to the party holding the (2%) voting common stock and a pro-rata part of the registered promissory notes, there should be no second level of corporate tax analogous to the branch profits tax.

In this described structure for holding equipment subject to operating leases, interest paid to the unrelated party holding the voting common stock of the USCo (2% of its total capital stock) and a registered promissory note of USCo (2% of the total principal amount of the USCo notes) would be subject to a 30% U.S. withholding tax, because such party would own 10% or more (actually, 100%) of the voting stock of USCo, the payer corporation. If the party subject to this tax is the sponsor of, or another service provider to, the offshore fund corporation, such party may find this tax cost acceptable.

VI. CONCLUSION

Even more innovative Islamic investment funds doubtless will be developed by Islamic banks and other Islamic financial institutions in the future. Where such funds will invest in the United States (or in other Western countries with complex legal, tax, and regulatory regimes), careful structuring will continue to be essential to achieving the desired investment results for Islamic investors.

[1] As used in this paper, the term "investment funds" refers to any type of collective or pooled investment arrangement.

[2] In recent years, lawyers working in the area of Islamic finance have devised numerous innovative Islamically-acceptable financing structures, including *Sharī'a*-compliant financing arrangements functionally equivalent to mortgages on U.S. real property, LBO financings for corporate buyouts, and real estate development financing arrangements.

[3] While this paper will focus on Islamic investment funds aimed at Middle Eastern investors based in the GCC countries, many of the concepts discussed here would be equally applicable to Islamic investment funds that seek investors resident or organized elsewhere in the Islamic world.

[4] In certain instances fund sponsors consider it desirable to structure an investment fund to include special political emergency protective provisions, aimed at protecting the fund's assets from the potential adverse effects of a political emergency in the home country (or countries) of the fund's investors—which in this case would be the GCC countries of the Middle East. Analysis of such political emergency "failsafe" structures is beyond the scope of this paper. See generally, Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law & Taxation Publishers, 1988), Chapter 18 ("Structuring to Protect U.S. Assets Against the Effects of Foreign Political Emergencies").

[5] In recent months, the Organization for Economic Cooperation and Development (the "OECD") has actively opposed jurisdictions it considers as engaged in "harmful tax competition." On June 26, 2000, the OECD Committee on Fiscal Affairs released a report identifying its "blacklist" of tax haven jurisdictions that, as of that date, had not cooperated with the OECD's two-year global campaign to stamp out what it views as harmful tax practices. See Goulder, "OECD Releases Tax Haven Blacklist," Tax Notes International p. 7 (July 3, 2000). In considering where to base an offshore fund legal entity, the status of a particular jurisdiction in this OECD crusade should be considered—as well as possible counter-measures the OECD might seek to impose against an offshore jurisdiction that has not "cooperated" with OECD efforts to eliminate "harmful tax practices."

[6] U.S. Internal Revenue Code of 1986, as amended (hereafter, the "U.S. Tax Code"), Section 884.

[7] Rule 902(k) promulgated under the U.S. Securities Act of 1933, as amended (the "Securities Act"), provides a "safe harbor" from registration under the Securities Act for offers (and issuances) of securities to persons other than "U.S. persons." "U.S. person" means: "(i) Any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the United States; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and (viii) any partnership or corporation if: (A) organized or incorporated under the laws of any foreign jurisdiction; and (B) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a)) who are not natural persons, estates or trusts." 17 C.F.R. § 230.902 (k).

[8] Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange: (1) To employ any device, scheme or artifice to defraud, (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. See generally, Lowenfels and Bromberg, "U.S. Securities Fraud Across the Border: Unpredictable Jurisdiction," 55-3 The Business Lawyer 975 (May 2000).

[9] U.S. Tax Code, Section 892. For discussion of the tax rules pertaining to income realized by "integral parts" of non-U.S. governments and non-commercial "controlled entities of such governments," see Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law and Taxation Publishers, 1988) at Section 7.12.

[10] U.S. Tax Code, Section 884.

[11] See Fillman v. United States, 355 F.2d 632 (Ct. Cl. 1966).

[12] U.S. Treasury Regulations § 1.864-2(c).

[13] See Rev. Rul. 73-522, 1973-2 C.B. 22. See generally, Isenbergh, "The 'Trade or Business' of Foreign Investors in the United States," 61 TAXES 972 (1983).

[14] U.S. Tax Code, Section 897. See generally, Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law and Taxation Publishers, 1988).

[15] U.S. Treasury Regulations § 1.871-14.

[16] U.S. Tax Code, Sections 871(h)(3)(B) and 881(c)(3)(B).

[17] U.S. Tax Code, Section 881(c)(3)(A). For a detailed analysis of the "foreign bank exception" to the portfolio interest tax exemption, see New York State Bar Ass'n Tax Section, "Report on the Bank Loan Exception to the Portfolio Interest Rules," reprinted in Highlights and Documents (Tax Analysts), Sept. 18, 1992, at p. 4499. It is not clear whether a typical Islamic bank would be viewed as a "bank" for purposes of the "foreign bank exception" to the portfolio interest tax exemption. In two recent technical advice memoranda, which are not binding on the U.S. Internal Revenue Service (the "IRS"), the IRS held that, for

purposes of the foreign bank exception to the portfolio interest tax exemption, an entity must accept deposits in order to be considered a bank. See TAM 9822007, TAM 9822008.

[18] Certain liberal *Sharī'a* scholars apparently view as forbidden only interest that is usurious or excessive. This paper treats *any* interest payment or receipt as inconsistent with *Sharī'a* principles, however.

[19] This assumes that the recipients of the interest do not fall within the "foreign bank exception" to the portfolio interest tax exemption, discussed above, and that the loans are not recharacterized as equity for U.S. tax purposes.

[20] *Sharī'a* principles are incompatible with typical provisions in many "market standard" U.S. equipment leases. To be Islamically acceptable (for example), equipment lease terms must require the lessor of the equipment to repair and maintain the equipment, an approach contrary to most standard U.S. equipment leases. As another example, typical U.S. lease provisions to the effect that a lessee of equipment must continue to make lease payments even if the equipment is destroyed are not permissible under the *Sharī'a*. In order to establish an equipment-leasing fund consistent with Islamic principles, these sorts of *Sharī'a*-offensive lease provisions must be obviated. See Vogel & Hayes, Islamic Law and Finance: Religion, Risk and Return (Kluwer Law International, 1998), pp. 143-145.

[21] U.S. Treasury Regulations § 1.871-14(d)(1).

[22] U.S. Treasury Regulations § 1.864-2(c).

[23] U.S. Tax Code, Section 163(j).

Trading In Equities

A Sharīʿa *Perspective*

Nizam Yaquby*

ABSTRACT

This paper reviews the current literature, all in Arabic, on the participation and trading in equities of companies, the core business activities of which are lawful but which are fraught with some prohibited transactions. It then discusses the arguments of those who allow this type of investment and those who hold that it is not permissible. A brief analysis of both pro and con arguments is provided, ending with the author's own conclusion.

I. INTRODUCTION

All praise is due to Allah, and may His peace and blessings be upon the Messenger of Allah, his folk, his companions, and those who follow his path.

The following paper, prepared at the request of the *Sharīʿa* Studies Committee, concerns itself with a question of relatively limited scope. It endeavors to determine a *sharīʿa* perspective on dealing with equities in which prohibited transactions constitute a peripheral part of otherwise permissible business activities.

II. JOINT STOCK COMPANIES AND CONTEMPORARY ECONOMIES

Over the past few years, capital markets have witnessed remarkable developments. Perhaps most notably, information technology has interlinked global capital markets and stock exchanges to an unprecedented degree. Joint stock companies have thus become among the most important and feasible means of investment and absorption of liquidity surpluses. Further, the Internet has largely democratized access to the stocks of global companies. Previously confined to financial investment institutions and high net and liquidity corporations, investment opportunities in these global markets have now extended to broader segments of society. From a personal computer, individuals can trade in these equities without need of a broker or intermediary.

In short, joint stock companies of limited liability have now assumed a primary role in the global economic and investment arena. They constitute an indispensable means for undertaking various construction, development, and manufacturing projects. Against the backdrop of emerging global privitization, joint stock companies play a central role in areas such as power generation, water desalination, agriculture, minerals and natural resources, transportation, medical services, and education. Such projects fulfill an important, *sharīʿa*-countenanced purpose.[1]

These companies, of which many exist in the Muslim world, cannot therefore be ignored. They cannot, in the same vein, be left without support and direction. In this respect, the economist Dr. Mohamed Ali Elgari has noted:

> "Joint stock companies have become one of the most important financial innovations in modern times. Through this innovative form, it has been possible to raise enormous capital which otherwise could not have been raised by using any other financial product. It also has made it possible to channel such funds toward viable investments and useful utilizations in the fields of industry, agriculture, real estate development, construction, and development projects. Therefore, there are many companies all over the world with huge turnover amounting to tens of millions of dollars. Yet, there are many countries whose economy is underpinned by a large number of joint stock conglomerates and colossal financial companies. There are also thousands of small and medium firms which rely on the same form of investment. For example, in Britain, there are now more than 120,000 joint stock companies, and this could not have been possible without this innovative form of joint stock companies. The most important point of strength in joint stock companies is their ability to attract capital and pool funds and savings from the overwhelming majority of the members of the public, who are mainly limited income people who constitutes of the middle class and the lower brackets of the society."[2]

* *Sharīʿa* Scholar and Advisor, Manama, Bahrain.

Due to the lack of Islamic banks in many Muslim countries and in most of the non-Muslim world, these companies use conventional banks to finance their major undertakings. Even in countries with an abundance of Islamic banks, such banks are usually unable to provide the amount of capital needed. Thus, most companies resort to conventional sources of borrowing to raise funds and liquidity or to deposit their cash surpluses. Does the *sharīʿa* allow participating or trading in the equities of these companies? If so, what guidelines apply?

III. REVIEW OF THE LITERATURE

The following Arabic literature has informed much of the discourse on this issue:

1. "A research on the ruling of trading in equities of joint stock companies by way of buying, selling, acquisition and possession" written by His Eminence Shaykh Abdulla Bin Sulaiman Al Manea, which has been also published in his book *Buhooth Fi Al Iqtisad Al Islami (Research Studies in Islamic Economics,*) Al Maktab Al Islami, Beirut 1416 A.H, pp. 219-251.
2. "A research on the ruling of trading in the stocks of joint stock companies and related restrictions and guidelines required by the fundamentals and legal principles of Islam." This is a modification of the above research which includes appendixes and useful additional ideas presented by Shaykh Al Manea in Kuwait Finance House's (KFH) 5th *Fiqh* Seminar organized in October 1998.
3. (Trading in the stocks of companies whose main objectives and business activities are permissible but extend loans or borrow from banks on a continuous basis), a paper presented by Dr. Ahmed Al Hajji Al Kurdi during KFH's 5th *Fiqh* Seminar organized in October 1998.
4. (Participation in Companies that occasionally deal with *ribā* transactions), a paper presented by Shaykh Abdulla Bin Beeh, during KFH's 5th *Fiqh* Seminar, 1419 A.H.
5. (Trading in equities of companies whose main objective and businesses are permissible, but extend loans and take loans at interest), a paper presented by His Eminence Shaykh Mohammed Al Mukhtar Al Sallami, the former grand Mufti of Tunisia, during KFH's 5th *Fiqh* Seminar, 1419 H.
6. (A research on trading in equities of companies whose objectives and businesses are permissible but extend loans and borrow on an ongoing basis from banks at interest,) presented by Dr. Mohammed Fawzi Faidhallah during KFH's 5th *Fiqh* Seminar, 1419 H.
7. (Dealing and participation in companies the business activities of which is originally lawful, but they conduct unlawful business activities), by Dr. Ajeel Jassim Al Nashmi, submitted to the KFH during its 5th *Fiqh* Seminar, 1419 H.
8. "A Ruling on participation in companies which place deposits or extend loans at interest) by Dr. Saleh Bin Zaben Al Marzooqi Al Baqmi in *Majallat Al Buhooth Al Fiqhiyah Al Mu'asirah*, issue No. 21, 1414 H, pp. 70-167.
9. Resolution No. (182) of the *Sharīʿa* Supervisory Board of Al Rajhi Banking and Investment Corp., dated 7.10.1414 H and amended by Resolution No. (310) dated 6.4.1419 H. It is published as part of the resolution of the *Sharīʿa* Supervisory Board of Al Rajhi Banking and Investment Corp., 1419 H Vol. 1, pp. 239-251.
10. "Participation and dealing in stocks of companies whose businesses are preliminarily lawful but may place deposits or seek loans at interest), by the writer of this paper, which was submitted to IDB, 1417H.

In addition, various memoranda, recommendations, rulings, and *fatwā*s issued by the *Sharīʿa* Supervisory Boards, will be referred to throughout the paper, In sha' Allah.

IV. DIFFERENCES AMONG CONTEMPORARY SCHOLARS

Contemporary scholars have differed on the permissibility of participating and trading in the stocks of these companies. Two major positions have defined the contours of this debate.

A. Permissibility

One school of thought advocates the permissibility of participating and trading in such stocks, with the condition that any profits be purged from unlawful gains. In other words, unlawful gains should be channeled into public interests and charity services according to certain rules and conditions.

Scholars who articulate this position include:

1. His Eminence Shaykh Mohammed Bin Saleh Bin Uthaymeen.
2. His Eminence Shaykh Mustafa Al Zarqa.
3. His Eminence Shaykh Abdulla Bin Sulaiman Al Manea.
4. His Eminence Shaykh Mohammed Taqi Al Othmani.
5. His Eminence Dr. Abdul Sattar Abu Ghuddah.
6. His Eminence Dr. Ali Muhiddin Al Qara Daghi.[3]

B. Impermissibility

This view argues that participation in such companies and trading in their stocks, either by buying or selling, is strictly impermissible.

Advocates of this position include:

1. His Eminence Shaykh Abdulla Bin Beyyah.
2. His Eminence Shaykh Dr. Ajeel Al Nashmi.
3. His Eminence Shaykh Dr. Ahmed Al Hajji Al Kurdi.
4. His Eminence Shaykh Dr. Mohammed Fawzi Faydhallah.
5. His Eminence Shaykh Dr. Ali Ahmed Al Saloos.
6. Dr. Saleh Al Marzooqi Al Baqmi.[4]

V. Authorities and Arguments Cited by Advocates of Permissibility

The advocates of permissibility have cited a number of authorities. These authorities are as follows.

A. The Legal Maxim that Says, "That which is independently impermissible becomes permissible when done in conjunction with the permissible."[5]

With regard to the application of this legal maxim, advocates of permissibility cite a number of examples to clarify their position. They note, for example, the permissibility of selling the property of a slave together with his person. Ordinarily, the *sharīʿa* does not permit one to sell a slave's property, except if the conditions of the currency of exchange are satisfied. If one engages in selling the person of the slave, however, the selling of his property becomes permissible. Therefore, an otherwise unlawful act becomes lawful because of its association with the lawful act. Proponents of this view also cite the legality of selling a pregnant slave or animal together with the unborn offspring. Though the *sharīʿa* does not permit selling an unborn child or offspring independently, this transaction becomes permissible when the offspring is sold in conjunction with its mother.

Proponents of permissibility draw an analogy between such examples and participation in stock companies with occasional dealings in prohibited transactions. "These stocks may be reconsidered under this legal maxim because lawful methods are prevalent in the investments activities of these companies. The unlawful dealings, such as borrowing from banks or extending loans to them at interest are very negligible in the face of their lawful stocks or dealings and thus the participation therein is consequential lawfulness that is not lawful independently."[6] In other words, the *sharīʿa* strongly condemns independent dealings with interest-based transactions. But if these transactions are mixed with lawful means and those lawful means significantly outweigh the unlawful, then lawfulness will prevail.

Advocates of the impermissibility of participating in these stock companies critique the forgoing analysis. Namely, they argue that the cited legal maxim does not apply. "Because what is intended by remissibility or neglectfulness (yugtafar) as regards to impermissibility to dispose of incidental rights by sale or otherwise when they were separated from the principal right is because of being part of the principal and being attached to it. In other words, one cannot sell, for example, services or a particular benefit attached to things as inseparable part of the intended thing separately. However, since it is permitted to dispose of the principal, such incidental right or services or benefit is automatically included in the contract of sale. The incidental right per se thus is not intended but the principal as in the case of slave and his property, and the sale of the pregnant slave maid. The purchase contract is concluded on the slave or slave maid and not their properties, which follow them with the conclusion of the contract to buy them. Thus, the permissibility here is governed by the permissibility to contract on the original. As such, the application of this legal maxim in the case at issue is out of context. Because the interest per se, if we consider it as *tābiʿ*, i.e., not intended, is not permissible by itself even though it is incidental in our issue here and one cannot dispose of it as a lawful income. The fact is that it is hardly possible to legalize secondary financial transactions that are attached to a process of lending in contingent on usury, which is unlawful by itself. In other words, there is a

vast difference between contracting on incidental rights, the selling of whose principal is lawful, and dealing with secondary transactions, whose principal is unlawful *ab initio*.[7]

B. General Need Takes the Ruling of Specific Necessity[8]

Advocates of permissibility have also argued that prohibiting the sale or purchase of such stocks will lead to an imposition of undue hardship. In support of this principle, Ibn Taymiyyah, may Allah have mercy on him, has argued that "necessity permits things that are otherwise impermissible as in the case of permissibility of a barter sale or exchange between ripe dates for unripe dates, namely (بيع العرايا).[9]

The invocation of this principle has also been met with skepticism, however. It is argued that the notion of necessity should be considered in light of the legal maxim that "whatever is permitted for reasons of necessity should be measured or practiced according to the magnitude of such necessity."[10] Therefore, because the need in question only applies to a few members of society, advocates of impermissibility argue that this principle cannot be applied.[11] They note that the public at large should be in need of the transaction in order for this legal maxim to apply.

C. Mixture of a Negligible Unlawful Part with the Lawful Major Part[12]

Advocates of permissibility have argued that "[t]his legal case is mentioned by the scholars of *fiqh* and Islamic jurisprudence and the majority of them have reached a conclusion that it is permissible to use these mix funds provided that the unlawful part is negligible, whether by way of sale, purchase or any form of usage which the *sharī'a* has sanctioned. The stocks of companies, which are the topic of our discussion, are of this type. Although some of the earnings of these companies consist of unlawful parts that come from *ribā* financing or borrowing, the major part of the income earned is lawful."[13]

Detractors of this view have asserted that the cited legal maxim actually points to impermissibility, because if an unlawful act is mixed with a lawful act, the former prevails. This finds support in established legal principles of the schools of *fiqh* and the rulings of the scholars of Islamic jurisprudence.[14]

Moreover, it is noted that the authorities and cases cited by those who argue for the permissibility only apply in cases of doubt, such that one cannot distinguish between the unlawful and lawful, although one is aware that the unlawful exists. However, no such doubt figures into this question. Rather, specific knowledge and deliberate intention characterize the participation in stocks.[15]

D. The Legal Maxim that Says, "Majority has the ruling of the whole, or the majority counts"[16]

This legal maxim posits that if lawful elements constitute the majority, then the legality of such a transaction prevails despite the presence of unlawful elements. In this respect, advocates of permissibility cite a number of precedents and provisions of *fuqahā'* to establish their position.

It has been argued that "[d]ue to the fact that the stocks, the subject of the discussion, are predominantly lawful, and that unlawful acts in them are negligible compared to the permissibility of their majority, and so the application of this legal maxim ruling of dealings in these stocks, by way of buying, selling and possession, to the issue of the ruling applicable to the majority is clear, and does not need any further discussion.[17]

Those arguing for impermissibility reply that the legal maxim that "the majority counts" is applicable only in customary practices. In other words, this maxim concerns acceptable conditions of customary practices that are fraught with illegal practices, which are the conditions of domination and majority.[18] Moreover, this maxim can be rebutted by another legal maxim that holds "if the lawful and the unlawful are mixed, the unlawful prevails."[19]

E. The Legal Maxim that Says, "What is Inescapable is Tolerable"[20]

Generally speaking, this can be considered under the legal principle of general need or necessity.[21] Under the rubric of this legal principle, supporters of permissibility cite many legal positions of the *fuqahā'*. For example, they cite Al Bahooti, may Allah have mercy on him, who says: "What cannot be drained, like the sewers of Mecca, does not become impure by urine, or by anything else, until its color or look is changed."

Also, in his al-Majmoo', al-Nawawi, may Allah have mercy on him, is quoted as saying: "The principle is that the *gharār* (uncertainty) sale is null and void in view of the clear-cut ®*adīth*. But the unlawfulness meant therein is the sale that involves an apparent *gharār* that can be avoided. However, a sale that cannot be avoided due to compelling need is lawful although it might involve some degree of *gharār*. An example of this is the *gharār* relating to disclosure of the strength of the foundation of a house purchased. One cannot surely disclose the strength of pillars of the house and this inability to disclose is *gharār*, but it is tolerable because it is unavoidable. Equally important is the disclosure of the nature, sex, and number of the fetus of the pregnant slave maid introduced for sale. There is uncertainty in this sale with complete ignorance of the number, sex and nature of the fetus in the womb but

this uncertainty is tolerable for the same reason. So, also, uncertainty as to whether the udder of the goat purchased for its milk really contains milk or not, is not affecting the sale contract. Uncertainty with regard to all these cases and the like is tolerable because it cannot be avoided and such a sale is needed. This view is unanimously agreed upon by the *fuqahā'*.[22]

Those who argue for impermissibility note that this legal principle applies only on things or acts that cannot be prevented or avoided and yet they constantly and continuously occur. This is certainly differs from usury. Usury can be avoided and lawful dealings in lieu thereof are sufficient. Moreover, it is generally accepted and agreed upon that legalizing an act based on general need and hardship is lawful only if there is no explicit provision prohibiting it. If there is an explicit textual source prohibiting an act, the principle of general need and hardship is inapplicable. In this respect, Ibn Nujaym says: "Hardship and inconvenience are used as a justification in matters where there are no express provisions, whereas when there is a provision to the contrary, they cannot be used as justification for unlawful acts."[23]

VI. Authorities and Arguments Cited by Advocates of Impermissibility

Those who argue for impermissibility cite the following sources:

A. The Qur'anic verses that generally prohibit usury, such as: "O you who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers." (2:278)

It is argued that all the prohibitions of Qur'anic verses as regards usury are clear and straightforward. Thus, all that Allah has forbidden is unlawful and therefore should be avoided completely. There is no forgiveness or excuse for committing any of the prohibitions, particularly usury. The stocks of companies that place deposits, or take loans, at interest are included in these prohibitions, and as such should be avoided completely.[24]

One may respond to this by saying that the advocates of permissibility to participate in these stocks acknowledge that usury is unlawful, whether in the form of stocks or otherwise. That notwithstanding, the sale and purchase of equities is lawful, because the business activities of these companies are primarily lawful and the unlawful part generated from a usury-based income can be purged.

B. The *A®ādīth* of the Prophet (Allah bless him and give him peace).

1.

"Every form of usury from the pre-Islamic era is rejected. You shall have your capital sum and do not deal with injustice nor should you be reciprocally dealt with injustice. O my nation, have I conveyed the message? And the Prophet repeated this three times and they said, 'Yes.' The Prophet said, 'May Allah bear witness with me, that I have delivered the message,' and this was also repeated three times."[25]

If this is the case, how then can one ignore the *®adīth* of the Prophet (Allah bless him and give him peace) that "Every form of usury from the pre-Islamic era is rejected…." and boldly declare that usury, if negligible or overwhelmed by the prevailing lawful activities, becomes permissible?[26]

The advocates of permissibility reply that they do not hold usury to be permissible. Rather, they argue that the large part of the businesses of these companies are lawful, and that any negligible usury involved in these dealings should be set aside and donated to charity and the public interest of Muslims.

2.

"One usury-based *dirham* income that is knowingly earned by a person is more unlawful and worse in degree than thirty six adulteries." Narrated by A®mad and al-Tabarani.

The point here is that this *®adīth* is a clear-cut source that does not distinguish between minor or major as far as the prohibition of usury is concerned.[27]

However, as previously noted, the advocates of permissibility acknowledge that usury is unlawful. Instead of allowing profit gained from such usury, they recommend purging one's wealth by spending such usury for the interests of Muslim society at large. In addition, the chain of narration of this *®adīth* is not free of criticism and allegations of weakness. Indeed, Ibn al-Jawzi listed and categorized it as fabrication.[28]

VII. Collective *Ijtiß¡d*s (Personal Reasoning)

1. The resolution passed by the Jeddah-based Islamic *Fiqh* Academy, during its 7th session, which states as follows:

> "As a principle, it is impermissible to participate in companies which occasionally deal with prohibited transactions, such as usury, and the like, although their main business activities are primarily lawful" (Resolution No. 64/1/7, subsection (1) (c) of the first clause)

2. The resolution issued by the participants in a seminar on "participation in equities of a joint stock company dealing in usury," held at IDB in Jeddah under the auspices the Jeddah-based Islamic *Fiqh* Academy on 22.10.1413 H, in which they confirmed the preceding resolution.
3. The recommendation issued as part of the recommendations of the Second Seminar on Stock Markets, held in Bahrain, which states as follows: "The principle is that it is unlawful to participate in companies that occasionally deal with prohibited transactions, such as usury, and the like, although their business activities are basically lawful."[29]
4. The recommendations issued by the participants in a workshop on "participation in joint stock companies which occasionally deal in usury," held in response to a joint invitation extended by the Jeddah-based Islamic *Fiqh* Academy and the Islamic Research and Training Institute (IRTI), affiliated to IDB, in which more than one hundred scholars and researchers took part (27-29 Muharram 1419 A.H.).

Due to the importance of these recommendations, it is therefore relevant to provide the text of these recommendations as it is considered the latest resolution issued by an academic institution so far.

VIII. RECOMMENDATIONS

The participants in the workshop are of the view that it is necessary to confirm the resolution adopted by the Islamic *Fiqh* Academy, which was passed during its 7th session held in Jeddah 7-12 Dhi al Qi'dah H, which states as follows:

> "The principle is that it is unlawful to participate in the equities of joint stock companies which occasionally deal with prohibited transactions, such as usury, and the like, although their main business activities are basically lawful."

The participants suggest that the following be excluded from the preceding principle:

1. Participation, in the referred companies, for those who are capable of making such companies eschew dealing with unlawful activities right after participation in the first meeting of the general assembly of the company, provided that such persons should withdraw from participation if they are unable to make any changes.
2. Permissibility to participate in the stock companies operating in Islamic countries so far as their objective is to manufacture and produce necessary goods, or to provide basic services related to public utilities that the individuals cannot make it without their production. This rule applies whether these companies are private owned (private sector) or public companies (public sector). But this rule is subject to the company being uninvolved in seeking interest financing, except in situations of dire need to seek such financing or loans. This rule is also subject to unavailability of similar companies that operate on lawful fundamentals.
3. Taken into consideration the role played by IDB in promoting development in Islamic countries and communities, it is permissible for the Bank to participate in shareholding companies in Islamic countries and societies, which companies occasionally deal with usury, provided that there should be a specific program drawn up by these companies to rectify their position to comply with the provisions of the *sharīʿa*, and such program should be approved by the Islamic *Fiqh* Academy's *Fatwā* Committee.

In all cases, a Muslim and an Islamic institution is obliged to purify its funds and purge them from any usury earned from these companies, in accordance with certain guidelines set by the *Sharīʿa* Economic Committee of the Islamic *Fiqh* Academy.

The participants hereby recommend that a committee be formed, comprising a number of *sharīʿa* scholars and economists, by the Islamic *Fiqh* Academy in collaboration with IRTI in order to look into the following matters:

1. Conducting research on the operational limitations on the application of need in *sharīʿa*, particularly public need and its effect on permitting the prohibited act.

2. Undertaking research on the characterization of joint stock companies, their corporate identities, the relationship between the shareholder and the management, their legal liability for their acts, and the ruling on the acts performed by them from a *sharīᶜa* point of view.
3. Conducting a thorough research on the topic of limited liability in joint stock companies in order to complement the resolution issued by the Islamic *Fiqh* Academy in this respect during its 7th session.

The participants recommended that research centers of Islamic banks should seriously endeavor to find alternatives whereby Islamically acceptable financing can be provided for joint stock companies, as well as finding lawful channels to invest the surplus cash available to them.

The opinions of several *sharīᶜa* supervisory boards also discuss the permissibility of involvement in the equity of otherwise lawful firms that deal with some unlawful business:

1. The *fatwā* of the Al Baraka's 6th Islamic Economy Seminar (6/5) on "Purchase of Equities in Joint Stock Companies with Lawful Objectives but occasionally deal with usury-based banks by way of extending, or seeking loans." The opinions of the majority of the participating *fuqahā'* appear to be in favor of permitting such purchase.
2. The *fatwā* of Al Baraka 7th Islamic Economy Seminar (7/8) on the subject thereof.
3. A memorandum issued by the unified *sharīᶜa* committee of Al Baraka Group in reply to a letter sent by the Chairman of the Board of Directors of Dubai Islamic Bank, Hajj Saeed Lutah, in respect of investment in equities and carries the signature of their eminence: Shaykh Yousuf Al Qaradawi, Shaykh Mohammed Al Mukhtar Al Sallami, Shaykh Abdulla Bin Sulaiman Al Manea, Shaykh Mohammed Taqi Al Othmani and Shaykh Abdul Sattar Abu Ghuddah. The said memorandum permits investment in these equities.
4. The resolution issued by the *Sharīᶜa* Committee of Al Rajihi Banking and Investment Corporation in respect of equities of joint stock companies (No. 182), dated 7.10.1414 H, on page 13, signed by the Chairman of the Committee, His Eminence Shaykh Abdulla Bin Abdul Aziz Bin Aqeel, amended by resolution No. (310), dated 6.4.1419 H.
5. The *fatwā*s of the *Sharīᶜa* Supervisory Boards of each of the following are noteworthy: Dar Al Maal Al Islamic (DMI), Abu Dhabi Islamic Bank, First Islamic Bank (Bahrain), City Islamic Bank and Jordan Islamic Bank. The *Sharīᶜa* Boards of these banks adopted the view of those who argue for permissibility.
6. The *fatwā*s issued by the *Sharīᶜa* Supervisory Boards of the investment funds of international equities, such as, Al Hijra Fund, Fleming Fund, American-Saudi Bank Fund as well as the *Sharīᶜa* Supervisory Boards of stock index companies, such as the *Sharīᶜa* Supervisory Board of Dow Jones International Company.

IX. EVALUATING THE LITERATURE

In considering the arguments on both sides of the issue, the view of permissibility seems closer to the truth for the following reasons:

1. The strength of their sources from jurisprudence (*fiqh*) provisions and legal principles.
2. The backtracking of some advocates of impermissibility that can be found in the recommendations of the workshop on "participation in joint stock companies which sometimes engage in usury-based transactions." 27-29 Muharram 1419 H. Some participants in this workshop who previously argued for impermissibility now concluded otherwise.
3. The adoption of permissibility serves the common interest of Muslims by facilitating vital business activities.
4. The position of permissibility has led to vast potential for Islamic banking activities on world markets. As a result, some global companies are now paying due attention to Islamic requirements and rules of investments. In fact, some Jews have recently asked experts of Islamic investment funds to set guidelines for them from the Jewish religion. A Dow Jones periodical has recently published an interesting article about Islamic investments in stocks and about religious and ethical guidelines, which was unthinkable only a few years ago.[30] Thus, this is not only an investment or economic issue, the permissibility of such transactions has opened a door for *daᶜwa* and the propagation of the message of Almighty Allah.
5. Islamic banks have been deprived of many of the short-term investment instruments and vehicles, and they are finding it increasingly difficult to cope with the situation. They are also prevented from underwriting treasury bills issues and other related usury-based bonds and bills, owing to the unanimous ruling by Muslim scholars on their unlawfulness. Therefore, if we prohibit them from investing in equities, which

are originally permitted and lawful, we impose a gross injustice on them, and force them to be confined to *murāba®a* sales and transactions and international markets dealings (commodities and metals), most of which are known to be spurious.

6. The issue is a contemporary one, which is related to personal reasoning, and no explicit provisions make this kind of transaction prohibited.

X. *SHARĪ^CA* REQUIREMENTS

Sharī^ca Supervisory Boards have laid down certain parameters that should be complied with in order for these stock companies to become lawful. The parameters are as follows.

A. Exclusion of the Categorically Prohibited

As a matter of absolute principle, companies engaged in prohibited business activities must be avoided. This rule also applies to the subsidiaries of such companies if they deal with unlawful activities. Examples include conventional banks, insurance companies, alcoholic-beverage companies, gambling, pork, brothels, and pornography-related companies. Other companies recommended against include those that unfairly treat their employees, cause environmental pollution, and engage in biotechnology projects such as using aborted embryos and participating in human cloning.

B. Permissibility Excludes Companies Whose Debt and Cash Money Form 50% of Existing Assets

It is established in the *sharī^ca* that a debt cannot be sold to a third party. Likewise, selling cash for cash is an exchange transaction that should comply with the conditions of currency exchange as sanctioned by the *sharī^ca*. Therefore, contemporary scholars stipulate that the equities of companies, the business activities of which are lawful, may be traded if the total cash and debts in their balance sheets do not exceed the total value of other assets. In other words, real assets, and not debts and cash, should constitute the majority of their assets. Contemporary scholars, however, differ on the estimation of this majority, or percentage, but most of them agree that it is achieved if it exceeds half the assets (50%) as stated in the *fatwā*s issued by the 2nd Al Baraka Seminar, *Fatwā* No. 5).

For this reason, the equities of companies in which debts and cash are more than other assets should be excluded from permissibility.

C. Permissibility Excludes Companies with Debt-to-Equity Ratios over 30%

It is noticed that many joint stock companies sometimes resort to leverage at a certain interest for expanding their business activities or to meet their emergency cash requirements. This involves paying interest to the lending parties. Although the dividends of these companies do not include explicit interest payments (because in this case they are paying interest), they are still dealing in unlawful usury-based loans.

Hence, the ratio of debt to the shareholders' equity should be as low as possible. From practical experience, and from an extended survey of many joint stock companies, it has been found that the ratio between debts and shareholders' equity is sometimes as much as sixteen times as high.

For this reason, the Religious Supervisory Boards argue that a percentage of not more than 30% is considered to comply with this requirement. This has been deduced from some of the *sharī^ca* rulings on the determination of minimum and maximum limits. Scholars have been accustomed to the rule, in many issues, that what is less than one third is the criterion of a small percentage. This inference is analogous to what is reported from the Prophet (Allah bless him and give him peace), who said, "One third, and one third is too much."[31]

Some *fuqahā'* have drawn an analogy from this provision and apply it to many issues, which include exempting the purchaser from spoiled fruits if they amount to one third and permitting exclusion from the sold commodity if the excluded commodity constitutes less than one third.[32]

It should be clarified here that the opinions of researchers differ on shareholders' equity, as to whether it means the market value of the stocks, the paid capital, the net asset value (NAV), or the total assets. In my opinion, companies themselves differ on this, for each company has its own criteria.

D. Permissibility Excludes Equities of Companies Whose Interest Income or Unlawful Gains Exceed 5-15%

Many joint stock companies deposit their extra liquidity with conventional banks at interest, and this interest is mixed with the revenues earned from their lawful business activities. *Fuqahā'* have investigated the legitamacy of investing in the equities of these companies, and have suggested the following guidelines.

It is a necessary requirement that the ratio between the interest, or unlawful earned income (or both combined), to the company's total income, should be negligible and as low as possible, for two basic considerations:

1. The lower the percentage, the more a company is tilted toward producing lawful commodities and services.
2. Realizing a lawful profit for the investor cannot be achieved unless the percentage deducted from the dividends is negligible.

Researchers and *Sharīʿa* Supervisory Boards differ on the acceptable minimum of this percentage, but they agree that it should range between 5% and 15% for any company, which seems to be a bare minimum. However, practical experience has revealed that profitable and economically viable stocks can be traded at far smaller than this percentage, by the grace of Almighty Allah.[33] However, the opinion that it should not exceed 5% of total revenues has gained wide acceptance. This is what the Dow Jones Islamic Index follows, for example.

XI. CONCLUSION

Joint stock companies play an important role in the modern world economy and are popular investment vehicles that have facilitated the individual's access to capital markets. Since joint stock companies play a significant role in the development of Islamic countries and—in the absence of Islamic financial institutions that can provide large amounts of capital and can manage surplus funds—have been forced to rely on conventional financial institutions, Muslim *sharīʿa* experts have been faced with the question of the permissibility of transacting in the shares of companies whose primary business is lawful but that occasionally enter into unlawful transactions.

A survey of Arabic research papers by Muslim *sharīʿa* experts confirms that there are two opinions among contemporary Muslim experts on this issue: one group holds that transacting in the shares of companies whose earnings come in part from interest-yielding bank accounts and interest-bearing loans is lawful, provided certain conditions are met, while the other group holds that such participation is unlawful.

The scholars who hold that investing in these companies is lawful base their arguments on several legal maxims and argue that since the primary business of the companies is lawful, transacting in their shares is also lawful. Those who hold that it is not lawful to invest in such companies cite texts from the Qur'an and Sunna that prohibit usury and argue that the legal maxims used by those who regard such transactions as lawful do not apply.

In the view of the author, the argument of those who hold that this type of investment is permissible is stronger than that of those who hold the opposing view. One indication of this strength is that some of the scholars who once held the opposing view have since abandoned their opinions and joined those who permit the transactions in question. The position on those who permit the transactions in question is also more beneficial to the development of Islamic finance.

Finally, it should be noted that the scholars who permit the transactions in question require that certain conditions be met in order for these transactions to be permissible. These conditions include that the company not engage in certain types of businesses (such as conventional finance), that the company's real assets be greater than its cash and debt, and that the revenue that it derives from usury be kept to a quantifiable minimum.

May Allah's peace and blessings be upon our Prophet Muhammad and his folk and companions.

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[1] Malaikah, Saleh J. *Al-Musahama fi sharikat tata'amal ahyanan bi-al-muharramat* (Participation in Companies That Sometimes Deal with Prohibited Transactions). Dallah Al Baraka Group. p. 3.

[2] Elgari, Mohamed Ali. *Mubarirat I'adat Al-Nazar fi Mas'alat Al Istithmar fi Ashum Al Sharikat Allati Yakunu Aslu Nashatiha Mubahan Walakinnaha Tata'amal Bi-alfawa'id Al Masrafiya* (Justifications for Review of Investment in Companies the Business of Which is Originally Permissible, but Which Deal in Banking Interest). Research paper submitted to the Islamic Development Bank (IDB), Jeddah.

[3] Yaquby, Nizam. *Al Musahama Wa al-ta'amul*. pp. 4-8; Al Marzooqi, Saleh. *Hukm Al-Ishtirak*. pp. 73; Al Manea, Abdulla. *Hukm Al-Mutajarah*.

[4] Al Marzooqi, *supra*. pp. 76-77; Al Nashmi, Ajeel. *Al Ta'amul Wa al-Musharakah*.; Al Kurdi, Ahmed. *Al Mutajarah Bi-ashum Sharikat Gharaduha Wa'amaluha*.; Fawzi Faydhallah, Mohammed. *Al Mutajarah Bi-al-ashum*.

[5] Refer to the general rule in Al Nadawi, Ali Ahmed. *Mawsoo'at Al-Qawa'id Wadhawabit Al Fiqhiya Al Hakimah Lilmua'malat Al Maliyah Fi Al Fiqh* 2. Al Rajhi Banking and Investment Corp. and The International Investor, 1419 H. p. 505.

[6] Al Manea, *supra*. p. 10.

[7] Al Nashmi, *supra*. p. 4.

[8] For more details, refer to Al Nadawi, *supra*. 152.

[9] *Majmoo' fatawa Shaykh Al Islam Ibn Taymiyah* 29. p. 480; Al Manea, *supra*. p. 11.

[10] Al Nashmi, *supra*. pp. 6-7.

[11] Al Marzooqi, *supra*. p. 121, with slight modification.

[12] Al Nadawi, *supra*. 468.

[13] Al Manea, *supra*. p. 14.
[14] Al Nashmi, *supra*. p. 14.
[15] Al Marzooqi, *supra*. p. 126.
[16] IslamiQ Financial Daily. http://www.islamiqdaily.com.
[17] Al Manea, *supra*. p. 17.
[18] Al Marzooqi, *supra*. p. 133.
[19] Ibid.
[20] Al Nadawi, *supra*. 420.
[21] Al Nashmi, *supra*. p. 17.
[22] Check these quotes and the sources in Al Manea, *supra*. pp. 18-19.
[23] Al Nashmi, *supra*. p. 19.
[24] Al Marzooqi, *supra*. p. 95.
[25] Narrated by Imam Muslim, Abu Dawood, Al Tirmidhi, Ibn Mājah, A®mad (in his Musnad), and others.
[26] Al Marzooqi, *supra*. pp. 95-96.
[27] Al Marzooqi, *supra*. pp. 96-97.
[28] Ibid. p. 141.
[29] Ibid. p. 76.
[30] "A New Stock Index for Muslim Investors." Dow Jones Global Indexes, Quarterly Review Issue 1 (With Kr 1999). pp. 5-10.
[31] Narrated by Al Bukhari in his *Sahih*, "Book of Wills."
[32] Cf. *Sharh Al Kharshi Ala Mukhtasar Khalil* 3/131.
[33] These guidelines are derived from a group of Islamic mutual funds and the *fatāwā* of their *Sharī'a* Supervisory Boards.

PART III

ISLAMIC FINANCE

Introduction

Mohammed Obaidullah*

Islamic finance faces many challenges today. Yet, it is a growing industry, and one in transition. The papers in this volume of the Proceedings of the Harvard Forum, which seek to address many of the problems, issues, and challenges of the field, have now become indistinguishable from Islamic finance research. The papers that follow cover a wide range of interesting research questions, encompassing definitional problems, techniques of investment management and risk management, issues relating to accounting and regulation, strategic marketing, strategic enhancement of reach and richness, and an overall assessment of problems and prospects.

I begin with a gem of a paper by Mahmoud A. El-Gamal. Although *An Introduction to Modern Islamic Economics and Finance* is supposedly targeted at the uninitiated, it merits serious reading by avid researchers and scholars. El-Gamal debunks widely held misconceptions about the prohibition of *ribā* and *gharār*. His approach is novel: while Islamic scholars have traditionally defended these prohibitions on ethical grounds (such as protection of the weak, poor, and disadvantaged), El-Gamal argues that the prohibitions are more about economic efficiency. His explanations are simple yet sensible. The prohibition of *ribā* is about ensuring that a sale is backed by real assets and is "marked-to-market," while the prohibition of *gharār* is about the sale of risk. Given that one finds a myriad of definitions and explanations of the above concepts, which are fundamental to understanding Islamic finance, El-Gamal makes a landmark contribution to the discipline. El-Gamal questions the industry's obsession over branding financial products after classical *sharīc a*-nominate contracts. He also urges contemporary jurists to go back to the basics and find solutions with minimal use of jargon. This, in my opinion, is a profound observation and can pave the way toward greater convergence and rational tolerance of differences of opinion (*ikhtilāf*) among scholars.

The only paper on financial innovation and engineering, *The Scope of Off-Balance-Sheet Transactions in Islamic Finance*, is by none other than Zamir Iqbal, who has authored several articles in the past on the subject. Risk management remains an area of concern, notwithstanding the permissibility, in the view of a handful of scholars, of conventional options, futures, and other derivatives. The majority of scholars, with good reason, find these instruments objectionable. It is perhaps pertinent here to recall the excellent explanation of *bayc al-gharār* (sale of risk) provided by El-Gamal. When risk is packaged with the sale of a real asset and becomes a less significant, it moves into the domain of permissibility. If derivatives as independent contracts have no place in Islamic finance, then alternatives in which risk management is achieved through risk-sharing, and without involving wholesale risk transfer, need to be explored. Iqbal provides an excellent example of such a possibility by demonstrating the construction of a synthetic currency forward by packaging *murāba®a* with spot (and therefore permissible) exchange of currencies. His paper also briefly touches upon the possibility of designing currency swaps, floating-to-floating or fixed-to-floating, using *ijāra* contracts. It is left to the discerning reader to note that such a mechanism ensures that the forward rates are tied to the *murāba®a* rates prevailing in the economies. By contrast, the ever-widening divergence between real and financial economies is a natural offshoot of the conventional financial system and is a matter of grave concern. On the other hand, the Islamic financial system has corrective mechanisms in place, for as Iqbal notes, the foundation of an Islamic financial system lies is asset-backed securities that link each financial claim to an underlying asset. Each financial claim in an Islamic financial system can be considered as a contingent claim whose return/performance depends on the return/performance of the underlying real asset.

Omer Ahmed's *Islamic Investing: An Institutional Investor's Perspective* attempts to articulate strategies and processes in Islamic investing from a practitioner's point of view. It seeks to combine the ethical concerns of Islam with the principles of sound investing. Although his assertion that "there are costs of complying with Islamic requirements and that one must be realistic and accept that it is not possible to achieve full compliance on a mass scale" would not sit very well with proponents of purity, Ahmed augments the growing literature on the subject.

Essam Mahmoud and Gillian Rice make a significant contribution to the scant literature on the strategic marketing of Islamic financial services with *Meeting the Competitive Challenge: Marketing Leadership in Islamic Financial Institutions*. As they see it, Islamic financial institutions (IFIs) need marketing leadership in order to succeed. Taking into account the special characteristics of IFIs, their paper provides a framework showing how to nurture marketing leadership.

* Associate Professor, International Islamic University, Kuala Lumpur, Malaysia.

The remaining articles generally undertake an overall assessment of the Islamic banking and finance industry by highlighting its many achievements, challenges, and future prospects.

In *Culture or Accounting: What Are the Real Constraints for Islamic Finance in a* Ribā*-Based Global Economy?* Andrew Cunningham predicts that Islamic finance will continue to maintain its distinct identity for reasons that are not entirely financial in nature. While international financial regulators would like to see a total integration of Islamic finance into the global accounting and regulatory architecture, this scenario is unlikely to emerge. According to Cunningham, international regulators seem to argue convincingly that the supervision of IFIs and the accounting practices that they employ can with little difficulty be adapted to Western (*ribā*-based) norms that would bring benefits to all. However, they miss a fundamental point. Cunningham states that "for a significant constituency of Islamic financiers, the 'otherness' of Islamic finance is more important than any advantages conferred by complicity with the global accounting architecture." Cunningham asserts that the rise of Islamic sentiment and the search for an Islamic identity are the most important factors contributing to the growth of Islamic finance. Hence, attempts at global integration are unlikely to succeed, even though the distinction between Islamic and conventional finance is more apparent than real.

Stephen K. Green focuses *Challenges Facing the Islamic Financial Industry* primarily on the recent initiative to develop an international Islamic money market. In order to realize the full potential of this enterprise, urgent needs exist on a number of fronts. For instance, laws and regulations in many Muslim countries, such as restrictions on land ownership that stifle *ijāra* (leasing) transactions, must be reformed; *sharīʿa* standards must be harmonized; quality issuers should be encouraged to establish benchmark issues (for developing primary markets); and financial institutions with market making abilities must be persuaded likewise (for developing secondary markets). Green also treats e-commerce possibilities in Islamic finance.

Jassar Al Jassar, in *Islamic Finance: Successes, Prospects, and Neglected Areas*, deals with similar research questions. The key weaknesses of Islamic finance are identified as: lack of a uniform regulatory and supervisory regime; absence of consensus on legal rulings; inadequate transparency; and failure to develop standardized contracts, short-term liquidity, and investment instruments. *Islamic Finance: A Quarter-Century Assessment* by Ibrahim Warde has research objectives along the same lines. Warde asserts that "Islamic finance is a success, no longer an uncertain experiment but a reality as a large and rapidly growing industry. Nonetheless, Islamic finance has its shortcomings: it has not yet fulfilled its original objective of becoming an original and innovative system, based on risk sharing, that brings social and economic benefits to the Islamic world." He laments the absence of widely accepted interest-free instruments; the presence of scandals and other problems that have raised serious ethical and religious issues. Warde then strikes a positive note and asserts that "most problems of Islamic banks are unavoidable growing pains, and many venerable conventional institutions have not proven exemplars either of probity or of strategic acumen." Thus, many of the disappointments of Islamic finance are part of an unavoidable trial-and-error process. Warde goes on to list the challenges—religious, economic, regulatory, strategic, and political—faced by Islamic institutions and suggests a few new directions. Warde introduces a new concept, "Islamic moral hazard," which suggests that the very introduction of religion into finance can foster unscrupulous behavior. As he asserts, "In reality, religion can be a double-edged sword, since it often attracts the wrong element while lowering the guard of bankers and regulators. This is an unsettling issue, but one that needs to be addressed if Islamic finance is to fulfill its potential."

The Challenge of Reach and Richness in Islamic Finance by Iqbal Ahmad Khan deserves special mention for its "rich" analysis of the evolution and growth of the Islamic financial services industry across the globe, and its "rich" prescriptions for enhancing the scope and depth of the industry. Khan does a commendable job. As he notes, "Fundamentally, Islamic finance being a growth industry does not have the traditional conflict between reach and richness… Therefore… new levels of reach and richness are attainable." And what are his prescriptions? "The route to richness lies in affiliation and strategic alliances." Khan highlights the immense need for research and development projects by *sharīʿa* scholars, leading universities, and practitioners. He also talks about the need to harmonize best standards among Islamic financial institutions, as well as to take the best from conventional financial institutions. He notes, "The most important route to richness lies with the theme of culture, people, and training. We can replicate the tangibles but we can never replicate the intangibles." As for expanding the reach of Islamic finance, Khan's prescription includes, inter alia, increasing the market share in home markets, opening up new markets, reaching the unreachable, and embracing e-commerce. And how can Islamic financial institutions increase their market shares at home? "First and foremost they have to build credibility in their home markets. Creditability is built on creating a culture of transparency, *sharīʿa* credibility, earning power, enhancing their legality, improving the quality of service, and providing richness based on added value and above all educating the customers."

Finally, *The Islamic Banking System in Malaysia: Some Issues* by Sudin Haron and Norafifah Ahmad undertakes an exhaustive survey of Islamic banking in Malaysia and contends that a few *sharīʿa*-related issues, such

as the applicability of the *bayᶜ al-dayn* and *daᶜwa ta'ajjal* principles underlying the management of bonds and Islamic bills, require urgent resolution. Islamic scholars in the Middle East and other international scholars disagree strongly over the applicability of these principles. Their differences threaten any kind of cooperation and integration by IFIs on a global scale. Haron and Ahmad also argue for a distinct identity of Islamic banking that is only remotely possible as long as the concept of "cost of funds" in an Islamic bank is the same as that in a conventional bank.

Islamic Investing

An Institutional Investor's Perspective

Omer Ahmed*

ABSTRACT

With the maturation of the Islamic financial mindset, many Islamic investors are seeking more concerted efforts toward an application of the principal philosophy of Islamic finance and shunning conventional financial instruments that are window-dressed as Islamic investments. This paper outlines some old concepts that are incorporated into a new paradigm of Islamically managed assets. A three-component asset-management format shall be discussed, beginning with a "flow-through" method that is initiated by private equity investments. This is followed by trade- and lease-finance exposure, which also provides for an adequate cash management function. The process culminates in a public equity structure, which can also be regarded as an exit strategy for some investors. A comprehensive Islamic investment management vehicle shall be discussed from the institutional perspective.

I. INTRODUCTION

A significant aspect of Islam is the extent of its involvement in social, commercial, and political issues. The Islamic economic system differs quite substantially from the liberal, capitalist system that most Western-trained economists take as their base case. It is vital to appreciate that Islamic economic theory is defined in the context of an Islamic society, the objectives and structures of which differ substantially from the societies that many of us inhabit today.

While it is critical to define and envisage an ideal Islamic economy (essentially an academic and theological process), it is also crucial to examine the transition from our current state toward the ideal (essentially a practical exercise).

The process of defining an ideal Islamic economy can occur in the context of an Islamic society. However, the practical process of defining a transition must work in the context of a secular society or an interest-based economic system and must, as a staring point, concern itself with individual persons or institutions that operate in an alien environment.

II. ISLAMIC ATTITUDES TOWARD WEALTH

Islamic attitudes toward wealth underpin Islamic economies. Islam does not suggest that wealth possesses any intrinsic ethical qualities, whether good or bad. Unlike some cultures and religions, Islam does not teach that the absence of wealth is a virtue or a vice, nor that its presence implies any particular character.

> "Wealth properly acquired is a good thing for the good man."
> (*ßākim al-Mustadrak*, Vol. 2, p.2; Hyderabad, 1340 A.H.)

Instead, Islam judges the manner in which wealth is generated, deployed, and consumed. It does not place any specific or unique responsibilities upon the wealthy.

> "The honest, truthful Muslim trader will be in the company of the martyrs on the Day of Judgment."
> (Ibn Mājah, Sunan, *Asbāb al-Tijāra*, *Bāb al-ßa¥¥ al-Makāsib*)

Islam stresses modesty in consumption and avoidance of waste. On the other hand, it also emphasizes the importance of self-reliance.

> "To earn an honest living is a duty [ranking] next to the chief duty [of offering prayers]."
> (Mishkāt, *Kitāb al-Buyūᶜ*)

* President, Crescent Capital Management, Chicago, Ill.

In terms of precedent, it is important to note that the Prophet Muhammad and those close to him carried out commercial businesses on a successful basis.

III. Participation and Risk

One of the few obligations that Islam places on those who control wealth is to invest it productively. The hoarding of wealth has been strictly prohibited, as has taking advantage of wealth. Islam defines wealth in terms of assets, not in monetary terms. Money is seen as a medium of exchange but not as a store of value: money has no value of its own. Islam places great importance on fairness and justice: in the context of finance, owners of capital are not permitted to exploit, take advantage of, or protect their positions. The *sharīᶜa* places the providers of all the various factors of production on an equal footing. In particular, a strong body of evidence suggests that the providers of capital cannot obtain favorable treatment over the providers of labor, skills, and entrepreneurship. There are numerous references to the fact that Islam recognizes the separation of ownership and control. Hence, investments can be made in ventures that are not managed by the owner.

IV. Philosophical Mandate

Islamic finance in its truest form comes down to a philosophical mandate:

1. Wealth must be deployed productively, i.e., invested rather than saved.
2. The hoarding of wealth is unlawful.
3. Money is not considered to be an asset.
4. Islam recognizes the separation of ownership and control.
5. Providers of capital cannot take advantage of their position.

Although none of these points are controversial in themselves, when taken together as a whole they have far-reaching implications. A closer look at the implications permits a better understanding of the true characteristics of Islamic finance. Consider the stipulation that wealth be invested in an economic venture, which by definition is risky. Lending is only permitted for altruistic purposes. Providers of capital must share in the outcome of the business; they cannot protect their capital or extract other forms of guarantees (of capital returns). Capital cannot take preference over other factors of production and therefore cannot secure the cash flows or assets of the business by way of guaranteed profits, certain returns, or predetermined returns. Under the Islamic financial mandate, investors may reduce risk by diversifying their investments across a number of different ventures. Money cannot be bought and sold for itself (nor can any other commodity). Neither is money a fixed asset; thus, it cannot be rented out. Islamic economics, unlike conventional economics, does not recognize the concept of financial capital. Money is not a factor of production, and it is, at best, a deferred or a potential asset. These implications are important defining characteristics of Islamic finance and must be taken into account by any Islamic financial institution.

V. The Islamic Law of Contract

To imply a philosophical mandate, one must have a means to uphold these principles. Islamic law governs Islamic finance and its principles. There are four main sources of Islamic law: the Qur'an; the Sunna of the Prophet, which reflects his way of life and hence sheds light on the Qur'an; the consensus (*ijmāᶜ*) of the great jurists and interpreters of Islamic law; and finally the principle of analogy or precedent (*qīyās*) by which the rules of Islamic law are extended to similar or analogous situations. These sources of Islamic law prescribe lawful means of transacting and provide the criteria for judging the legality of transactions that are not strictly covered by the four sources mentioned previously. Islam does not dictate a particular contractual format; in fact, the concerned parties possess the freedom to choose the most convenient form of contract from the array of permitted contracts.

VI. An Islamic Asset Management Product

Given the starting point for most Islamic investors and institutions, one must accept that there are costs to complying with Islamic requirements and that one must be realistic and accept that it is not possible to achieve full compliance on a mass scale. Any Islamic financial product must pass several tests: it must be productive, involve full participation (profit-and-loss sharing), free of interest, and free of ®*arām* elements.

While these criteria do not appear particularly onerous, they have far-reaching practical implications when viewed together and in the context of a conventional economy. The presence of Islamic requirements in a conventional macroeconomic framework can possibly have detrimental side effects, such as a greater level of risk and a loss of liquidity. These side effects are not entirely offset by the benefits of an Islamic macroeconomic framework, such as greater economic stability, increased investment, and the absence of inflation. In fact, substantial synergies can be achieved by applying Islamic requirements in an Islamic macroeconomic framework, including a reduction in the risk and volatility of equity investments, greater economic growth, and higher returns on equity.

The Islamic macroeconomic framework is the foundation for a three-tiered paradigm of Islamic asset management. First, investment is initiated through a private equity transaction. It is then enhanced through a trade or lease finance structure. Finally, it is enhanced through a public equity structure, which can be regarded as an exit strategy that includes public equity floatation and the management of public equity exposure.

The Islamic macroeconomic framework defined above can take asset management one step further and apply it to an institutional investor's customized portfolio. This portfolio obviously must be structured to meet specific requirements and preferences: Islamic restrictions, geographic and sector allocations, risk preferences, diversification and risk control, and benefit to Islamically inclined businesses or regions.

The customized portfolio is put through a comprehensive screening process to ensure that it meets Islamic financial conditions. The typical screening begins with individual companies and progresses on to various sectors, different stock markets, and the attributes of each company. Moreover, portfolios are continuously screened in order to ensure adherence to the principles of Islamic finance and a bias toward Islamically inclined regions and companies.

VII. INVESTMENT STRATEGY AND PROCESS

Each portfolio should contain a comprehensive Islamic investment management vehicle that is managed from an institutional perspective. The vehicles include a specific investment strategies and processes that involve four steps:

1. focus on deal-screening criteria;
2. the investment process;
3. the structure of the investment vehicle; and
4. investment constraints.

A. Focus on Deal-Screening Criteria

Deal-screening criteria center on due diligence procedures. The due diligence review prior to a private equity investment, while adhering to Islamic principles, should include a number of other components. Each private equity investment should have an attractive and proven business model that includes advantageous positioning within the industry. The investment should also have an organized and focused management team and exhibit significant competitive advantage. The amount of debt should be low to negligible, and total debt should not exceed 25% of total equity or capital, whichever is higher. The private equity investment should have an established business plan that manages and maintains these criteria. The target of the Islamic investment should not engage in a prohibited business (gambling, tobacco, alcohol, pork, pornography, weapons of mass destruction, and conventional finance). Here, a socially responsible investment strategy acquires paramount importance. Finally, the screening process entails the inclusion of a plan to effect an initial public equity offering within three years.

B. The Investment Process

The investment process includes the above-mentioned procedures as well the standard due diligence prior to an investment. This process involves the extraction of information on the investment's true characteristics as well as the driving forces behind each company. It includes an extensive look into the background of the company's management team and the basic economic premises that drive the firm's business model.

C. The Structure of the Investment Vehicle

The structure of any investment vehicle used in Islamic investing should be based on equity. The Islamic law of contract and Islamic macroeconomic ideals (when juxtaposed with conventional methods of structuring investment vehicles) suggest that limited partnership is the most desirable structure for an Islamic investment

vehicle. It is imperative to base the said vehicles on a profit-and-loss model and not burden them with debt finance or any interest-based financial instruments.

D. Investment Constraints

The final investment strategy pertaining to Islamic investment vehicles managed from an institutional perspective involves the actual constraints on investment. No more than 10% should be invested in any single company. Investments should contain trade and/or lease-finance opportunities as well. The investment should also have a regional bias (more Islamic focus, if applicable) while maintaining global exposure.

VIII. Conclusion

The long-term strategy of Islamic financial institutions must be to expand their influence and spread Islamic finance. This will be accomplished by demonstrating the greater effectiveness and efficiency of the Islamic financial system. So far, Islamic institutions have established themselves but have not yet demonstrated to the institutional investor that Islamic investing generates superior long-term returns. Now that Islamic institutions are reaching a level of maturity, it is time for them to implement the substance of Islamic finance. When they have achieved sufficient size, prominence, and power in the financial industry, they will be able to convince the companies in which they invest to amend the legal form of transactions to comply with Islamic requirements. The commercial imperatives of competing in the deposit market, gaining size and critical mass within it, are important and have largely been achieved, yet progress in the substance of Islamic finance remains elusive.

Culture or Accounting

What Are the Real Constraints for Islamic Finance in a Ribā-Based Global Economy?

Andrew Cunningham*

ABSTRACT

International financial regulators would like to see Islamic finance adopt accounting practices consistent with global standards. As global standards become more widely accepted—and international regulators more insistent on the importance of global comparability—any financial system that fails to conform stands out in ever-greater relief. Regulators argue, convincingly, that the supervision of Islamic financial institutions and the accounting practices that those institutions use can with little difficulty be adapted to Western (*ribā*-based) norms. However, these arguments miss a fundamental point: for a significant constituency of Islamic financiers, the "otherness" of Islamic finance is more important than any advantages conferred by complicity with the global accounting architecture. The rise of Islamic finance in recent decades has mirrored the growth in Islamic sentiment and the search for an Islamic identity to replace post-colonial models. Non-Muslim regulators and accountants seeking ways to incorporate Islamic finance into the global accounting architecture should start by recognizing the importance of its otherness, rather than by treating that otherness as a technical inconvenience that can be mechanically fixed.

I. INTRODUCTION[1]

The inspiration for this paper came from a conference held by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain in February 2000. The conference, in which the author was a discussant to one of the sessions, was centered on the issue of the regulation and supervision of Islamic financial institutions (IFIs). Participants included practitioners of Islamic finance as well as officials from international agencies such as the IMF and the International Accounting Standards Council (IASC), among others.

The strongest impression that the author took away from that conference was that the two sides—Islamic financiers and international regulators—had different agendas. The international regulators extolled the virtues of global accounting comparability. They emphasized the necessity of having a single accounting and regulatory system in order to forestall a reoccurrence of crises such as that seen in Asia, and they tried—unsuccessfully—to convince Islamic financiers that all the instruments and systems of Islamic banking could be expressed within a global regulatory architecture without losing their integrity. The international regulators praised—occasionally in absurdly hyperbolic terms—the importance of the *Core Principles for Effective Banking Supervision*, published by the Basle Committee in 1997. These principles, they argued, were broad enough and flexible enough to encompass all the aspirations of Islamic finance.

But the Islamic financiers felt differently. Time and again, they referred to a need to recognize the different and unique features of Islamic finance, and the conference's final communiqué established a policy group charged with finding ways of adapting international regulatory standards to take account of these different and unique features.

What the international regulators did not fully appreciate—or would not accept—is that Islamic finance is about more than just finance. The move to establish IFIs, which in its most recent manifestation began in the 1960s and continues to gain pace, is part of a search for an Islamic identity. Western colonialism led to the physical occupation of Islamic lands by foreign armies and bureaucracies. Western legal canons were imposed, replacing traditional codes based on Islamic law. Cultural hegemony both preceded and succeeded physical occupation. The secular nationalism of leaders such as Gamal Abdel Nasser and of the Ba'th Party, which followed the withdrawal of colonial powers, ultimately disappointed. The search for an identity that can be both a route to success and a source of pride is now frequently centered on Islam. The development of Islamic finance is part of a movement that includes greater support for Islamically-orientated political parties and more widespread wearing of "Islamic" dress.

* Vice President and Senior Credit Officer, Moody's Investors Service, London, United Kingdom.

Seen in this context, one can understand why Islamic financiers give such attention to the recovery of defunct Islamic financial vocabulary and forms—the medieval geographers being a particularly rich source. "See," the financiers are saying, "We had these instruments a thousand years ago, when Islamic trade spanned continents."[2]

Arguments that Islamic finance can be accommodated within global regulatory and accounting principles are, this paper will argue, sound, but they miss the point. For a significant constituency of Islamic financiers, the "otherness" of Islamic finance is more important than any advantage to be gained though consistency with global architecture. As a result, progress will be made toward adapting global norms to the particular circumstances of Islamic banks, and, over time, we are likely to see increasing use of such adapted standards. This is the reverse of the global trend whereby national standards that differ from global ones are diminishingly important. For example, Portuguese banks continue to cite their capital ratios according to Bank of Portugal rules, but they know that analysts are only interested in ratios calculated according to international (Basle) norms. In contrast, we are likely to see an increasing tendency for Islamic banks to cite their AAOIFI ratios rather than, say, Basle ratios. How far this trend goes will depend in part on the response of national regulators in the Islamic regions (who are likely to be sympathetic) and on the acquiescence of international capital markets. And it will also be driven by the ebb and flow of Islamic sentiment.

The thesis of this paper is rooted in two interlocking questions: First, are IFIs and the instruments they employ so inherently different from *ribā*-based banks and instruments that they cannot be measured and monitored through the norms applied to *ribā*-based banks and instruments? If the answer to that question is "no," then it must be that resistance to such incorporation is based on something more than financial considerations. That then leads to the second question: if not financial, what is the basis of that resistance?

These two questions are addressed from two vantage points. The first is that of a bank analyst who analyzes financial institutions and instruments in a professional capacity. The second is solely that of an interested observer. The Islamic world has suffered much at the hands of Western analysts who sought to impose their own discourse on Islamic themes, and who believed that they were better able than Muslims themselves to articulate their aspirations and concerns.

II. Is Islamic Finance Different? The Regulatory and Accounting Perspective

A. Treatment of Deposits

The greatest potential difference between the accounting practices of Islamic finance and that of *ribā*-based institutions lies in the approach to on-balance-sheet and off-balance-sheet instruments. One of the principles underlying Islamic finance is that providers of funds should share in the risks and rewards of the ventures that they fund. Bank depositors are providers of funds, so the question arises as to whether they should be required to take a write-down in the value of their deposits if the value of the assets they have funded has been written down. This is a major difference from Western practice—depositors in a Western bank have a claim on the bank for the full value of their deposit plus any accrued interest. If the bank writes down the value of the assets, the bank's obligation to depositors is unchanged. Since Western regulators, and the accounting systems that they promote, have the safeguarding of individual deposits as one of their primary objectives, a profit-and-loss sharing (PLS) approach to deposits clearly presents huge problems for them.

And yet, within the Islamic context, the treatment of PLS deposits is far from straightforward. *Qar∞ ®asan* is a well-established Islamic financial instrument akin to a Western bank's demand deposit. The bank is obliged to return the deposit on demand and in full. (The bank is compensated for this obligation by the fact that *qar∞ ®asan* deposits are interest-free.) On the other hand, Islamic banks offer investment funds, which are kept off-balance-sheet, and where the return to investors is directly linked to the performance of the fund. The difficulty—in respect of integrating the Islamic and Western systems—lies in the ground between these two points. Some Islamic banks collect deposits that are not wholly *qar∞ ®asan*, but are on the balance sheet.

The way into analyzing the status of Islamic banks' deposits is to ask first, "What is the explicit presentation of these deposits in the published accounts?" Then we must ask, "Whatever the presentation may be, what would be the likely treatment of those deposits, in practice?"

A survey of published accounts indicates that most Islamic banks do not see their on-balance-sheet deposits as being profit-and-loss sharing.[3]

- Of the balance sheets reviewed, only Kuwait Finance House made clear that a portion of some of its deposits bore the risk of investment loss.
- Most banks refer in their annual reports to investment funds that they offer as part of their range of financial products. The fact that these funds are presented as a separate product—sometimes explicitly included in the

accounts as an off-balance-sheet item—would imply that a distinction is being made between one type of account, which contains investment risk, and another that does not.

- Of the balance sheets reviewed, none raised any "fair value" accounting issues in respect of deposits. (If the deposits were to be written down to cover write-downs on the assets side, the fair value of deposits would be less than the book value.)

It is hard not to conclude that, except where specific exclusions are made (as in the case of Kuwait Finance House), the banks surveyed recognize that they have an obligation to repay to customers the book value of their deposits. Furthermore, these deposits have not, in practice, been treated as PLS. Islamic banks that have written down the value of assets have not in practice written down the value of deposits. The present author has on several occasions asked distinguished gatherings of Islamic bankers to name a single occasion on which depositors in an Islamic bank have been forced to accept a write-down in the value of their deposits—no one has ever been able to cite a case.[4]

In practice, Islamic banks are drawing a distinction between deposits that are on-balance-sheet and that they, their customers, and their regulators assume will be paid in full; and investment funds that are off-balance-sheet and whose value fluctuates with the performance of the fund.[5] Yet Islamic banks face a dilemma: if the funds are to be repaid in full, then they must be *qar∞ ®asan*, repayable on demand, and unremunerated. This raises questions of liquidity (the maturity structure of liabilities will be overwhelmingly short-term) and competition (none but the pious will place money for free when *ribā*-based banks will pay a return). On the other hand, if the funds are profit-and-loss sharing, with a longer maturity and (hopefully) paying a return, should they really be on the balance sheet?

From a regulatory and accounting perspective, the dilemma hardly seems insurmountable. If PLS accounts were taken off the balance sheet, the main reservation that Western regulators have about Islamic banks would be eliminated. The question of maturity structure could then be addressed, in the short term, by giving Islamic banks extended access to a central bank discount window, and, over the longer term, through the development of medium-term liability instruments that suit the risk appetites of Islamic depositors.

Potentially, such a move could reduce significantly the size of the balance sheets of Islamic banks. Balance-sheet size is frequently (and misguidedly) a source of pride to managers and shareholders, and the prospect of having to move a large proportion of assets and liabilities off the balance sheet would be a disincentive to many.

B. Calculation of Capital Adequacy

From the regulatory perspective, the main purpose of bank capital is to insulate depositors against loss. The calculation of capital adequacy is a function of the availability of capital in relation to the size of potential losses.

Calculating available capital presents no problems. Islamic banks' capital funds comprise elements such as paid-up shares, reserves, and retained earnings, just as Western banks' funds do. The difficulties arise in judging the size of potential losses. The potential loss that capital will have to absorb is less when part of the balance sheet comprises PLS accounts, since such losses will be absorbed by the depositor. It is on this basis that Islamic financiers have frequently argued that they require less capital than *ribā*-based banks.

In March 1999, AAOIFI published a *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*, which identified three types of risk arising from the management of PLS accounts:

1. Nominal commercial risk: the risk that the assets funded by the deposit will have to be written down, so causing the deposit to be written down.
2. Fiduciary or management delinquency risk: the risk that a bank could be sued or suffer reputational damage, whether or not it has acted improperly.
3. Displaced commercial risk: the risk that customers may refuse to accept the possibility of sharing losses, and so take their business elsewhere, thereby diluting the bank's franchise.

According to AAOIFI, the first risk is borne entirely by the depositor and presents no threat to capital. However, the other two risks are borne entirely by the capital. This situation leads AAOIFI to assign a risk weighting to assets funded by PLS deposits based on fiduciary and displaced commercial risk. Since that risk weighting is less that the risk weighting that would routinely be assigned to assets funded by PLS deposits, this accounting methodology has the effect of raising Islamic banks' capital ratios above the level that would be seen if Basle-based methodology were used.

The point at issue between the Islamic treatment and the Basle treatment comes back to the treatment of deposits already discussed. If the liabilities that are available to absorb losses are moved off the balance sheet, or at least clearly identified on it, the potential losses that capital may have to bear should be explicit. Any problems comparing capital ratios of Islamic and Western banks would then arise only over which risk-weightings to assign to respective on-balance-sheet asset classes. Western regulators have themselves had disputes on this issue (for example, on the weighting assigned to mortgages), but by and large have been able to resolve them.

It would therefore appear that if the issues surrounding the differential treatment of deposits can be resolved, there is no reason Islamic capital adequacy standards can not become directly comparable with those based on the international Basle methodology.[6]

III. The Nature of Islamic Financial Instruments

It is sometimes argued that IFIs cannot be integrated into the international regulatory and accounting architecture because the nature of Islamic financial instruments is unique and consequently incomparable with that of instruments used elsewhere. *Prime facie* this appears improbable. Every banking system has its particular features, some of which may even be unique. The *Core Principles for Effective Banking Supervision* were devised specifically with the aim of being appropriate for banking systems throughout the world, and there has been no significant backlash against them on the basis of non-comparability (though some may have other reasons for not wishing to adhere). It seems hard to argue that if financial institutions that have grown up in a Buddhist, Confucian, or any other cultural context find no problems with comparability, those from an Islamic context should.[7] The same would apply when the analysis is based on geographical and historical antecedents rather than cultural ones. Furthermore, if the international regulatory and accounting architecture can accommodate the derivative instruments now being concocted by Western banks, they can surely accommodate the complexities of Islamic financial instruments

In practice, Islamic financial instruments do not seem to present particularly difficult accounting issues (other than those already mentioned). As an analyst of IFIs, the author has had to seek guidance on the timing of income recognition on *murāba®a*, but income recognition is an issue that arises with *ribā*-based financial instruments as well. Many Islamic banks used to declare the remuneration of depositors as a dividend below the net profit line (to make the point that they engaged in profit-and-loss sharing), but that practice has now stopped. Islamic financial instruments are less familiar to Western regulators and accounts, but that does not mean that they are *inherently* incomparable.

A. If There Were a Will, There Would Be a Way

An English expression says, "Where there's a will, there's a way." If Islamic financiers wanted to integrate their regulatory and accounting practices with the global architecture, they could find ways of doing so. The fact that they do not implies that they do not wish to. The final section of this paper explores why that might be so.

B. Islamic Banking as a Cultural Expression

It is not disputed that Islamic sentiment has increased in the Muslim world over the last thirty years, even after discounting any aspects of that sentiment that may more properly be considered articulations through Islam of issues that are essentially secular, traditional, or tribal. The reasons for that increase have been widely discussed and fall outside the scope of this paper.[8]

The revival of Islamic banking has been part of this wider increase in Islamic sentiment. In some cases, the beginnings of the revival can be placed at the start of the "post-post-colonial" era, a time of disappointment and unfulfilled hopes (so, in Egypt, the years that followed the death of Nasser). In others, it has to be related more to economic factors, such as the 1973 oil price hike. In all cases, the growth of IFIs has additionally to be linked to the growth of capital markets as a whole, including, in their most basic form, greater demand for bank-deposit taking functions and the need to fund state-driven economic growth. This growth in capital markets has been powered largely by increased resources. In the Gulf, the creation of new banks, both Islamic and *ribā*-based, occurred in two main phases: after the 1973 price hike and after the increase in oil prices that followed the Iranian revolution in 1979.

It should also be recognized that in some cases the establishment of IFIs might itself promote an increase in Islamic sentiment. The creation of Islamic banks in Sudan, which were more willing than *ribā*-banks to lend money to small businesses, is believed to have been a factor enhancing support for the Muslim Brotherhood in the late 1970s.[9]

C. Islamic Finance as a Religious and Cultural Business Model

Yet the observation that the creation of IFIs has tended to run parallel to an increase in Islamic sentiment does not in itself explain why Islamic financiers should resist integrating aspects such as regulation and accounting practices with the global architecture. But an explanation does start to appear when we consider how practitioners articulate the merits of Islamic finance as a business model.

Islamic financiers do not generally argue the merits of Islamic finance in terms of its economic or financial efficiency relative to *ribā*-based systems, even though in some areas they would have a convincing case when doing so. So for example, Islamic financiers do not argue that IFIs have inherently greater operating efficiency than Islamic banks (although their low cost of funds means that in some respects they do). Nor do they argue that Islamic banks have inherently stronger asset quality or solvency (although if loan losses can be set off against deposits, that would likely be the case). Nor do they argue that IFIs are inherently more profitable than *ribā*-based banks.

Rather, the merits of IFIs are articulated in terms of their proximity to wider Islamic issues of equity and inclusion. Examples include:

1. The provision of financial services to people who might otherwise be excluded from the financial system. A few years ago, a *ribā*-based bank in Kuwait concluded that the deposit balances and transaction volumes of some of its clients were so minor that the bank was unable to make a profit from their custom. Those clients were encouraged to take their accounts elsewhere, and many went to Kuwait Finance House, the only Islamic deposit-taking bank in Kuwait, which accepted them because it believed that as an Islamic bank it has a duty to provide them with banking services, whether or not they generate profits for the bank. On the credit side, the *muzāraᶜa* financing technique is often cited as a method of extending credit to small farmers in a way that would not be attractive to *ribā*-based banks. *Muzāraᶜa* might involve a bank's providing seed, fertilizer, and machinery to a farmer and linking the timing and size of the repayment to the success of the crop.[10]
2. The promotion of greater equity in global financial relationships and the avoidance of unmanageable debt burdens. It is argued that if international banks and lending agencies extended credit on a profit-and-loss sharing basis, they would take greater care in credit appraisal, avoiding, for example, loans to huge prestige projects that they suspected would never make an economic return. The third-world debt burden, it is argued, would not have been created, and could not continue to exist, under an Islamic financial system.
3. IFIs conduct financial transactions in line with Islamic religious principles. Many Islamic banks cite Qur'anic injunctions against interest in their annual reports. A prominent position is usually given to the photographs of the members of their *sharīᶜa* boards, who are responsible for ensuring that nothing the bank does contravenes the tenets of Islam. Practitioners of Islamic finance frequently cite precedents for current Islamic practice from the actions of the early Muslim community, which is believed to provide a model for Islamic conduct. It is clear that the religious aspect of IFIs is central to their identity in a way that, for example, Hinduism is not to Indian banks, nor Catholicism to Italian banks.[11]

Some consideration must be given to occasions when *ribā*-based banking systems have been converted to an Islamic model by government fiat. Iran, Pakistan, and Sudan provide examples. In these cases, the conversion was driven either by the interaction of political and religious factors (i.e., the need for politicians to secure the support of the religious authorities) or, with Iran, by a belief that only an Islamic system of finance could fulfill the government's social agenda. The Iranian government did not introduce legislation converting existing banks to an Islamic system because it believed that Islamic banks would be more efficient, profitable, or strong. It believed that Islamic banks would promote greater economic equity, as well as discharge the obligation of the Muslim community to conduct itself in a manner consistent with the *sharīᶜa* and the best practices of its forebears.

IV. CONCLUSION

The distinguishing feature of Islamic finance lies in its expression of Islamic values, and that expression has been given greater value by the *aporia* that has pervaded much of the Muslim world in recent times. (The fact that many of those Islamic values are shared by other systems of belief is irrelevant.) In this context, it is hardly surprising that the cries of international regulators that Islamic finance *can* be integrated into the global regulatory and accounting architecture, and that advantages would accrue to all if they *were*, find scant resonance in the Muslim community. Islamic financiers are engaged in what they see as a far grander enterprise: playing their part in a holistic reconstruction of Islamic institutions and social structures.

[1] *Ribā* is the Arabic word for "interest" or "usury." (Its precise meaning is itself a subject of dispute among scholars.) In this paper, the terms "*ribā*-based economy" and "*ribā* bank" are used in contradistinction to an economy or bank that eschews the payment or receipt of interest, in accordance with the tenets of the *sharī*‾*a* (Islamic law). The term "Western banks" is also used in the paper in contradistinction to those that are based in an Islamic or developing market environment.

[2] In case any Western financiers should think of deriding such reference to historical precedent, a recent edition of Risk, a financial industry journal whose articles are sometimes so abstruse that they appear to contain more Greek than English letters, included an article by two investment bankers about an eleventh-century finance deal led by a Genovese alum merchant that, the authors said, illustrated many contemporary issues surrounding the boundaries between hedging and insurance.

[3] The 1999 balance sheets of the following banks were reviewed: Al Rajhi Banking and Investment Corporation, Bahrain Islamic Bank, Dubai Islamic Bank, Kuwait Finance House, Muslim Commercial Bank, Qatar International Islamic Bank, Qatar Islamic Bank, and United Bank Ltd. The GCC banks were selected because they are retail deposit takers, with reasonably sophisticated businesses including exposure to Western financial markets. The Pakistani banks were included because in addition to these factors, they operate in a financial system that is explicitly managed according to the tenets of Islamic finance.

[4] When Kuwait Finance House, like other Kuwaiti banks, declared a net loss in the early 1990s, it did not write-down the value of deposits. When Qatar Islamic Bank had to write down loans that it had made to the Bank of Credit and Commerce International, it did not write-down the value of deposits. Nor did Dubai Islamic Bank, when in 1998 its asset write-downs were so severe that the bank needed to be recapitalized (or to put it another way, the shareholders had to accept the loss in order to protect the depositors). Nor does the collapse of so-called Islamic investment companies in Egypt in the late 1980s provide an example. *De facto*, the companies were investment funds, not banks. *De jure*, they were not regulated as banks, or apparently as anything else.

[5] Among the banks surveyed, a qualification must be made for Kuwait Finance House, which, as already mentioned, has some on-balance-sheet funds that bear investment risk.

[6] An assumption is being made that the concept of fiduciary responsibility is clearly defined and accepted within Islamic law. That is, a difference is recognized between losing money due to poor investment decisions and due to fraudulent investment management. If that difference is not defined and accepted, then an Islamic bank acting as a *mu∞ārib* (fund manager) could be liable to compensate investors for routine losses.

[7] To avoid any confusion, it should be emphasized that the fact that a banking system *does* not adhere to international regulatory architecture is not same as saying that it *can not*.

[8] See for example, Piscatori, James. Islam in a World of Nation States. New York: Cambridge University Press, 1986. Chapter 2, "The Nature of the Islamic Revival."

[9] Woodward, Peter. "Sudan, Islamic Radicals in Power" in Esposito, John (ed.). Political Islam. Boulder: Lynne Rienner, 1997.

[10] One should recognize that many "microfinance" initiatives in developing countries would also offer this type of facility, but without any explicit Islamic overtone.

[11] Some European banks have their origins in religious sentiment: for example, Italy's Monte dei Paschi de Sienna and Portugal's Caixa Economic Montepio Geral. The name of both banks refers to the Catholic religious concept of a "Holy Mountain." Yet, this religious dimension is expressed through a mutualist business model rather than a religious identity.

An Introduction to Modern Islamic Economics and Finance

Mahmoud A. El-Gamal*

ABSTRACT

This paper attempts to examine Islamic economics from the standpoint of conventional economics. Included is a background of the canonical prohibitions that are the foundations of Islamic banking and finance. The precise meaning of the terms *ribā* and *gharār* are also explored. Given that today's complex financial markets did not exist during the classical age of Islam, the adoption of a more objective-driven approach and the pursuit of disciplined freedom from the mindset of outmoded texts are also addressed.

I. INTRODUCTION

Many of the assertions made in the name of "Islamic economics and finance" do not make much economic sense to a "mainstream economist." Taking off my Islamic economist hat and putting on my regular economist hat, I shall try in this brief talk to make some sense of the assertions of Islamic economists. I am primarily concerned in this talk with what I believe Islamic banking and finance is truly about. Therefore, for the duration of this talk, I shall ask you to forget what others say about it. We have talked about Islamic economics elsewhere, and tried to understand it from an insider's point of view. In what follows, I shall try to give you a standard economist's informed and sympathetic point of view.

I always like to refer to Judge Richard Posner's statement: "Often the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character." He is talking about American common law, but I think this is much truer of Islamic law. Islamic jurists often justify their juristic rulings on the basis of ®*aqq* (justice): that clearly this or that is what justice dictates, without providing a thorough account of the analysis on the basis of which they reached that conclusion. So you have to dig more deeply, as Judge Posner does in opining that legal education basically consists in training to drill beneath the rhetoric in order to find the true basis of decisions. This is my task as an economist and an Islamic economist: to venture into books of jurisprudence, trying to understand the implicit analysis underlying professed opinions. In many cases, the type of analysis that jurists professed to be doing was *different* from what they actually did.

II. THE PROHIBITIONS OF *RIBĀ* AND *GHARĀR*: WHY DO THEY EXIST?

Talk about Islamic banking and finance is often dominated by discussions of business ethics. The truth of the matter, however, is that this industry would not be here if the prohibitions of *ribā* and *gharār* had not driven people away from conventional banking, through fear of transgressing against the Sacred Law, thus forcing them to think of other alternatives. Ethical aspects are all very good, and we try to include them in the analysis whenever we can, but basically the industry is driven by prohibitions. When someone stands in the mosque and says, "*Ribā* is ®*arām* and you're declaring a war against Allah and His apostle," that's what will bring ordinary people to start thinking about Islamic banking and finance.

When talking about prohibitions, we must mention why those prohibitions are there, because basically all the financial instruments available today were not available when the original legal documents were drawn up. And they definitely did not exist when the canonical documents, the Qur'an and Sunna, were revealed. Hence jurists have to make inferences from the canonical texts and later explanations by jurists. To do this, they have to go back and determine what objectives of the law were served by various prohibitions, to see whether we can extend the prohibition of *ribā* and transfer it to something like modern-day interest (in all its forms). When we address the objectives of the law as they pertain to financial innovations that were not dealt with in the original texts, analysts have to rely on reasoning by analogy, thus giving rise to many differences in opinion.

* Chaired Professor of Islamic Economics, Finance, and Management and Professor of Economics and Statistics, Rice University, Houston, Tex.

In this regard, one must wonder why certain prohibitions were spelled out explicitly in canonical texts, while others were not. For instance, there is no explicit text prohibiting hitting one's head against the wall a hundred times each morning, but it's obvious to us that that's harmful. By contrast, explicit prohibitions will be required in cases where there is a subtle benefit to abstaining from the forbidden activity, but casual empiricism would not reveal that benefit. In economics jargon, that says that optimal social behavior may not be "incentive-compatible." For example, if I think of what is best for me right now, I may not see that I should not engage in *ribā*. However, if I think about it more deeply, I might recognize that abstention from the forbidden *ribā* would make everyone in society better off. However, it might be the case that given the behavior of all others, each member of society has a myopic, individual incentive to defect. This is a basic tension between issues of economic efficiency (what is best for society), and equilibrium behavior (where no one can do any better by deviating from the social norm). Immanuel Kant expressed this notion in moral philosophy using the "universalization of behavior" hypothesis. For instance, it is best for society if nobody lies, thus enhancing the level of trust, and minimizing monitoring costs. However, given that everyone else tells the truth, I can gain an advantage by lying. But then if I universalize this behavior and consider a society in which everybody lies, then all confidence in the supposed society deteriorates, and the foundation of society would collapse. In the economic sphere, there are many instances of conflict between individual advantage given the actions of all others, and social benefit. In such instances, a religious prohibition can make everyone better off by providing a disincentive for each individual against deviating from the efficient social norm. In essence, the prohibition alters the individual preferences to put them in line with the social preferences. Paradoxically, the end-result is an improvement of social welfare, including for all the individuals who would otherwise have caused the social norm to collapse.

III. How Do We Define "*Ribā*" and "*Gharār*"?

According to Ibn Taymiyyah, almost all prohibitions of economic transactions can be reduced to one of two things: *ribā* or *gharār*. We have to grapple with what *ribā* is from an economist's point of view, avoiding the many bad translations and ideological misconceptions surrounding it. The first thing you read or hear on Islamic finance is that "interest is forbidden in Islam." However, the most basic analysis of the behavior of Islamic banks will show that this is a gross oversimplification. An extreme form of *ribā*, certainly, is *lending* with interest. There's no question about this: if I lend you a dollar with a condition that I must collect two dollars at a later date, this is a form of forbidden *ribā*. However, there are many forms of modern "interest" that jurists have allowed, whether or not they wish to use the word "interest." For instance, the markup over cash prices in credit-sale and lease financing contracts, upon which 95% or more of Islamic banking is based, lend themselves trivially to the calculation of the interest rate in this contract. Refusing to use the term "interest" for this markup does not change its nature, and only helps to confuse the issue. In my research (c.f. my paper on the prohibition of *ribā* in the Proceedings of the Third Harvard University Forum on Islamic Finance), I have arrived at a definition of *ribā* as "the sale of credit."

The second prohibition mentioned by Ibn Taymiyyah is of *gharār*, which most people confuse with some of its instances, such as gambling, deception, etc. In another paper of mine (c.f. proceedings of the Islamic Development Bank's 4th International Conference on Islamic Economics), I have found, after reviewing the opinions of jurists and through economic analysis, that the best definition of *gharār* is "trading in risk." The extreme form of *gharār* is gambling, where you pay a certain amount of money to have a roulette wheel, say, spun, and you win money if the ball falls in a particular slot.

Thus, I have argued that the two major prohibitions underlying the need for Islamic finance are prohibitions of trading in credit and trading in risk. This is an important problem, since any interesting financial transaction involves the transfer of credit and/or the transfer of risk. The questions are, how do you regulate such transfers of credit and risk, and how do the contemporary Islamic alternatives that have evolved based on contemporary jurisprudence make sense from an economic point of view?

IV. Misconceptions Surrounding *Ribā*

Starting with *ribā*, it is noteworthy that modern translations of the Qur'an, and English books on Islamic jurisprudence, translate *ribā* either as "interest" or as "usury." Both are bad and misleading translations. In fact, *ribā* is a term that does not have a good single-word translation in English (unless one uses the literal meaning of the term, i.e., "increase," but then it loses all juristic meaning). It is surprising that Arabic terms such as *murāba®a*, *bayᶜ bi-thaman aᶜjil*, *ijāra*, and so on, are very common in Islamic banking, despite the fact that good translations of those terms are readily available (e.g., cost-plus sale, credit sale, and leasing, respectively). In contrast, the use of

the English terms "interest" or "usury" (and even the Arabic word for interest, fa'ida) has all but replaced the use of the technical term *ribā*, for which no English translation is available.

Ribā and interest are not the same thing: there is *ribā* without interest, and there is interest without *ribā*. The famous ®*adīth*, "Gold for gold, silver for silver, salt for salt, dates for dates, barley for barley, and wheat for wheat, hand-to-hand, in equal amounts; and any increase is *ribā*," clearly states two conditions: hand-to-hand and in equal amounts. Thus, trading those goods for others of the same genus in different amounts is still *ribā* [*al-fa∞l*], even though there is no time factor and therefore no interest. Thus, there is therefore *ribā* without interest. On the other hand, all jurists agree in credit sales that a time value can be attached, so if a cup would sell for a dollar as cash-and-carry, I can sell it for $1.20 if I'm being paid in one year. Any child can divide the $0.20 mark-up by the $1.00 cash price and calculate an annual interest rate of 20%. However, this is not forbidden *ribā* because the interest is embedded in the credit price of a valid sale. Nonetheless, it is interest without forbidden *ribā*. Hence, we have shown that neither does all forbidden *ribā* involve interest, nor does all interest involve forbidden *ribā*.

Another common misconception is that the prohibition of *ribā* is meant primarily to prevent exploitation of poor debtors. In this regard, the popular translation of Yusuf Ali is misleading, because he stops in the middle of the verse on *ribā*, adding a separate sentence: "If you repent, then you shall keep your capital sums. Deal you not unjustly, and you shall not be dealt with unjustly." In fact, the commentary of all major exegetes (±abarī, Qur≤ubī, etc.) suggests that the verse continues in a single sentence: "But if you repent then you can keep your principals without inflicting or receiving injustice," which they explained as "without any increase or diminution." The exploitation explanation is quite old. Al-Subki, in his continuation of Al-Nawawi's *Al-majmū^c*, reported an opinion by Ibn Kayyisan that *ribā* was prohibited in order to prevent rich creditors from exploiting poor debtors. However, that explanation was fully debunked because it is easy to exploit individuals through loans with exorbitant interest that are denominated in non-*ribāwī* goods [*ribāwī* goods, based on the six mentioned in the ®*adīth*, are limited to fungible goods that are measured by volume or weight, or monetary numeraires].

According to Merriam-Webster's dictionary, one of the definitions of "interest" is "the profit in goods or money that is made on invested capital." If I invest capital in a commodity and aim to make a profit through a credit sale, the return is called interest. Hence, the translation of forbidden "*ribā*" as interest is incorrect. Moreover, the translation of forbidden "*ribā*" as usury is also mistaken, since modern usage of the term refers only to exorbitant interest. However, interest in a loan is forbidden *ribā*, regardless of its percentage. Hence, the use of "usury" is also incorrect.

A further prevalent fallacy is that *ribā* is "return without risk." However, the risk in a loan with interest is identical to the risk in a credit sale: credit risk. If $1.00 is used in a loan that is to be repaid as $1.20 in one year, or to buy a $1.00 commodity that is sold with a credit price of $1.20 payable in one year, the risk and return are the same. In both cases, once the debt is established on the borrower or buyer, the risk borne for one year is the possibility that the debtor cannot pay the $1.20. The differences between the two contracts are subtle: the credit sale involves automatic collateralization of the debt, and the rate of return can be easily marked to market using the rental value of the property (again, see my paper on the prohibition of *ribā* for further details and a complete analysis).

Thus, I would argue that the forbidden *ribā* is not the same as interest, is not the same as usury, is not only about exploitation, and is not about return without risk. Some also say that there is no time value of money in Islam. Populist arguments abound that if you put money in a jar it does not multiply, etc. In fact, the concept that money is sterile is a Catholic doctrine alien to Islam. There is a time value of money as long as it is used in a real transaction. Shaykh Yusuf al-Qaradawi, in his book on *zakāt*, notes that "*zakāt*" means "increase" or "growth," and therefore concludes that all properties with the property of growth or "*namā*'" (including money) are subject to *zakāt*. *Ribā* also means "increase," so *ribā* and *zakāt* linguistically are almost synonyms.

V. AN ECONOMIC EXPLANATION FOR THE PROHIBITION OF *RIBĀ*

The question then is: Interest alone is forbidden as *ribā*, but interest in a credit sale is not—why? Humans are known to exhibit dynamic inconsistency. In the paper I referred to earlier, one can go through verses of the Qur'an that mention that people are dynamically inconsistent in their thinking about future vs. immediate returns. Through experimental evidence and theoretical work, we know that people are inconsistent in the sense that if there is a restaurant that offers a good steak and a good salad, I might go there with the intention of eating the salad. Once I see the menu before me, however, I end up eating the steak. The solution to this in economic theory is that I go to a restaurant that does not offer steak. So even though the restaurant that offers steak might be offering better salad, I go to the other restaurant so that I will not be worried about my future self not following through with my current plan. This is called pre-commitment.

In fact, this pre-commitment explanation underlying the prohibition of *ribā* can be deduced from a ®*adīth* in which Bilal (may Allah be pleased with him), went to the Prophet (peace be upon him) with dates that he really liked. The Prophet asked where he had gotten them, and Bilal replied that he had traded lower-quality dates for the higher-quality ones. The Prophet (peace be upon him) was very angry: he said that this was precisely the forbidden *ribā*. Instead, he (peace be upon him) said that Bilal should have sold the low-quality ones and used the money to buy the others. This practice forces pre-commitment, because you first find the person who will buy your original product from you at the highest possible price, and then the person who will sell your desired product to you at the lowest possible price. This "marking to market" ensures that the ratio at which the low-quality dates are finally traded for the high-quality dates corresponds to the ratio of their market prices. This is a pre-commitment mechanism explanation of the prohibition of *ribā al-fa∞l* (which does not involve interest). I extend the analysis to dynamic settings in which interest is inherent, showing that the prohibition of *ribā al-nasā'* also imposes pre-commitment to tie the time value of money in a real transaction to the time value of the real object of that transaction (through marking its rental value to market).

VI. MANIFESTATIONS OF *GHARĀR*

Now we turn to the forbidden *bayᶜ al-gharār*. What is it? Under the section on *gharār* in a book of jurisprudence, a long list of Prophetic traditions indicates instances of forbidden transactions. Some involve ambiguity in contract language: two sales in one is described by Imam Al-Shāfiʿī as a practice in which a person says, "You can buy this for $1 now, or $1.20 in a year, and whichever you accept becomes binding on me." Thus, the offer is ambiguous, resulting in a prohibition based on uncertainty that may lead to dispute. There are other examples of prohibitions based on unnecessary uncertainty, such as the sale of a diver's catch. That's another Prophetic tradition: you cannot pay a diver an amount of money and say that whatever he catches is yours. However, you can lease his diving services for an hour. In a hiring contract, one can define either the work or the time, thus knowing what one is paying for. By contrast, one cannot pay for the future catch because there is unnecessary uncertainty, but I can pay for one hour of the catcher's time, and there is no uncertainty about the latter. Another set of instances of *bayᶜ al-gharār* involves undeliverable merchandise. Thus it is forbidden to sell birds in the sky and fish in the sea, for instance. Another forbidden instance is that of selling an unborn calf, in which case the object of sale might never materialize if the calf is stillborn. It is difficult to find the economic principle that is common to all those examples.

When the contract language contains ambiguity, it is easily possible to avoid *gharār* by eliminating the ambiguity. In this regard, most ambiguity can be removed by using known contracts in books of Islamic jurisprudence. The detailed rulings for each contract in each school of Islamic jurisprudence serve as the proverbial "fine print" for those contracts, eliminating all unnecessary ambiguity. Thus, if someone offers you a "lease" and you know that he follows ßanafī rulings, then you go to whatever is accepted in the ßanafī school and read the fine print, since any later disputes will be decided accordingly. Thus ambiguity in contract language can be eliminated.

However, *gharār* also involves uncertainty in most cases. The best definition of *gharār*, in my opinion, is that given by the late Professor Mustafa Al-Zarqa: *bayᶜ al-gharār* is "the probable sale of items whose existence or characteristics are not certain." Al-Zarqa then says that that renders the sale similar to gambling. A major Mālikī jurist, Al-Baji Al-'Andalusi, said that the Prophet (peace be upon him) in the Prophetic tradition does not say that *gharār* itself is ®*arām*, only that the sale of *gharār* is forbidden. As a matter of fact, a majority of jurists (with the exception of the Shāfiʿīs) permits uncertainty in a gift contract. Thus, Al-Baji said that what the Prophet (peace be upon him) meant by *bayᶜ al-gharār*, or the sale of *gharār*, is a sale in which *gharār* is a major component. Thus, the reason jurists disagree over whether to forbid a certain transaction is that they differ on whether *gharār* is present as a major or a minor component.

In juristic terms, the prohibition only applies to commutative financial contracts in which property changes hands, e.g. in sales. In my recent paper on the prohibition of *gharār*, presented at the IDB 4th International Conference on Islamic Economics (c.f. http://www.ruf.rice.edu/~elgamal/files/gharar.pdf), I provided an economic explanation of this prohibition based on a human idiosyncrasy called loss-aversion. To give a simple example, consider the recent computer purchase I made at a store. After I selected the computer and was in the process of paying its $1200 price, the salesperson asked whether I would like to buy the store's "Extended Warranty Plan." I thought for a second and asked how much it cost; he replied $200. He said, "You know, this screen alone, if it breaks down, will cost you $700 to replace." I thought, "He is appealing to my fear of potential loss—he could have told me earlier that I could either get it for $1200 with a limited warranty, or get it with the extended plan for $1400" (ignoring for a second the issue of two sales in one). However, he probably knew that at the buying stage, I would compare the inherent insurance in the $1400 package to the lower price of the $1200 package, and probably would

not have taken the extended warranty plan. But, he waited until I felt that the computer was mine. At that time, I feared losses more than I would have before I actually bought it, and I may buy the forbidden insurance for $200. Thus, Islamic jurisprudence would have allowed permissible risk sharing by bundling the insurance with the purchase (the extended warranty package for $1400), but forbids the sale of risk through insurance (the post hoc insurance for $200). In sharing the risk, the risk transfer is just a small component of the computer package with which it is bundled, and thus does not qualify as the sale of risk.

VII. *RIBĀ* AND *GHARĀR* IN STANDARDIZED CONTRACTS

Thus, we may gain an appreciation of the economics of the prohibitions of *ribā* and *gharār*. But when we read books of Islamic jurisprudence, we encounter numerous standardized named contracts—standardized in the sense that each school of jurists developed extensive rules on what constitutes a valid or invalid *murāba®a* with *bayᶜ bi-thaman aᶜjil*, *ijāra*, etc. These are alternatives in which credit is extended without selling credit directly, so they do not involve forbidden *ribā* even when they clearly involve interest. In credit sales, a fourth-grader can calculate the implicit interest rate from the cash price and the marked-up credit price. In a lease, the same fourth-grader can similarly calculate the interest rate. But *ribā* is absent because the major component is the sale of the good or the service. Thus, the named contracts avoid the sale of credit by bundling it in real economic transactions.

Similar provisions in standardized named contracts are made to ensure that risks are shared rather than sold. For instance, in silent partnerships (*mu∞āraba*), the provider of the capital risks losing his capital, while the worker risks losing his labor if the partnership produces no profits. But if the venture turns a profit, the investor and the worker share the realized profits according to the rules agreed upon beforehand. In *mushāraka*, or simple partnership, profits are shared according to an agreed-upon formula and losses according to the initial capital contribution. Thus, various partnership contracts specify how risks are shared between the partners. This eliminates unnecessary ambiguity and the potential for disputes, and ensures that the main objective of the contract is to engage in productive and profitable activity rather than merely to reallocate risks among parties.

There are exceptions to the prohibitions of *ribā* and/or *gharār* that jurists explicitly permit based on the Sunna or juristic approbation (*isti®sān*). For instance, in *salam* contracts, which are the Islamic alternatives to forward contracts, the buyer pays a price instantly for goods to be delivered in the future. In many cases, this contract is used when the object does not exist. This is a classical form of *gharār*—the very object does not exist at the time of the contract. Moreover, it may often involve *ribā* based on the difference between the forward and the spot market prices. The contract is permitted, however, based on the *®adīth* that whoever engages in a *salam* contract, let him specify the term of the contract, the price to be paid, and the characteristics of the item. *Istisnā'* (commission to manufacture) is a similar contract permitted based on juristic approbation. In that contract, the price is paid in installments as the object of the contract is being manufactured. Thus, we have standardized contracts that either evade *ribā* or *gharār*, or limit them to the absolutely necessary extent. Jurists worked over the centuries to perfect all the details (or "fine print") of those standardized contracts within their respective schools of jurisprudence.

Before sophisticated legal mechanisms were available for writing lengthy contracts, this standardization served an important role in facilitating business dealings. Thus, individuals could simply shake hands and agree to engage in an *ijāra*, *salam*, *istisnā'*, etc., and everyone would understand what they meant. Moreover, if a dispute should ensue, they would have to accept arbitration based on the rulings of that contract in the appropriate school of jurisprudence. Today, we have the facilities to write down the specific details of a lease or credit sale contract, and we do not need the implicit fine print of the books of jurisprudence anymore. Why then do people use Arabic terms? One reason is that jurists feel confident when they know that they are basing their decisions on solid precedent. Instead of innovating, they can say that they know *murāba®a* is correct, so if they use the same word and make minimal changes to what the term meant in a twelfth-century text, they feel that they are on solid ground.

Contemporary jurists and bankers can also gain credibility by appealing to the authority of certain historically renowned scholars, thus claiming that their current decisions are derived from the views of such highly respected historical figures. Perhaps one can push this cynical line of thinking further, and argue that the use of the Arabic names of contracts gives the jurists an unfair advantage by forcing others to argue on their turf. All professions try to gain an advantage over outsiders by creating a jargon in which they have a comparative advantage, and jurists are not exception to this trend. This ability to exclude others and form a closed circle of "scholars" allows members of the circle to collect rents that they would not otherwise. Indeed, the lucrative business of serving on so-called *sharīᶜa* boards of Islamic banks is a good proof of the existence of such rents.

However, there are also practical considerations that encourage the use of those Arabic terms. The fine print of any contract requires continuous refinement. By using the Arabic term, one has something that is ready-

made, and then all that one has to do is add small changes as the need arises. You take, for example, a *murāba®a* contract and add to it that it is *murāba®a li-al-amr bi-al-shirā'* (cost-plus sale on order), as many Islamic banks did in the 1980s. In the original cost-plus-credit sale, the person who already owns the car sells it to you at a higher credit price than the cash price he paid for it. But then the jurists respond, "What if you do not own the car and the person wants to buy it from a dealership? Can he tell you to go buy it from a dealership and sell it to him at a higher price and make the promise that he will buy it?" If one can take the existing credit sale, and add this small innovation to it, while preserving the name of the classical contract, the innovation seems less revolutionary.

Thus, we have seen the positive advantages of using the standardized contracts of classical Islamic jurisprudence, with their Arabic names. However, legal machinery that allows us to transcend that jargon is now in place, and well-trained lawyers can do a better job defining the fine print than a medieval jurist, regardless of the sophistication of the latter by the standards of his time. Whether the conclusions from the classical fine print that lawyers produce will abide by the canonical texts is an issue that we have to discuss. But do we have to be constrained by that fine print and merely be adding to it? The end result of this process often is an unnecessarily long and soon-to-be obsolete contract. The main question is this: are we serving the objectives of the law in the best way we can by adjusting the classical fine print of contracts, or are we better off starting from scratch? We often hear calls nowadays to transcend the old texts of classical jurisprudence, quoting Ibn Taymiyya's maxim that "the default in transactions is permissibility." Thus, all we have to do is to ensure that any proposed new contract does not transgress the law by inclusion of a forbidden factor such as *ribā* or *gharār*. However, the problem with such a pro-active approach is one of credibility. It is easy for jurists to return the debate to their turf by questioning the person's credentials and ability to infer that a new contract is devoid of forbidden factors. Indeed, some of the most respected contemporary jurists were severely criticized by other jurists for venturing in this direction.

VIII. CONCLUSION

Thus, Islamic finance is likely to remain trapped for the foreseeable future between the small juristic perturbations of classical contracts, and the faulty rhetoric of "prohibition of interest" and "no time value of money." I hope that the sophisticated listener/reader will be able to see beyond those shortcomings. In particular, I hope that he or she can recognize that there are valid substantive advantages that an Islamically inspired financial sector may have over its conventional counterpart. This is an invitation to others who, like myself, may come to the areas of Islamic economics and finance after acquiring some degree of expertise in mainstream economics and finance: Do not be discouraged by the faulty rhetoric and the archaic understanding of financial affairs. When the novelty of Islamic finance as a fad expires, the rents to be collected from scared Muslims run dry, and the rhetoric of ideologues and scaremongers fizzles away, we may yet have a reasonable economic and financial vision to be called "Islamic."

Challenges Facing the Islamic Financial Industry

Stephen K. Green*

ABSTRACT

This paper examines the emergence and relevance of Islamic finance in the 21st century. The development of the Islamic financial industry over twenty years, from stand-alone institutions to a credible financial force that is gaining significant shares of its core markets, testifies to the impressive strides the industry has made. With its core principles in ethical values, and its focus on economic sectors producing real value, Islamic finance has significant relevance to global financial markets. The paper highlights the key obstacles preventing Islamic finance from reaching its full and true potential. These include the lack of regulatory standards specific to Islamic finance, the absence of Islamic capital and money markets, and the shortage of sovereign and top-tier quality issuers. It will touch upon the challenges facing Islamic finance in the years ahead: the emergence of new models, the opportunities afforded Islamic finance by the Internet, and the need for size and scalability in this growing market.

I. INTRODUCTION

One may ask what qualifies an executive from a conventional financial institution to discuss, alongside Islamic bankers, *sharīʿa* scholars, and Islamic economists, the challenges facing Islamic finance. The author is a practitioner, a banker who represents an industry that has franchises in twenty nations that are members of the Islamic Development Bank (IDB). Conventional banks, through their ordinary business in the IDB area, have observed the impact of the Islamic financial industry on the local client base. Moreover, the HSBC Group's strategic ownership of the British Bank of the Middle East (now rebranded as HSBC Middle East) as well as its presence in other IDB member countries has offered the firm a unique perspective on the development of Islamic finance. The job of a client-focused bank is to serve its clients, and the growing demand for Islamic products is something any bank in the region might seek to satisfy.

Tremendous strides have been made over the last two decades in Bahrain, which has emerged as the international center for the industry, with an impressive number of offshore Islamic investment banks. For a number of years, the Malaysian central bank, Bank Negara, has actively promoted an interest-free banking system alongside its conventional counterpart. This has resulted in advances in all customer segments, particularly the retail and corporate sectors.

In Kuwait, official central bank statistics show the Islamic finance sector to be gaining significant market share, while the central bank of Oman has recently approved the establishment of the country's first Islamic bank. The Saudi Arabian Monetary Agency is now encouraging conventional banks to open Islamic banking windows.

A survey of the scene reveals Islamic financial institutions that now provide investment banking, asset and portfolio management, financial advisory, underwriting, syndication, and private and public placement services. In fact, virtually the entire range of modern financial techniques is being adopted and adapted to suit the principles of Islamic finance. Of notable interest over the last five years has been the development and growth of instruments on the liability side of the balance sheets of Islamic banks and, in particular, the establishment of collective investment schemes. These funds now cover a broad spectrum of investments, including real estate, trade finance, leasing, and commodities. The growth of these funds over the last five years has been a very significant development for the Islamic financial industry.

The opening up to Islamic investors of equities as an asset class, following approval from *sharīʿa* scholars, has added a new dimension to the industry. A broad pool of Islamic equity funds is now in operation, from plain-vanilla funds to more sophisticated products with particular emphasis, in recent years, on technology and health care. In fact, because of their emphasis on health care and technology, Islamic funds have outperformed the market in recent years, except perhaps in 2000. Certainly, top-tier asset management companies from the Western world are bringing their considerable experience in fund management to the Islamic financial industry, and combining it

* Executive Director, HSBC Investment Bank, London, United Kingdom. The following is the edited text of Green's Keynote Speech on Islamic Finance at the Fourth Harvard University Forum on Islamic Finance.

with the *sharīʿa*-structuring expertise of Islamic financial institutions in order to create acceptable and well-performing Islamic equity products.

Asset securitization is another important trend in the Islamic financial sector. Islamic financial institutions have viewed asset securitization as a vehicle to permit extending maturities in transactions while providing liquidity for investors. Securitization products in some Middle Eastern markets, especially for infrastructure projects, are likely to be offered. A particularly interesting transaction that suggests possible applications in the Islamic world was in the United Kingdom, where car leases were securitized into an asset with a maturity of 7 years.

Private equity, too, is emerging as an asset class for Islamic investors. The drive toward enhanced yields and the desire to manage their funds more efficiently has led Islamic investors to seek opportunities in private equity markets in the OECD as well as at home. The IDB's efforts in the recent establishment of a private equity technology fund for the Middle East, through its subsidiary the Islamic Corporation for the Development of the Private Sector (ICD), are to be applauded.

The emergence of the contemporary Islamic financial industry is one of the key developments in modern banking and finance because of the impact it has had on its core markets over a short period of time. The fact that a certain financial system, whose core values and principles are based upon specific religious and ethical precepts, has taken root deserves due recognition.

In an era of global and increasingly complex financial markets, Islamic finance, with its focus toward the real-value-producing areas of the economy and the equitable sharing of risk, has significant relevance to conventional financial markets.

II. GROWING PAINS, LEADING TO MATURITY

However, it is important to recognize that this is still a growing industry that in many ways has yet to mature. Five areas of innovation, if successful in the next few years, will allow the industry to strengthen.

A. International Islamic Money Market

One of the most obvious needs is the creation and development of Islamic money and capital markets, i.e., short-term and long-term instruments and the ability to trade them. Islamic investors, like other investors, have varying liquidity and maturity preferences, and a money market is necessary in order to uncouple decisions about the maturity of an instrument from decisions about the management of the balance sheet. Most Islamic financial institutions in the Middle East prefer to invest their funds in short-term investments resembling the risk-return profile of conventional money market instruments. Currently, the great majority of such short-term investments is invested in commodity *murāba®a* transactions with creditworthy Western financial institutions. The industry is in dire need of alternative modes of short-term financing that have a range of risk-reward profiles at once compatible with the *sharīʿa*, permitting the development of liquidity, and allowing bankers to apply real balance sheet techniques. The Islamic Development Bank, with the Labuan Offshore Financial Services Authority (Malaysia) and the Bahrain Monetary Agency, are working together to devise an international Islamic money market ("IIMM"). The primary purpose of the IIMM is to provide a platform for participants in the Islamic financial market to issue Islamic money market instruments in primary as well as secondary markets so that a real market yield curve can be constructed. Without an IIMM, the Islamic financial market is likely always to be hindered and fall short of assets.

B. Need for Legislative Reforms

The drivers of the IIMM will have to persuade governments in some countries to reform laws and regulations that are unhelpful to Islamic finance. For example, *ijāra* (leasing) transactions cannot be structured Islamically in some nations that enforce restrictive land ownership laws. While conventional financiers can provide conventional loans and take charges over a property, Islamic financiers cannot provide financing via *ijāra* due to their inability to own land on a cross-border basis during the *ijāra* period. In some countries, Islamic financial institutions are unable to offer *ijāra* financing for indigenous property because under existing land laws the institutions are not considered to be local. Furthermore, the taxation regime in countries such as Egypt, Malaysia, and Turkey imposes strict withholding taxes on all cross-border leasing. Inasmuch as *ijāra* is the most suitable mode of financing for long-term facilities (those longer than two years), the restrictions due to existing laws have seriously impeded the development of long-term Islamic finance. These laws were often enacted before the birth of contemporary Islamic finance and thus did not consider its requirements. Reform of these laws is essential to the successful development of an Islamic capital market as well as an Islamic money market.

C. Harmonization of *Sharīʿa* Standards

The successful development of a primary market for international Islamic money market instruments hinges upon the harmonization of *sharīʿa* standards. It would be desirable to inhabit a world in which the pronouncements of a respected authority in a recognized center would freely be accepted throughout the market. The path to that state involves intensive dialogue among the various centers for Islamic finance and a move toward gradual harmonization, taking into account the subtleties of Islamic jurisprudence.

D. Need for Quality Issuers

Any successful primary market also requires quality issuers to establish benchmark issues. It would be good to see sovereigns, multilateral and public-sector development institutions, and top-tier corporations issuing into the market on an Islamic basis in order to establish benchmark levels of risk-reward-maturity profiles. The more this happens, the broader and more liquid the market will become, attracting even more investors as part of a snowball effect. Islamic financial paper could thus potentially offer an alternative source of funding as well as a wider investor-base for issuers. In order to attract conventional investors, Islamic issues will need to be rated by the established rating agencies. This means that the rating agencies must be educated about the subtleties of Islamic finance as well as about the risks involved. If required, a different rating grade for Islamic issues must be developed.

E. Market Making

The development of a secondary market for Islamic money and capital market instruments also calls for financial institutions with market-making abilities. Market-making expertise in the conventional market resides mostly in London and New York. It is a highly technical activity that depends on technical knowledge as well as on experience, but that can only be learned on the job. The Islamic financial industry faces the task of building market-making expertise within the various institutions that participate in the market. This can be achieved by training, recruiting, and inviting the participation of institutions that have the needed market-making expertise. The more that happens, the more primary issuers will be enticed, and the more investors will come forward, rounding out a virtuous circle promising rapid growth. In the beginning, most international Islamic money market instruments would be denominated in U.S. dollars, requiring market makers with sufficient expertise in that currency.

F. Issues to be Addressed Going Forward

The advent of the Internet and the e-commerce revolution is affecting all major industries. The financial services market is at the center of these changes, with the Internet already having a profound effect on the delivery of banking and financial services. The Internet in its early stages has affected some sectors of financial services, such as securities and brokerage, more directly than others, such as insurance. Nevertheless, the Internet promises to alter the way that customers perceive value and the way that value is delivered.

The Internet offers the Islamic financial market the opportunity to expand its global reach and target customers who previously were unreachable, in the Muslim world as well as in the significant Muslim communities in the Western world. This will help aggregate demand for *sharīʿa*-based products and services to an economically viable scale.

A number of Internet initiatives in Islamic finance have emerged recently. iHilal.com, IslamiQ.com, and Islamic Investors Online, among others, are all vying for this untapped market segment. Three thoughts headline how banking and financial entities should respond to the challenge:

1. E-commerce is not about glitzy Web sites and storefronts, and it is not about fancy interactive screen technology. If it is only that, it will fail.
2. An effective e-commerce financial offering is about richness, in terms of a sound product offering. In the end, clients are not fools. They want to know that there is real value-added to the service, and the Internet easily allows them to shop around for competitive products, breaking down monopoly profits.
3. E-commerce is not the stand-alone delivery of financial services. As the Internet matures, it will become clear that any e-commerce venture should serve as one of many modes of interaction between suppliers and consumers. Ventures that will succeed will be those that successfully dovetail their e-commerce capabilities with their ordinary services. While it is not clear who the winners and losers will be when things settle down, the Internet unquestionably provides the customer with new opportunities and presents financial institutions with challenges to which they must respond.

III. CONCLUSION

While Islamic finance has promise, much remains to be done. Its progress resembles that of the climber of a high mountain. The climber looks down and realizes that he has come a long way, then looks up and knows that a long ascent beckons. It is an exciting time and place to be for those in this growing industry as it moves toward the next stage of its evolution.

The Islamic Banking System in Malaysia

Some Issues

Sudin Haron[*] and Norafifah Ahmad[†]

ABSTRACT

Malaysia's commitment to developing a complete Islamic banking system began in 1983, when the first Islamic bank commenced operations. Although in the years since then the Malaysian Islamic banking system has managed to portray itself as a feasible alternative to conventional banking, certain issues have arisen. Questions such as public acceptance and the lawfulness of the Islamic principles in use as well as their applicability need consideration. This paper highlights the development of the Islamic banking system in Malaysia and the points that still need to be addressed to make this system more feasible and acceptable to both Malaysians and Muslims in other countries.

I. INTRODUCTION

The establishment of the Mit Ghamr Local Savings Bank of Egypt in 1963 marked a new milestone in the development of the modern Islamic banking system. This rudimentary effort was then refined and further developed by Muslim jurists and scholars. The period between the second half of the 1970s and the early 1980s was considered a boom period for the Islamic banking system as many Islamic banks gained a footing in Muslim countries. Currently more than 150 interest-free financial institutions operate in both Muslim and non-Muslim countries, including countries previously within the Soviet bloc. These institutions provide banking services comparable those offered by interest-based institutions, including insurance, pawnbroking, and stock market transactions.

As in most Muslim countries, the first Malaysian Islamic bank was established during Islamic banking's growth period. Since then, much has altered in the country's overall financial system. It has even been claimed that the Islamic financial system in Malaysia is now offering the most progressive array of services in the Islamic economic world. Besides a complete range of conventional Islamic banking services and products, Malaysian banks are now providing access to Islamic insurance and Islamic pawnbroking. The Malaysian Islamic financial market is moving out of its infancy toward greater maturity by also providing securities and financial derivatives that comply with *sharī'a* requirements.

The Malaysian Islamic financial system has developed rapidly, yet there remain a number of unresolved legality issues concerning which it will be desirable to consider the views of scholars. The second section of this paper will take up the development of the Islamic financial system in Malaysia, while the third will deal with some of the issues that still remain to be decided. The fourth and final section will be devoted to conclusions.

II. THE DEVELOPMENT OF THE ISLAMIC FINANCIAL SYSTEM IN MALAYSIA

Islamic finance, comprising banking and investment that fulfill the strictures of the *sharī'a* or Muslim religious law, has long been recognized as a niche industry. Its peculiar features have isolated it from the rest of the world of finance. However, in response to the need for an alternative financial system to meet urgent, growing demand for Islamic finance, Western and Islamic economists as well as financiers are now developing new products to link Islamic finance and its underutilized capital pool to the global finance system.

The last two decades have witnessed the rapid growth of Islamic banking around the world, both in volume and numbers. Islamic banking has established itself as an emerging alternative to interest-based banking and is taking root in both Muslim and non-Muslim countries. Islamic banks operate in over sixty countries, most of them in the Middle East and Asia. In Iran, Pakistan, and Sudan, the entire banking system has been converted to Islamic banking. Outside the Islamic world, many countries, including Denmark, Luxembourg, and China, offer Islamic banking facilities. In Britain, the Institute of Islamic Banking and Insurance was established to spread information

[*] Dean, School of Banking and Finance, Northern University of Malaysia, Sintok, Malaysia.

[†] Senior Lecturer, Northern University of Malaysia.

about Islamic finance, and London has emerged as the major center of activity. Islamic banking is the fastest growing segment of the credit market in Muslim countries, which have Islamic banks, even when conventional banking institutions still dominate the banking system. Banks in Muslim countries have developed their own methods for dealing with the ban on interest and speculation.

In Malaysia, the first move toward the development of an Islamic financial system was initiated with Islamic Banking Act 1983 and Government Investment Act 1983. In the same year, following hard on these acts, the first Islamic bank, Bank Islam Malaysia Berhad (BIMB), was established. Proving that Islamic finance was filling a felt need, BIMB recorded strong growth a year later. Total assets doubled from $170.7 million at the end of 1983 to $369.8 million at the end of 1984, with sharp increases of deposits from $91.0 million to $274.9 million, and of loans from $40.7 million to $249.8 million.

BIMB has been pioneering Islamic banking within Malaysia's banking system since its establishment more than a decade ago, expanding its menu of services rapidly. At present three subsidiaries are providing such services as leasing, trust funds, general *takāful* (insurance), nominees, and stockbroking.

However, the Islamic system did not begin to take off seriously until March 1993, when the Ministry of Finance introduced legislation regulating an "Interest-Free Banking Scheme" or *Skim Perbankan Tanpa Faedah (SPTF)*. As in most Muslim countries, where many of the first Islamic banks were development banks, the most promising field to start with was pilgrims' funds, a source of finance with considerable potential. In 1969 the Malaysian Pilgrims' Management Fund and Fund Board were founded to pool Muslim savings and manage pilgrimage expenses.

The central bank, Bank Negara Malaysia (BNM) boosted the growth of a Malaysian Islamic financial system by pioneering an Islamic interbank system. Malaysia has a full-fledged Islamic banking system, running in tandem with a Western-style banking system. Among the Muslim countries that offer Islamic financial systems, Malaysia is in the forefront of Islamic banking R&D. The BNM for example, in 1993, approved a total of 21 Islamic financial products for domestic financial institutions. The variety of Islamic financial products and the large number of participants, coupled with the development of the Islamic interbank system, the latter initiated as the start of a full Islamic secondary market, provided the prerequisites for the viability of a domestic Islamic financial system. The Islamic interbank money market has recorded and increase in volume from RM158 billion in 1998 to RM436 billion in 1999 (BNM Annual Report, 1999).

To further accelerate the growth of the Islamic banking sector, BNM has implemented new measures. In 1996, the new financial disclosure model form, the GP8, was introduced to promote transparency and disclosure of Islamic banking operations. This was followed by the setting-up of full-fledged Islamic banking branches (instead of the Islamic banking "windows" offered in the conventional banks), and the *Sharī*ᵀ*a* Advisory Council (SAC). The Council would be repealed once amendments to the Central Bank Act (1958), the Islamic Banking Act (1983), and the Takaful Act (1984) were completed.

As a consequence of the liberalization of the banking industry in 1993, Islamic banking services under the Interest-Free Banking Scheme (IFBS) have come to be offered by 50 other financial institutions including commercial banks, finance companies, merchant banks, cooperative banks, and discount houses

Although the Islamic banking system was, like other financial institutions in the country, adversely affected by the 1997 Asian financial crisis, Malaysia's rapid and vigorous economic recovery has made it possible for the system to experience some spill over effect. The total assets of the Islamic banking sector increased from $21.6 billion to RM35.7 billion by the end of 1999, registering a sharp growth of 65.3%. Total deposits mobilized showed a steady growth rate of 50.6% (BNM Annual Report, 1999).

The latest development in Malaysian Islamic banking is the establishment of a second Islamic bank, the Bank Muamalat Malaysia Berhad (BMMB), by merging Bank Bumiputra Malaysia Berhad and Bank of Commerce (Malaysia) Berhad. BMMB started operations on October 1, 1999.

Apart from these rapid moves undertaken by BNM to foster an active Islamic banking system, much attention is now being focused on applying Islamic principles to the equity market, an effort being vigorously made in all the Muslim countries that experienced the turmoil of the recent financial crisis. Like other Muslim countries with a population predominantly Muslim, Malaysia has an established stock market. Solid progress has been made in the preparations for putting in place the infrastructure necessary to facilitate stock trading in accordance with Islamic principles. In 1994, BIMB Securities, Malaysia's first stockbroker firm, was founded. Apart from providing Islamic brokerage houses and Islamic managed funds, it has been possible to establish a separate "Islamic Index." This index follows 179 permissible stocks traded on the Kuala Lumpur Stock Exchange (New Horizon, 1996). Muslim investors have been able to invest directly in ®*alāl* (permitted) counters. Conventional securities firms have also set up their own Islamic stockbroking windows to advise investors on ®*alāl* stocks. As of July

1996, 364 stocks of the 633 listed on the Kuala Lumpur Stock Exchange (KLSE) are considered ®*alāl*. On April 17, 1999, the KLSE *Sharī*˜*a* Index was launched to facilitate investment in instruments conforming to the *sharī*˜*a*.

Having a progressive and sound domestic Islamic banking system is just a beginning for Malaysia in its ambition to become a leading example of a country with a financial system that can be a viable alternative to interest-based banking. The country's bankers and regulators have already positioned Malaysia to become a regional Islamic financial center. With the establishment of an international Islamic bank in Labuan, Sabah, this vision is now becoming a reality.

III. ISSUES RELATED TO THE MALAYSIAN ISLAMIC FINANCIAL SYSTEM

This paper will focus on the issues related to the Malaysian Islamic financial system that are in need of remedial actions. Among these are (1) the seriousness of Islamic financial institutions about fulfilling their objectives; (2) adherence to *sharī*˜*a* principles (3) the level of *sharī*˜*a* compliance; and (4) public acceptance of products and services.

A. The Fulfillment of Objectives

As suggested by Khan (1983), Islamic financial institutions are intended to promote, foster, and develop banking services and products based on Islamic principles. Islamic banks are also responsible for promoting the establishment of investment companies or other business enterprises as long as their objectives are not forbidden by Islam. The main principles of Islamic banking are prohibition of interest in all transactions, and the requirement that business and trade activities be based on fair and legitimate profit. Islamic banks are required to pay *zakāt* (alms tax) and to develop an environment beneficial to society. Similarly, Ali (1988) believed that an Islamic financial system cannot be introduced merely by eliminating *ribā* but also requires adoption of Islamic principles of social justice and the introduction of laws, practices, procedures and instruments supportive of justice, equity, and fairness.

Islamic financial institutions, therefore, are not expected to have the same objectives and philosophies as those of other business entities. Their objectives and philosophy should be in line with tradition and the revelations of the Qur'an. Hence, while ordinary business entities are likely to make profit their primary objective, Islamic banks have to balance profit and moral values. Islamic banks' commitment to moral objectives are not only highlighted in their corporate mission statement and objectives but also in the way they do business.

A number of Islamic banks, like Islami Bank Bangladesh Limited (IBBL), Jordan Islamic Bank (JIB), and Bank Muamalat Indonesia (BMI), actively promote social welfare. IBBL, besides aiming to introduce a welfare-oriented banking system, has also succeeded in achieving economic equity and justice by creating activities intended to help the underprivileged to increase their income as well as creating job opportunities for youth. These social welfare activities are channeled through a special body, the Islamic Bank Foundation. By the end of 1998, the Foundation had established two modern hospitals, one at Dhaka and the other at Rajshahi, a service center, a sales outlet, and several other projects for the socioeconomic development of the country. The Foundation has also established two types of training institutes, a vocational institute for unemployed youth, and a college providing religious and moral teaching. In line with the objective of raising the economic status of the poor, the Foundation has established a retail center where the public can have access to products manufactured by poor and distressed women. The Foundation also maintains special funds to help flood victims and the victims of other disasters.

Just like Islamic Bank of Bangladesh, Jordan Islamic Bank (JIB) plays an important role in promoting social, spiritual, and ethical values in the community. Since its inception, JIB has allocated some portion of its net profit to be donated to Jordanian universities, scientific research, and vocational training. As for the social welfare, JIB continues to donate to communities, charitable associations, and mosques, as well as to other social welfare and religious activities, like providing cash prizes to winners of Qur'an recital competitions and also to newlywed couples to cover their marriage expenses. The Bank also sends deserving underprivileged on the minor pilgrimage (*umra*). JIB continues its *qar*∞ ®*asan* loans to needy persons faced with unavoidable financial burdens, such as bridegrooms. Other social activities that the bank continues to undertake are the financing of craftsmen and mutual insurance funds.

Though it has the objective of making realistic profits and ensuring optimal corporate growth, Bank Muamalat Indonesia (BMI) continuously makes positive social welfare contributions to the Muslim community. Among the activities on its social agenda are: (1) small enterprise development; (2) a people's economic empowerment project; (3) a ZIS fund; (4) an international development foundation fund; and (5) a financial institution pension fund. Under the small enterprise development program, BMI provides profit-sharing financing schemes to small enterprises. By the end of 1998, 14.73% of BMI's total loans were made under this scheme. The aim of the people's economic empowerment project is to enhance the development of Islamic financing units at

Islamic boarding schools. By end 1998, 3000 students and 160 staff at 1500 boarding schools were benefiting from this project.

The commitment of Malaysian Islamic financial institutions varies. In the case of Bank Islam Malaysia Berhad (BIMB), its corporate objective and the social welfare activities it undertakes are used as an indicator of its commitment to its moral obligations. Initially, the aim of BIMB was "to provide banking facilities and services in accordance with Islamic principles to all Muslims as well as the whole population of Malaysia. The Islamic principles meant here are essentially those belonging to the body of *sharī˜a* rules on commercial transactions related to banking and finance. The bank's efforts to provide these banking facilities and services are undertaken within the framework of its viability and capability to grow and expand continuously." (BIMB, 1985). The present objectives of BIMB are more focused and reflect the current direction and the philosophy of its top management. They are to:

1. Provide its customers with Islamic banking facilities and services of the highest possible quality;
2. Attain viability and a sufficient level of profitability to sustain growth;
3. Develop and foster a competent and innovative management imbued with high standards of integrity and Islamic banking professionalism;
4. Develop a motivated workforce inculcated with the appropriate work ethic, fully committed to the Bank and to efficient and courteous service to the customer;
5. Strive constantly to protect its shareholders' interests; and
6. Be conscious always of its responsibilities and duties as an Islamic corporate citizen.

Over the 15 years since its establishment, BIMB has accomplished many of these objectives. Its assets have grown from $145 million ($1 = RM 3.8) at the end of the first year of operations to $1,780 million as of June 1999. This success notwithstanding, BIMB has yet to discharge its moral responsibilities to the same extent as the Islamic banks in Bangladesh, Jordan, and Indonesia. Although BIMB has engaged in several initiatives to fulfill its moral obligations, the most significant has been paying its *zakāt* regularly. At the end of the 1998-1999 financial year, for example, a total of $315,500 had been paid in. Clearly, to be known as institutions that uphold Islamic business principles, it will be appropriate for Islamic banks in Malaysia actively to engage in social welfare projects. Activities using *qar∞ ®asan* or *mu∞āraba* principles must be introduced to finance small business. For this purpose, the kind of activities undertaken by Islamic banks in Bangladesh, Jordan, and Indonesia might well be considered for adoption.

B. The Use of *Sharī˜a* Principles

The *sharī˜a* principles for products and services of Islamic banks can be classified broadly into four categories: (1) profit-and-loss sharing; (2) the fee or charge basis; (3) free service; and (4) ancillary principles. Although a number of principles have been adopted for determining how Islamic banks shall conduct operations, it is the consensus of Muslim scholars that they belong to two clusters, i.e., strongly Islamic and weakly Islamic. Principles can be considered strongly Islamic if they conform to Islamic objectives both in form and in substance., while "weakly Islamic" refers to conformity with Islamic norms in form but not in substance. The basis for judgment as to the strength or weakness of a given principle is the extent to which that mode contributes to the achievement of the objectives of the Islamic economy. Thus, only those principles that share risk between providers and users of funds, can be considered strongly Islamic. Muslim scholars consider only two principles, i.e., *mu∞āraba* and *mushāraka*, as strongly Islamic, the remaining principles being recommended only in cases where risk-return sharing cannot be implemented (Mirakhor, 1987).

Since the early days of the modern Islamic banking system, scholars have recommended that Islamic banks apply profit-and-loss sharing principles for both deposit taking and financing (see Ahmed et, al. 1983; Siddiqi, 1983; Qureshi, 1985; and CII Reports, 1983). While these principles are widely used in deposit taking, their application in financing has been minimal. Islamic banks prefer fee-based transactions because of the simplicity, lower risk, and pre-determined fixed rate of return, as well as their conformity to the banking status quo, with its traditional emphasis on creditworthiness and the creditor-debtor relationship. It is believed that the fee-based transactions open the door to interest (Ahmed, et. al, 1983).

Resistance in financing to the profit-and-loss sharing principle by the management of Islamic banks is clearly seen in the figure for total funds channeled into these activities. In the case of Dubai Islamic Bank, for example, in 1998 the financing that adhered to the profit-and-loss sharing principle was only 10% of total financing. Similarly, the corresponding figures for Jordan Islamic Bank and Qatar Islamic Bank were only 3% and 4%.

Like other Islamic banks, Bank Islam Malaysia Berhad also prefers to use the fee-based principle in financing activities. In 1988, only 1% of total financing was *mu∞āraba* and *mushāraka*. By 1993, the figure had

increased to 2%, and at the end of financial year 1999 the figure gone back to 1%. After more than 15 years of existence is time for both Islamic banks in Malaysia and in other countries not to be overly dependent on fee-based financing. New strategies must be implemented to increase adherence to the profit-and-loss sharing principle.

The terminology used for these principles can be confusing. Malaysia, for example, is the only country where Arabic words are used for all the *sharīᶜa* principles governing its Islamic banking operations. Other countries retain Arabic words for certain principles only, using the vernacular. The principles most widely used in the literature of Islamic banking in Malaysia are *al-wa∞īᶜa, al-wa∞īᶜa al-∞amāna, al-mu∞āraba, al-mushāraka, al-murāba®a, bayᶜ bi-thaman aᶜjil, bayᶜ al-dayn, al-wakāla, al-kafāla, al-®awāla, al-ijāra, al-ijāra thumma al-bayᶜ, al-ᶜujr, al-rahn, bayᶜ al-ᶜīna, al-istisnā'*, and *qar∞ ®asan*.

C. The Legality of the Principles

Although Malaysia is considered a success as a Muslim country that has successfully promoted Islamic banking to parity with conventional banking, scholars in other countries doubt the lawfulness of the *sharīᶜa* principles used in its system (Al-Qaradawi, 1997; Homoud, 1999). One of the areas receiving heavy criticism is the issuance and trading of Islamic bills and bonds. The "Interest-Free Accepted Bill" or "Islamic Accepted Bill" was first introduced in 1991 with Islamic bonds gaining a foothold in 1992. The Islamic Accepted Bill is similar to the banker's acceptance used in conventional banking to facilitate international and domestic trade. However, the introduction of the Islamic bond was to help corporate bodies tap funds from the capital market (the details of these transactions are beyond the scope of this paper). The principles of *murāba®a, bayᶜ bi-thaman aᶜjil, bayᶜ al-dayn* and *daᶜwa ta'ajjal* are normally used in the issuance and trading of these documents. The use of *bayᶜ al-dayn* and discounting has drawn strong criticism from scholars, especially in the Middle East.

Criteria for these securities are (1) the existence of ownership, (2) securitization, (3) the issuance of securities, and (4) their being traded. In the case of Islamic bills, for example, the facility is provided only to customers who can produce evidence of involvement in either import (purchase) or export (sale) transactions. Upon presentation of evidence such as trade documents, bills of exchange, etc., single or multiple Islamic bills will be issued drawn on bank/purchaser for payment at maturity. The accepting/drawing bank receives a commission.

In the case of *bayᶜ al-dayn* or debt trading, this principle is widely used not only in the trading of Islamic bills but also in Islamic bonds. The issuance of these bonds is usually based on trade transactions based on the principles of *bayᶜ bi-thaman aᶜjil, murāba®a, ijāra*, and the like between issuers and investor. The principle of *bayᶜ al-ᶜīna* is used when a deal is negotiated and completed. As in conventional banking, a certificate is issued indicating the maturity date. The issuer pays the amount to the holder of the certificate. The certificate known as '*shahdah al-dayn*' is considered '*al-mal*' or property to qualify as an object of sale. Therefore, the holder has the right to resell in the secondary market using the *bayᶜ al-dayn* principle. Malaysian scholars strongly believe that this principle is allowable in Islam, and that Islamic bonds may be sold to third parties for cash and at a lower price (see Ishak, 1997, and Rosly and Sanusi 1999 for further elaboration).

In the case of *daᶜwa ta'ajjal* or discounting, the legality of this principle is said to be based on the following traditions (®*adīth*) (see Ishak, 1997, for further elaboration):

> Narrated by Ibn Abbas when Rasulullah (peace be upon him) directed Bani Nadir to leave Medina, they said: "There are still debts due to us." Rasulullah (peace be upon him) then replied: "give a discount and ask for early payment."
>
> (Narrated by al-Baihaqi)

> "When Kaab was in a mosque discussing with Abi Hadrad how he would pay his debt to Kaab, they did not realize that they had raised their voices and enabled Rasulullah (peace be upon him), who was in his house, to overhear their discussion. Rasulullah then said: give a discount on the debt. Kaab then replied: I have already done so," whereupon Rasulullah asked Abu Hadrad to pay the discounted debt."
>
> (Narrated by al-Bukhari)

Daᶜwa ta'ajjal is different from *ribā* because it has an element of *ra'fa* or compassion and assistance or support. Consent to reduce the loan or debt comes from the lender or seller, and it introduces an element of *ra'fa* and *takhfif* or lifting a burden from the borrower or buyer. Similarly, the use of this concept creates mutual goodwill for both parties, and this is one of the pillars of Islamic *muᶜāmalāt*.

Usmani (1999), however, strongly believes that the principle of *bayᶜ al-dayn* is not permissible in Islam. He argues that debt corresponds to money, and any exchange must be equal in value. He also reiterated that the Islamic *Fiqh* Academy of Jeddah has unanimously approved the prohibition of *bayᶜ al-dayn*.

D. Public Acceptance

Since its introduction, Islamic banking products have been well accepted by Malaysians. This is reflected in the increasing totals for deposits and loans based on Islamic principles placed by Muslim and non-Muslim customers. In the case of BIMB, for example, at the end of June 1984 (the first year of operations), deposits and loans totaled RM241 million and RM162 million respectively. By the end of 1994 (the 10th year of operations) deposits totaled RM2548 million, and loans RM977 million. The corresponding figures for the financial year 1999 were RM5,617 million and RM3,404.

Public support of the Islamic banking system is also reflected in the use of Islamic banking products offered by conventional financial institutions. In 1994, the first year selected commercial banks were allowed to introduce Islamic deposit facilities, a total of RM1,463 million was collected in deposits. This figure includes deposits in current accounts (RM166 million), savings deposits (RM1,146 million), and investment deposit facilities (RM151 million). Since then, these three types of Islamic deposits have been receiving continuous support from the public. At end 1999, total deposits in commercial banks had increased to RM2,744 million. The figure for current accounts was RM3,954 million, and RM7,469 million and RM1,321 million for savings and investment accounts respectively.

Although total BIMB deposits and Islamic deposit facilities at commercial banks have increased significantly over the last five years, this does not means that the Malaysian public is uniformly receptive toward Islamic banking products. The comparative growth figures between Islamic and conventional deposits are good indicators of this. The growth of various types of deposit facilities in conventional and Islamic commercial banks is shown in Table 1. With the exception of 1995, the yearly growth figures for Islamic deposits have exceeded those for conventional deposits. Looking at the individual figures, we can also see that in many instances the growth of various types of Islamic deposit facilities was greater that the growth of deposits in the conventional system.

TABLE 1. ANNUAL GROWTH OF DEPOSITS IN COMMERCIAL BANKS

	1995	1996	1997	1998	1999
Conventional deposits					
Demand	14%	23%	–2%	–16%	31%
Fixed	31	28	26	6	14
Savings	8	23	–10	4	12
Total Deposits	**23%**	**26%**	**15%**	**2%**	**18%**
Islamic deposits					
Demand	88	120	209	–5	96
Investment	–4	23	51	162	39
Savings	123	87	35	19	30
Total Deposits	**19%**	**51%**	**91%**	**67%**	**52%**

Looking at Table 1, we may tend to conclude that Islamic banking products are becoming more popular among Malaysians. These growth figures alone, however, cannot answer several pertinent questions related to the development of Islamic banking in Malaysia. Such issues include whether all economic units in Malaysia are really keen on the idea of the superiority of Islamic banking over conventional banking; whether in promoting Islamic banking products commercial banks in Malaysia are really committed to adhering to the directives of the Central Bank; and whether the Islamic banking system has a bright future in Malaysia. Answers to some of these issues can

be found by looking at the percentage of the deposits placed by Malaysian in the Islamic system against deposits in the conventional system. The percentage of funds placed in various types of deposit facilities available at commercial banks in Malaysia is shown in Table 2.

TABLE 2. FUNDS DEPOSITED IN VARIOUS DEPOSIT FACILITIES OF COMMERCIAL BANKS

	1995	1996	1997	1998	1999
Conventional deposits					
Demand	22.17	21.56	18.23	14.86	16.44
Fixed	62.42	63.22	68.90	70.93	68.99
Savings	14.34	13.94	10.79	10.82	11.23
Islamic deposits					
Demand	0.19	0.33	0.88	0.81	1.35
Investment	0.67	0.65	0.85	2.17	2.54
Savings	0.21	0.30	0.36	0.41	0.45
Total (%)	**100%**	**100%**	**100%**	**100%**	**100%**
Total Deposits (RM Million)	**163,739**	**206,609**	**239,677**	**247,647**	**293,902**

Notwithstanding the fact that there are signs of positive development of Islamic banking in Malaysia, at Table 2 makes it inevitable to conclude that public acceptance of these alternatives to the conventional banking system is far from satisfactory. Half of Malaysia's population is Muslim. The coalition government is led by UMNO (a Muslim-based party). Therefore, when the total funds deposited in the Islamic banking system do not exceed 5% of total deposits in commercial banks, remedial action is necessary to increase the share of the Islamic sector. As the governing body of the Malaysian banking system, not only must the Central Bank introduce directives that can lead to the progressive development of Islamic banking but penalize those who neglect the serious promotion of the Ilamic alternative. The research findings of Haron et. al (1994) indicate that almost 100% of the Muslims and 75% of the non-Muslims they interviewed were aware of the existence of Islamic banking. Most of them expressed a desire to have a relationship with an Islamic bank if they had a complete understanding of the system. The study also found that people believed that Islamic banks are not meant for Muslim customers alone. Therefore, there is no public acceptance problem. On the contrary, the major problem here seems to be the way these services are provided.

IV. CONCLUSION

Even though the Islamic financial system in Malaysia is recognized as the most progressive in the Islamic world, the problems highlighted here need immediately to be examined closely and addressed. Some of these issues affect the foundations of the *sharīʿa*, and will thus invite much-heated debate. They will inadvertently result in similarity to conventional banking. For example, the applicability of *bayʿ al-dayn* and *daʿwa ta'ajjal* principles is related to the management of bonds and Islamic bills. Islamic scholars in the Middle East disagree with scholars in other regions on the applicability of these principles. Their difference needs to be resolved Agreement would contribute to the spread of Islamic banking.

It is not only in Malaysia but elsewhere that a lack of interest is observed in Islamic banks in consistent application of approved Islamic financial principles. Unless this is corrected, Islamic banks will tend to seem

imitative of conventional banking, especially when the concept of "cost of funds" in an Islamic bank is the same as that in a conventional one, blurring Muslim perception of the difference between Islamic and conventional banking.

The goals and philosophy of Islamic banking should be seen as different from those of conventional banking. If conventional banking operates solely from the profit motive, then an Islamic bank has to portray itself as a bank that operates on a basis of both profit and morality. When this situation prevails, society will be confident that Islam is a religion that promotes not only moral obligations between God and humankind, but also among human beings. Realizing the superiority of Islamic banking for promoting human welfare, society as a whole will ultimately adopt the Islamic financial system, not as an alternative to the conventional system, but as the main choice for banking transactions. To achieve this ongoing commitment, there is a need for a strong collaboration between the regulators and those who are bounded by the law, to ensure new laws and regulations in line with the *sharīʿa*. Finally, all involved in the Islamic financial system must conduct themselves with probity and have complete faith that it is a sound alternative to the conventional one.

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The Scope of Off-Balance-Sheet Transactions in Islamic Finance

Zamir Iqbal*

ABSTRACT

Conventional finance experienced rapid growth as a result of financial innovation, including the introduction of off-balance-sheet transactions such as swap agreements. Such activities enabled financial intermediaries to enhance liquidity and returns on otherwise dormant assets, to manage portfolios through diversification, and to better manage market, price, and credit risk. This paper examines the scope of a subset of off-balance-sheet activities within the context of Islamic finance and explores the ways these can be either emulated or developed using existing instruments of Islamic finance. The paper demonstrates the construction of a floating-to-floating or fixed-to-floating swap agreement using *murāba®a* and/or *ijāra* contracts. It further examines the mechanism of introducing currency swaps using the same instruments. Finally, the paper argues that with the introduction of such off-balance-sheet activities, financial institutions or intermediaries in an Islamic financial system can achieve improved liquidity, portfolio diversification, and risk management.

I. INTRODUCTION

During the 1980s, a wide range of innovative financial products emerged to meet the rapidly changing demand of international financial markets. Financial innovation was triggered by increased interest and exchange rates, volatility as result of the breakdown of the Bretton Woods system, change in monetary policy targets, and the continued liberalization of global capital flow. In addition, tax asymmetries, regulatory changes resulting in increased competition, breakthroughs in telecommunication and computing technology leading to lower cost of information and transaction, as well as advances in financial theory (option pricing), further helped rapid application of financial engineering to develop and to innovate complex, flexible, and liquid instruments.[1] As a result, exchange traded derivative products in form of futures and options, and off-balance-sheet activities such as over-the-counter (OTC) contracts including forward contracts, swap agreements and synthetic instruments have dominated international financial markets.

Off-balance-sheet activities enabled financial intermediaries to enhance liquidity and returns on otherwise dormant assets. It helped them manage portfolios through diversification and better manage market, price and credit risk. This paper examines the scope of off-balance-sheet activities within the context of Islamic finance. It explores possible ways an off-balance-sheet instrument can be either emulated or developed using existing instruments of Islamic finance. The paper demonstrates construction of a currency forward contract using instruments sanctioned by principles of Islamic finance. Finally, the paper argues that by engaging in off-balance-sheet activities, financial institutions or intermediaries in Islamic financial system will be able to achieve improved liquidity, portfolio diversification, and risk management.

II. OFF-BALANCE-SHEET ACTIVITIES AND FINANCIAL RISK

The increasing complexity of domestic and international financial markets has led to greater awareness and realization of the critical role of risk and risk management in modern finance. Whereas financial innovations dominated the markets during the past two decades, most innovations were demand driven and were within areas of risk management so as to combat high levels of volatility in the financial markets. This result is due to the dramatic increase in volatility of interest rates, exchange rates and of commodity prices beginning in the late 1970s. Undertaking derivative transactions, such as swaps, options, and futures to manage financial risk are often referred to as off-balance-sheet (OBS) activities. Its activities typically include the business of a financial institution or other organization that does not book assets and liabilities on its balance sheet in the classical way.

By the early 1990s, the average exposure to off-balance-sheet transactions for each of the 30 largest banks in the world—American, European, and Japanese—was estimated to be equivalent of $1.1 to $1.4 trillion.[2] The fact that the balance sheet is not affected does not mean that the instrument is not reported. The size and impact of these instruments in the aggregate is usually summarized in a footnote in the financial statement. With increasing usage

* Senior Information Officer, World Bank, Washington, D.C.

and standardization of once exotic off-balance-sheet products, the Financial Accounting Standards Board (FASB) has recently recommended that balance sheet should include the impact of any off-balance-sheet activity.[3] As a result, these off-balance-sheet activities are gradually making their way onto the balance sheet.

Although both conventional and Islamic markets share similar risks, the level of risk is different and certainly higher in the case of today's Islamic financial markets. The higher risk is often attributed to the lack of risk management tools and the absence of institutional arrangements and infrastructure. Some researchers even claim that risk analysis for Islamic banks is underdeveloped and not sophisticated to the necessary extent.[4] The absence of risk management tools in Islamic finance will have a significant impact on the current and future growth of the market. This is because (i) a firm in Islamic financial markets will lose its business competitiveness due to its inability to handle variability in its cost, revenues and profitability by way of managing financial risk; (ii) a firm without active risk management will be perceived as a high-risk firm and thus will be subject to higher funding costs and to higher expected rates of return; (iii) there will be fewer optimal investment and diversification opportunities; (iv) a firm will be subject to high risk of financial distress; (v) a firm will be exposed to higher risk during a system-wide financial crisis; and finally, (vi) it will be difficult for Islamic financial institutions to integrate within the international financial markets.[5]

Long-term sustainable growth of Islamic markets largely depends on well-functioning secondary markets and on the introduction of liquidity-enhancing and risk-sharing products.[6] Introduction of risk management tools, which may be in the form of off-balance-sheet instruments, will require application of financial engineering in Islamic finance. It will not be an exaggeration to say that the development of financial engineering is at this time one of the most critical needs of Islamic financial markets in general and of risk management in particular.

III. Application of Financial Engineering

Financial engineering and financial innovations are the forces driving the global financial system toward the goal of greater economic efficiency. They expand opportunities for risk sharing, lower transaction costs, and reduce asymmetric information and agency costs.[7] The process of financial engineering can be viewed as a process of building complex instruments utilizing basic building blocks, or unbundling and repackaging different components of existing financial instruments, e.g., return, price risk, credit risk, country risk, etc.[8]

A close examination of instruments sanctioned by Islamic financial systems reveal that they offer features similar to many of today's basic building blocks. It is the financial engineer's task to design and to innovate more complex instruments without violating any of the boundaries defined by the Islamic system. Freedom and the permissibility of contracts in Islam, on a basis other than profit-sharing agreements, can open an extended menu of products for engineering. Throughout history, Islamic scholars have stipulated detailed terms of contracts dealing with a variety of types such as spot and future sales, leasing, trade, and partnership. It is generally accepted in matters of civil and economic dealings that economic agents have freedom of contract. Any agreement not specifically prohibited by the *sharīᶜa* is valid, binding on parties and enforceable by the courts.[9]

The Islamic financial system is primarily an equity-based system that has a set of basic building blocks in the form of asset-backed financial claims, like *murāba®a, bayᶜ muājjil* or *bayᶜ salām*, and behave similar to fixed-return instruments. Since these "asset-backed" instruments' risk/return profile are similar to fixed-income debt securities, it is possible to construct other synthetic securities, including derivatives, using these instruments without violating any of the principles of Islamic finance. In addition to basic "asset-backed" instruments, it is critical that the Islamic concepts of *juᶜāla* and *Kafāla* are fully understood and exploited. A financial intermediary will therefore be able to package basic tools to offer instruments and services to manage risk. *Kafāla* is a form of guarantee to perform against a financial liability, and it can play a critical role in underwriting credit enhancement. *juᶜāla* is a contract where one party undertakes to pay a specified amount of money to the other for rendering a specified service in accordance with stipulated terms agreed between the two parties. It can be applied to transactions such as consulting services, professional fees, fund placements, and trust services. Unique characteristics of *Jo'alah* allow contracting on an object not certain to exist or to come under a party's control to be utilized in innovative ways in Islamic finance.[10] So that entrepreneurs and investors can meet their specific funding, investment and hedging needs, financial intermediaries should develop customized services under the contract of *Jo'alah*. The design and implementation of risk management can be sold as a service in return for a fee by financial intermediaries that specialize in understanding and hedging that risk.

The following section will analyze how a currency forward contract—a basic off-balance-sheet instrument—can be constructed synthetically using basic Islamic instruments of *mu∞āraba, murāba®a*, and *juᶜāla*.

IV. THE SYNTHETIC CURRENCY FORWARD CONTRACT

The concept of arbitrage pricing and the ability to replicate a security synthetically have played a critical role in the development of derivatives and risk management tools in conventional finance. The concept of arbitrage is extensively used to demonstrate that in an efficient market two instruments with identical risk-return characteristics cannot have different prices. The ability to construct and to replicate a security or portfolio synthetically helped in the development of derivative products. It was demonstrated that two portfolios—one with derivative and the other with securities constructed synthetically—would have identical risk/return profiles. These principles and financial engineering can be applied to the basic building blocks of Islamic finance. They can also be used to devise derivative instruments that are priced fairly and efficiently.

The Islamic financial system permits forward contracts (future delivery at pre-agreed price) in commodities provided that certain *sharī*[c]*a* conditions are followed. Islamic forward contracts, *bay*[c] *salam*, permit one party to purchase a commodity at a pre-determined price for future delivery. The purchaser is required to make full payment at the time of contract. However, the application of *bay*[c] *salam* to foreign currencies is not allowed simply because Islam treats currency primarily as a medium of exchange. There are no other instruments, which allows hedging against future volatility of exchange rates. Advances in financial engineering have shown that a derivative instrument can also be constructed synthetically by using some of basic instruments. The following section demonstrates how a currency forward can be constructed without a standard forward contract.

A simple example of constructing a currency forward contract without use of any conventional currency forward or futures contract demonstrates how currency risk can be hedged in Islamic finance. Suppose that an importer in an Islamic country wants to hedge against the volatility of a foreign currency. In the absence of a currency forward contract, the importer will be exposed to risk due to appreciation of foreign currency. Assuming that there are no market frictions such as taxes, capital controls and transactions costs and that there exists financial intermediaries who have access to both local and foreign capital markets, a forward contract can be constructed synthetically using the Islamic contract of *murāba®a*. A *murāba®a* contract results from an asset-backed security or financial claim directly linked to a real asset. However, since the margin above cost (mark-up) is agreed upon in advance, the expected rate of return is pre-determined.

Suppose that the importer requires to hedge X amount of foreign currency for a period of time T from today. Current market rates of return on three-month *murāba®a* contracts in domestic and foreign markets are R_d and R_f, respectively.

The following steps can be taken by the importer to hedge a currency risk by taking positions in assets in foreign markets with the collaboration of a local investor.

At the date of contract (T_0):

Step 1: Find an investor in the domestic market who is willing to participate in arranging a currency forward for maturity T.

Step 2: Determine the amount required to hedge X amount of foreign currency. That should be equal to the value of a *murāba®a* at time T_0 such that cost plus the profit margin in foreign market is equal to required hedge amount of X in foreign currency at time T. Therefore, the amount required today to hedge X amount of foreign currency would be equal to x in foreign currency as shown below.

$$x = \frac{X}{(1+R_f)}$$

Step 3: Local currency (L) required at time T_0 will be equal to x * spot exchange rate between domestic and foreign currency. Importer asks the investor to enter into an equity partnership for initial investment of L. Importer invests the funds in a *murāba®a* in foreign currency whose cost in domestic currency at t_0 is L.

Step 4: Investor and importer agree that at the end of period, importer pays investor back in local currency such that the investor's return on investment is equal to return on *murāba®a* in local currency, i.e., R_d. This will be same as selling X amount of foreign exchange to the importer at a pre-determined exchange rate of F at the end of period. The forward exchange rate (F) will be determined such that forward discount/premium on currency is equal to the differential of the expected rates of

return, in domestic and foreign capital markets, on *murāba®a* contracts of equal risk. This rate (F) is not only the best estimate of future spot exchange rate but is also an arbitrage free forward rate for the currency.

At the date of delivery (T):

Step 5: Investor receives X amount of foreign currency against the *murāba®a* investment.

Step 6: Importer pays back to investor at pre-agreed rate an amount equal to X*F.

This synthetic forward is fully backed by an asset. As a result, investor earns R_d on the investment. Importer benefits from exchange rate hedge in case exchange rate moves unfavorably. Figure 1 gives a graphical and numerical illustration of how a currency forward contract can be created synthetically.

Local currency:	Pakistani Rupee (Rs.)
Foreign Currency:	U.S. Dollar ($)
Period:	3 months
Rate of Return on 3 month *murāba®a* in domestic market (R_{Rs}):	10%
Rate of Return on 3 month *murāba®a* in foreign market ($R_{\$}$):	5%
Spot Rate:	Rs. 55/$
Amount to hedge:	$100,000.00

Amount of investment required in local currency:

$$\frac{HedgeAmount}{(1+R_{\$})} * SpotRate = \frac{100{,}000}{(1.05)} * 55.00 = Rs.5{,}238{,}095$$

Arbitrage free forward rate for importer will be:

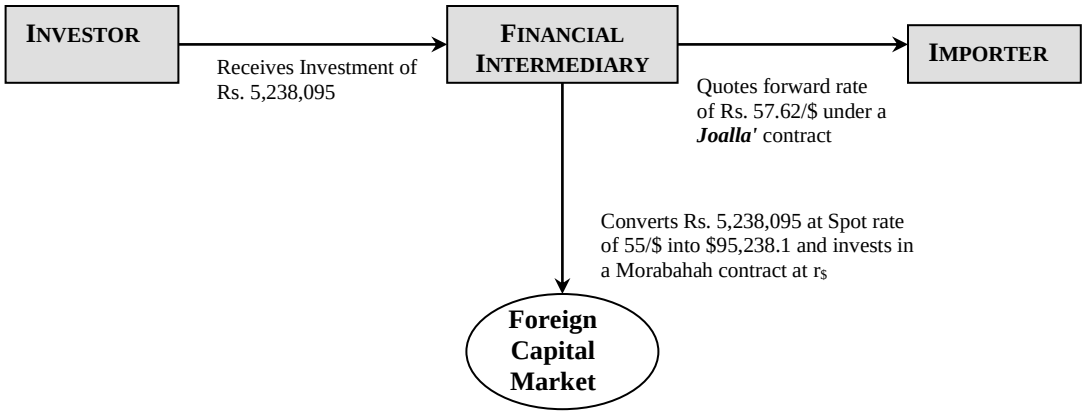
$$\frac{HedgeAmount * Spot * (1+R_{Rs})}{HedgeAmount * (1+R_{\$})} = \frac{100{,}000 * 55 * (1.1)}{100{,}000 * 1.05} = 57.62 / \$$$

Importers' expected cost of imports = Hedge Amount * Forward Rate
= 100,000 * 57.62
= Rs. 5,762,000

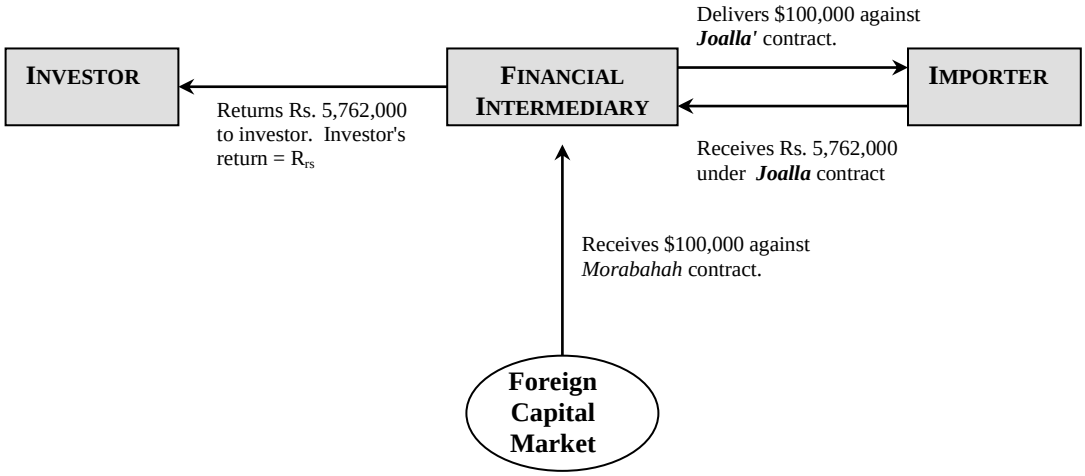
The above example is a simple version of how to construct currency forward synthetically. In a capital market where there are large numbers of users and providers of capital, a financial intermediary can serve the purpose of matching the needs to both entrepreneurs and investors. A financial intermediary who has wider access to capital markets can perform the function more efficiently by standardizing the products, enhancing credit through underwriting (*kafāla*) and offering clients risk management services for a reasonable fee (in form of *Joa'lah*). The following diagram illustrates the function of a synthetic forward with the inclusion of a financial intermediary.

FIGURE 1. THE CREATION OF A SYNTHETIC FORWARD CONTRACT

At Time of Contract (t_0):



At Time of Delivery (After Three Months):



Note: This illustration does not take into account any transaction costs or fees of financial intermediaries.

V. Currency Swaps

One of the most popular off-balance-sheet instruments is the currency swap, which is used frequently to hedge against currency risks, to lower funding costs through arbitrage in different markets or to gain access to markets otherwise not accessible. A currency swap can help an institution reduce its exposure to a particular currency by allowing it to swap existing assets or liabilities for ones that are more desirable. Although Islamic financial institutions may develop a comparative advantage in assets or liabilities in a particular currency, their advantage can lead to increased exposure to that currency. Therefore, there is a need to develop instruments similar to off-balance-sheet instruments such as the currency swap to manage currency exposure and also achieve better asset/liability management, thus reducing overall financial risk.

Although a currency swap is simply a series of forward contracts. Currency swaps are not practiced in Islamic financial markets mainly due to prohibition of currency trading in forward markets. However, there are other ways of creating currency swaps without using currency forward rates. As mentioned earlier, the foundation of an Islamic financial system is asset-backed securities linking each financial claim to an underlying asset. Each financial claim in an Islamic financial system can be considered as a contingent claim whose return/performance depends on return/performance of an underlying real asset. Therefore, financial engineering can be applied with a set of asset-backed financial claims to develop instruments similar to a currency swap to hedge currency risk.

For example, two *ijāra* (leasing) contracts can be used to construct a currency swap agreement. *Ijāra* contract is a well-established and widely practiced Islamic instrument that comes in both fixed and floating rates. Its structure is acceptable to conventional financial markets. A financial intermediary can arrange a swap between two holders of *ijāra* security in two different currencies such that each party's exposure to a particular currency or type of return (fixed or floating) is reduced as desired.

VI. Conclusion

Introduction of off-balance-sheet instruments in Islamic finance will help entrepreneurs to hedge against market and price risk. This will ultimately lead to an increase in the value of their firm. Islamic finance offers a set of "asset-backed" securities whose characteristics are similar to a fixed-income security. These basic building blocks can be used to create hedging instruments synthetically without using any derivative instruments. This paper offered an example of synthetically constructing a currency forward, which can be used to hedge foreign exchange risk. Islamic financial markets need to introduce new products to cater to the needs of firms so as to hedge against different risks. This will help maintain their competitive edge against their counterparts in conventional markets.

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[1] Marshall and Bansal, 1993.

[2] Chorafas and Steinmann, 1994.

[3] For further information, refer to FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities (FAS 133)," issued in 1998.

[4] Al-Omar and Abdel-Haq, 1996.

[5] Iqbal, 2000 (Alexandria).

[6] Askari and Iqbal, 1995.

[7] Merton.

[8] For a good summary of financial engineering, see Finnerty, 1988. In modern financial markets, financial engineering was motivated by such factors as tax advantages, reduced transaction and agency costs, risk allocation, increased liquidity, the regulatory and legislative environment, the level and volatility of interest and exchange rates, the level and volatility of prices, advances in financial theory, accounting benefits, and technological developments.

[9] See Mirakhor, 1989, and Khan and Mirakhor, 1992.

[10] Vogel and Hayes, 1998.

Islamic Finance

Successes, Prospects, and Neglected Areas

Jassar Al Jassar*

ABSTRACT

This paper will first detail the successes of the Islamic financial industry since its inception. These include acceptance by customers, investors, businesses, and bankers; its growing profitability; the increasing sophistication of Islamic financial contracts; the introduction of new instruments; and its ability to attract new players. Not content to deal with successes alone, in this paper we tackle the of the industry's lapses, especially its failure to develop transparency, standardize contracts, reach consensus on legal rulings, and create appropriate short-term liquidity and investment instruments. The continuing lack of a uniform regulatory and supervisory climate is also highlighted. The paper concludes by outlining the prospects of the industry for evolution and development, and suggests topics for research in areas that remain neglected, particularly public finance, secondary markets, and e-banking.

I. INTRODUCTION

It must be stated right at the outset that Islamic finance is based on religious belief, which provides the framework and encompasses and motivates all actions. Islamic finance is not about financing or investment alone. It is an integral part of the Islamic way of life and has philosophical repercussions at the core.

This paper attempts to take a critical look at where Islamic finance stands at present, taking account of its successes and prospects, as well as identifying areas that have remained neglected, to see what is needed for further progress and where Islamic finance is likely to be—or rather, where we would like it to be—at the end of this first decade of the first century of the new millennium.

II. SUCCESSES

Islamic finance is no doubt relatively young, but it has had to make giant strides to reach its present level of acceptance. Like every new system that has had to fight its way up to achieve parity with existing systems, Islamic finance has had its share of successes, and has had to get over daunting obstacles.

The first big success was winning over the skeptics who strongly doubted that economic activity could ever be interest-free. The disbelief was pronounced, especially since almost all Muslim countries are themselves dependent on interest-bearing loans from such institutions as the World Bank, the International Monetary Fund (IMF), and commercial banks. Thus, the first challenge to Islamic finance was to prove the skeptics wrong, and this was done, slowly but surely. Islamic financial institutions provided the solution and proved that Islamic finance can be a successful alternative to conventional loans. Most of the initiatives came from the private sector, and each one started from a small beginning. However, over the years Islamic finance has grown both in number of institutions and turnover, and now a significant number of the financial transactions in Muslim countries are *sharīʿa*-compliant.

The start of Islamic finance coincided with, and was even spurred by, the establishment of the Islamic Development Bank (IDB) twenty-five years ago. This was an important milestone and a great stimulus to the development of the Islamic finance industry.

Gradually even those Muslim depositors who were originally ill prepared mentally to accept the idea of possibly sustaining losses on bank deposits came round to accepting that Islamic finance was not, after all, a mirage, but a realistic, realizable, and reliable undertaking.

Other successes that can be noted are as follows:

The consistently high growth rate of the industry, with a track record of success proving the skeptics wrong. Islamic financial institutions have built a loyal core customer base. Over the last twenty-five years or so, the amount invested in *sharīʿa*-compatible investments has steadily increased, is now estimated to have exceeded $180 billion, and has been growing at the rate of around 15% per annum. It should be noted that the demand for good

* General Manager, Kuwait Finance House, Safat, Kuwait.

investments for Islamic investors' funds has been so high as to create demand for new and diverse product offerings. Perhaps the most convincing evidence of this success in overcoming skepticism and earning recognition, is the acceptance of the feasibility of Islamic finance as a business line by major Western banks such as Citibank, ANZ, HSBC, and Société Générale, as shown by their introducing separate Islamic finance subsidiaries or divisions in their own operations. Likewise, major conventional market benchmarking companies like Dow Jones have launched distinctive Islamic market benchmark indices.

Customers and users have shown approval of the increasing sophistication of Islamic finance products and instruments on offer and their broadening range. In the earlier years of the industry, concentration was on relatively simple *murāba®a* financing and a certain number of real estate ventures, the last five years or so have seen many new products and instruments added. These new products have been diverse, including, for example, project finance, securitization, structured financing transactions, lease finance, asset management/investment funds, direct investments, and other investment instruments, all developed in conformity with the principles of the *sharī¢a* and adequately complying with the basic requirements of *ijāra*, *mushāraka*, *mu∞āraba*, *murāba®a*, *salam*, *istisnā'*, and the like. A growing number of major international banks are willing to arrange deals in cooperation with Islamic financial institutions. Islamic institutions have demonstrated an ability to work alongside major conventional banks on large regional financing deals structured so as to include an Islamic tranche alongside a conventional tranche (e.g. the $200 million Islamic tranche in the $1.2 billion project finance for the Equate Petrochemical Complex in Kuwait and the $100 million Islamic tranche in the $600 million financing for Thuraya Satellite Telecom, UAE).

As a growing number of investors and businessmen in Islamic countries turn to Islamic finance as a business alternative, major corporations in the West are now increasingly open to using Islamic investor funds as an alternate source of finance. This is good news for the Islamic finance industry, as it stimulates the development of geographically and otherwise diversified high quality investment product offerings.

Acceptance on the regulatory level has been increasing, as evidenced by major initiatives of the central banks and monetary authorities in such countries with majority Muslim populations as Bahrain, Malaysia, and Kuwait. The Islamic Development Bank has often made important direct or indirect contributions to the developments leading to this acceptance. In Bahrain, the Bahrain Monetary Agency (BMA) is planning to issue Islamic government bonds. In Malaysia, an Islamic offshore financial market is being developed in Labuan, under the auspices of the Malaysian monetary and regulatory authorities. In Kuwait, a new banking law is being discussed by the parliament. Consultations are being held with all relevant groups, including the Chamber of Commerce and Industry, *sharī¢a* and legal experts, and constituent institutions, to bring Islamic financial institutions under the Central Bank's umbrella and integrate them into the banking system. This is intended to build further upon the foundation laid twenty-three years ago when the Kuwait Finance House was established by *amīrī* decree, with express recognition of the *sharī¢a* as the regulatory system for governing its operations. (The government of Kuwait continues to be the major shareholder of the KFH.) These initiatives by monetary and regulatory authorities can be seen as testimony of Islamic finance's acceptance and political recognition. Another such evidence is the slow but sure growth in the number of Islamic financial institutions and product offerings in Western countries, with their highly-developed regulatory climate, tried and tested compliance, reporting, accounting, and auditing standards and practices. This development is especially welcome, as it is likely to have beneficial ripple effects on the growing industry and help ensure that growth does not come at the cost of sidestepping compliance issues and normal standards of good practice. The recognition of Accounting Standards for Islamic Financial Institutions by central banks as well as international institutions like the IMF and the World Bank, is another important facet of this success.

Recognition at the theoretical level has been growing, with many prestigious seats of higher learning introducing research and study programs in Islamic finance and related subjects. Today such universities as Harvard, King Abdul Aziz University in Jeddah, the University of Durham in the United Kingdom, and the International Islamic University in Malaysia, among many others in Muslim as well as other countries, have introduced Islamic finance into the curriculum or initiated studies and research, while specialist institutions like the Institute of Islamic Banking and Insurance and the Islamic Foundation, among others, have made remarkable contributions to the spread of Islamic financial knowledge and are providing a basis for further development.

Thus Islamic finance has earned respect and come to be regarded more and more a part of the mainstream than, perhaps, an interesting idea.

All of the these developments can, with legitimate pride, be counted as successes achieved by Islamic finance, but in the competitive and constantly evolving world of modern finance can Islamic finance afford to rest on its successes? Certainly not. Islamic finance has to embark on an exercise in self criticism and take into account the neglect of certain important areas, thus preparing to repair lapses and weaknesses and visualize prospects of

further growth in the direction of becoming, and being accepted as, equal members in good standing of the international financial community.

III. NEGLECTED AREAS

Attention is needed to the neglected areas, which we have outlined below, together with ideas for rectification.

A. Production of Popular Liquid Short-Term Investment Instruments

Traditionally, investment in short-term *murāba®a* transactions has been used by Islamic financial institutions as the closest substitute for such liquid investments as the marketable securities found on the balance sheets of conventional banks. However, even short-term *murāba®a* is not as readily convertible to cash as a conventional bank's portfolio of T-bills and negotiable CDs; therefore, no *sharī*ᶜ*a*-compliant alternative to T-bills or marketable securities is available as yet.

New products have recently been launched by Islamic financial institutions, such as securitizations with some liquidity features. However, neither do securitization-type issues have the liquidity of T-bills issued by a central bank. It will be necessary to develop Islamic instruments with full state credit backing (something similar to T-bills but within a *sharī*ᶜ*a*-compliant structure). We hope the initiative of the Bahrain Monetary Agency (BMA), who have been discussing plans to issue Islamic bonds, may prove to be the pioneering example that could fill the vacuum. However, much effort will be needed to reach that point.

B. Standardization

While most conventional banking contracts are fairly standardized, those used by Islamic banks can often differ significantly. Standardization of routine agreements could save a lot of time, effort, and other resources, including legal costs. If achieved, standardization would allow Islamic finance professionals and their business counterparts to focus energies on business and product development, rather than repeatedly reinventing the wheel. It would also promote more widespread familiarity with the principles of Islamic contracts and loan structures, enabling other institutions to know exactly what products are available and encourage them to become more actively involved in Islamic finance. So far, most of the institutions involved have been concerned more with the immediate bottom lines than in research that will produce future benefits. However, as the industry matures, this is starting to change and much more progress can be hoped for in this area. What is required is for resources to be committed, not only funds and outstanding researchers, but also line-management time—something in relatively short supply. Since issues related to intellectual property and the like will have to be addressed before private institutions will commit critical resources other than funds, the main role in standardization will probably be taken by public bodies, industry associations and larger institutions.

C. Evolving a Consensus on *Sharī*ᶜ*a* Rulings

By far one of the most controversial and complex problems in Islamic finance has been a lack of consensus among *sharī*ᶜ*a* rulings. Admittedly, there are various schools of thought within the brotherhood of Islam, which differ sharply on some matters, for example insurance and investing in stocks. It is tempting to take heart from the reality that even within the United Kingdom English law differs from Scottish law, and this difference has not seriously hampered business, making it possible that differences of opinion among *sharī*ᶜ*a* scholars may also be something that can be endured. However, achieving something closer to a consensus can only help the industry. A number of efforts are being made toward this end. For example, the Kuwait Finance House has been hosting annual *sharī*ᶜ*a* forums, inviting eminent *sharī*ᶜ*a* scholars to meet and exchange views on industry issues. Laudable efforts have also been made by other institutions. Much remains to be accomplished in this area.

D. A Uniform Regulatory and Supervisory Climate

Depending on country, Islamic financial institutions are regulated in different ways. In Saudi Arabia, all commercial financial institutions report to and are regulated by the Saudi Arabian Monetary Agency (SAMA, the Saudi central bank). In the UAE, a special Islamic banking law exists, and the Islamic institutions are under the umbrella of the Central Bank, which readily supported the Dubai Islamic Bank during the crisis it experienced several years ago.

In Kuwait Islamic banks are under the ministry of commerce, unlike conventional banks, which are regulated and supervised by the Central Bank. However, several drafts of a new Islamic banking law are being discussed in parliament, all agreeing on bringing all Islamic banks under the supervision of the Central Bank.

E. Public Finance

The lack of acceptable government-guaranteed liquid instruments poses a major challenge to the management of assets and liabilities and other balance-sheet items.

Islamic finance has so far failed to come up with alternatives to products with the credit quality and liquidity of the T-bill and T-bond. The kick-start could come with the commitment by a Central Bank of liquidity to a product.

F. Secondary Markets

Although a very small number of products launched recently are backed by trading arrangements for a secondary market, Islamic investments generally have tended to be illiquid. This aspect also needs to be given due attention. It is hoped that the IIMM (Islamic International Money Market, Labuan) will be of benefit in improving this situation, but perhaps it cannot realistically be expected by itself to provide a global solution.

G. Improving Reporting and Transparency

Differing regulatory regimens, together with differences in operations, have often meant differing reporting and disclosure requirements and practices. Credit rating agencies have normally focused on this issue. In some cases, a relatively lower level of disclosure, even when all current regulatory requirements and applicable accounting standards are met, has led to lower ratings for Islamic financial institutions than would given to a conventional institution with comparable financial standing. Another factor might be a lack of familiarity with Islamic finance.

IDB's recent sponsorship of a professional credit rating agency for Islamic financial institutions, and the initiatives of the Accounting and Auditing Organization for Islamic Financial Institutions are laudable steps, but much more needs to be done.

H. E-commerce and E-finance

The Internet and the development of e-commerce are considered likely to lead to major changes in banking and finance as we know them. The advent of electronic-commerce is likely to mean much more than just the addition of one more delivery system to the many old ones. Although Islamic banks have made some limited progress, they need to focus more meaningfully on this rapidly-developing dimension of the finance industry.

IV. PROSPECTS

The prospects for the growth of Islamic finance remain very strong. The ten largest Muslim countries have a combined GDP of $1.2 trillion. The Islamic banking market exceeds one billion people, including some 150 million Muslims who reside countries where Muslims are a minority. Six million of them live in Western Europe. Many of them appear keen to channel their assets into Islamic finance, and many have quite sizeable disposable incomes. They, therefore, represent potentially a very lucrative market for high quality Islamic financial institutions. Currently only a small segment of Muslim-owned monies are invested Islamically (mainly in equity funds, real estate, and short-term instruments managed by Islamic financial institutions or international banks operating Islamic banking windows). The investment funds of public bodies in Muslim-majority countries are among the assets that are not yet a part of the Islamically-run finance market.

Demands have been voiced by Muslim clients in the Middle East and elsewhere for their pension funds to be placed in *sharī*ʿ*a*-compliant investments. These pension funds are very sizeable, especially in the oil-exporting Middle Eastern countries, but their investment is usually, and rightly, managed by conservative public institutions. Once a suitable range of high quality Islamic products is available to choose from, it is reasonable to expect that pension monies will start pouring in, very significantly boosting the prospects of the Islamic finance industry.

V. CONCLUSION

In conclusion, without trying to deride older economic systems, but just stating the facts, it is now common knowledge that Communism and its centrally planned economic and financial system has either been given up altogether or has been drastically toned down. As for Capitalism and its market-economy system and free market finance, its virtues have also come under serious questioning recently as an aftermath to the huge, even violent, demonstrations in places as far apart as Seattle, Bangkok, Prague, and Melbourne. The violent price swings in financial markets, speculative stock market booms and busts, unsettling currency rate volatility and wide

fluctuations in asset prices and the like have put the free market's perceived role in question as the only viable allocator of resources and puzzled or disturbed many eminent Western economists and financial experts enough for them to start advocating radical changes ranging from a return to the gold standard, to calls for greater regulatory intervention to discourage debt financing, and to transaction taxes on secondary markets for controlling unbridled speculation. None of these ideas has so far been seriously tried.

Without going into the merits and demerits of this criticism, it can safely be concluded that the older economic systems have either failed or need drastic changes if they are to meet the needs of mankind as a whole. And it is here that the Islamic system of economics and finance—which combines in itself the virtues of free enterprise and social justice—can, if properly defined and applied, present itself as a viable alternative.

Alternatively, the Islamic financial system need not necessarily compete with other systems, but may exist side by side and even act in cooperation where possible. This is demonstrated by the joint arrangements involved in some major regional financing schemes, with conventional and Islamic banks cooperating, with the approval of the *sharīʿa* supervisory boards of the Islamic banks and by having an Islamic tranche alongside a conventional credit tranche to make up the total financing. The landmark financing for Equate of $1.200 billion comprised of an Islamic tranche of $200 million, with the remaining amount arranged conventionally by the other banks, is one such example. The $600 million financing for Thuraya Satellite Telecom Co., UAE, contained a $100 million Islamic tranche.

Having reviewed the successes, neglected areas, and prospects of Islamic finance, and having noted the increasing recognition and acceptance, and the current demand-driven momentum of the industry, it seems reasonable to us to expect that Islamic finance will be able to build on its successes, and address the issues it has neglected so far. On the basis of conservative estimates of present-day wealth and growth predictions for the population of the Islamic and potential Islamic investor markets, it also seems reasonable to estimate that ten years from now Islamic finance could well be an industry with the equivalent of at least $1 trillion under management. However, in order to get there, and it will likely get there—such being the pull of existing demand—it needs to be ensured that the major issues are addressed as much as necessary to develop new products and solutions to the problems discussed above. The issues can be generally identified as compliance- and innovation-related, for example:

1. Ensuring the suitability of products sold to retail investors,
2. Ensuring proper management, especially in regard to credit/investment quality and asset-liability management,
3. Improving professional expertise to become able to face increasingly the complex challenges emanating from the growing size and stature of the industry in an increasingly sophisticated and competitive environment, and, most importantly,
4. Maintaining focus on its real purpose, which is to offer financial products complying with the spirit of the *sharīʿa*.

Thus it is apparent that Islamic finance, though relatively young as an industry, has grown so fast and become so robust that it can legitimately claim not only to have come of age also to be here to stay.

The Challenge of Reach and Richness in Islamic Finance

Iqbal Ahmad Khan*

ABSTRACT

The Internet continues to profoundly affect all businesses, particularly those in the evolving Islamic financial industry. This paper examines how informational economics is shaping the growing Islamic financial industry. A new business design that offers customers *sharī*ʿ*a*-compatible products in a much more convenient and cost-effective way is emerging, and this model will enhance the global reach of Islamic finance. Some of the practical ways in which the reach of Islamic finance can be broadened are explored, including the customization of information, interactivity among players, and reliability of information. As a new industry, however, Islamic finance must build enhance the richness of its products and services, a task that is fraught with challenges and that requires buying and commitment from regulators, investors, and issuers. Building richness also needs proactive collaboration between conventional and Islamic financial institutions. Finally, the paper analyzes the trade-offs between reach and richness.

I. INTRODUCTION

Islamic finance is a growing industry, and it is important to examine its trends and to see how the reach and richness paradigm can be applied to it. It is essential to focus especially upon means of building richness, on the fundamental proposition that enhancing richness builds the industry, and takes it to the next stage in its evolution. The creation of an infrastructure and a review of industry efforts and community initiatives toward this must be made. Similarly, it is important to discuss the expansion of the reach of Islamic finance, and means of accomplishing this using the new technologies introduced in recent years. From such discussions, a clearer picture of the future of this industry may emerge.

II. THE LANDSCAPE OF ISLAMIC FINANCE

Islamic finance is an emerging product in emerging markets, an industry in transition along with the markets in which it operates. Jassar Al Jassar of Kuwait Finance House recently put the market size of the industry at $180 billion, with a growth rate of 15%–20% per annum. It is an industry that is broadening the ownership base and building a strong, vibrant middle class, thus bringing a hope of stability to the 1.3 billion Muslims of the world.

A. The Five Stages

In stage one we find countries such as Singapore, Hong Kong, China, and Azerbaijan, which are all studying Islamic finance as a concept. Islamic finance is relevant to them on two accounts: either they have large Muslim minority populations, and want to offer products and services based on this ethical concept, or alternatively these countries are in areas where neighboring countries offer this value-added product that they wish to explore. This exploration lays the foundation for Islamic finance.

In stage two, a group of pioneering individuals start converting the concept of Islamic finance into a reality, through the establishment of an investment company, a fund management company, or perhaps a *takāful* company. This brings together retail investors and high-net-worth individuals behind Islamic finance. Many Muslim countries and some OECD countries are now at this stage; examples include Algeria, Syria, Lebanon, the United Kingdom, Germany, and the United States. At this stage the regulators, community, and the financial service intermediaries have a dialogue; it is a stage of consensus-building and establishing a way forward.

The next stage sees the creation of both banking and non-banking Islamic financial institutions. Thus Brunei has the Islamic Bank of Brunei, the Islamic Development Bank of Brunei, and Brunei Haj Fund. Indonesia has Bank Mumalat, Morocco has Faisal Finance, and Turkey has its own brand of Islamic financial institutions. Included in this category are Qatar, Palestine, Bangladesh, and even South Africa.

In stage four begins the creation of mutual funds and the initiation of full capital market activities. Countries in this category include Malaysia, Kuwait, Bahrain, the UAE, Saudi Arabia, Egypt, Jordan, Pakistan, Iran

* Managing Director, HSBC Amanah Finance, HSBC Group, Dubai, U.A.E.

and Sudan. In this stage, Islamic financial institutions participate in increasing the embedded capital of their home countries, and Islamic finance tries to establish mainstream relevance in the markets in which it operates.

In stage five, capital markets develop fully. In this stage, issuers and investors get together and create the infrastructure for full-blown capital markets, i.e., market-making leading to secondary markets. This is the stage to which Islamic finance aspires today.

B. A Brief History of Modern Islamic Finance

The decade between 1970 and 1980 marks the early beginnings of Islamic finance. During this time the concept was first translated into reality by the pioneers of the field, including Prince Mohammed al Faisal al Saud of DMI Group, Shaykh Saleh Kamel of Al Baraka, and a number of other entrepreneurs and leaders. This is the period in which the Islamic Development Bank (IDB), Kuwait Finance House, Dubai Islamic Bank, and Faisal Islamic Bank of Egypt were created. During this time *murāba®a* was the instrument of choice, and most transactions under such contracts were at the short end of the maturity spectrum. Considerable strides were made resulting in the evolution of the *mu∞āraba* contract. At this time there were serious industry and macroeconomic impediments preventing these pioneers from venturing into new territory or tenure-stretching. This was also a period in which equities were a no-go area.

The next stage of the evolution of Islamic finance, the years between 1980 and 2000, has seen a gradual evolution of this growth industry. Covenant-based project-financing has become more common, and institutions practice tenure-stretching with 3, 5, 7, and even 10 years financing. *Istisnā', ijāra*, *bay^c salam* and a combination of other melded instruments are used more frequently. Islamic financial institutions have begun to reach Euro Money league tables as arrangers and providers of finance. This happened primarily because Islamic financial institutions, like any group of investors, have their own unique perception of risks. Investors who are close to the risk understand it better and therefore price it better, and perhaps take a longer-term view. Islamic financial institutions have become among the leading providers of cross-border lines in a belt of IDB member countries, and have consequentially gained competitive advantage.

This period has also witnessed equities opening up as an asset class. A pioneering group of institutions has partnered with asset managers to move boldly into this field, to secure higher economic profits for customers. The second generation of Islamic financial institutions, such as the First Islamic Investment Bank, the Citi Islamic Investment Bank, Abu Dhabi Islamic Bank and many others have entered the market, bringing an enthusiasm for change and innovation. Islamic finance has finally established itself as an industry that is here to stay. When we look beyond the year 2000, we find Islamic finance operating in the economies of the OECD world, which are gradually opening up. The rulebook for Capital Marketing is being written. In this period it can be envisaged that Islamic finance will achieve mainstream relevance in the OIC world by increasing its embedded capital, and will establish itself as a niche product in the rest of the world.

III. "REACH AND RICHNESS"

For the Islamic finance industry to be successful it requires an enabling legal and regulatory environment, which is, regrettably, currently not available. It needs both local and foreign investors, of whom there is an abundance, investment and financing opportunities of which there is a shortage, and a competent management with performance incentives. The industry still has a long way to go for most of these.

We now move on the central theme of this paper: the reach and richness paradigm of Islamic finance. Being a growth industry, Islamic finance does not have the traditional conflict between reach and richness: it is a market of around $180 billion growing at 15% per annum, with revenue spreads of approximately 2%. New levels of reach and richness are therefore attainable. In order to build the richness profile of Islamic finance, first the extant richness profile must be analyzed. Then means of creating an enabling infrastructure in terms of macroeconomic, regulatory, and fiscal framework for Islamic financial instruments must be considered, and industry efforts and community initiative briefly looked at. Finally, the routes to richness must be examined, before addressing the issue of building the reach of Islamic finance.

A quick snapshot of the richness profile of Islamic finance reveals that products currently available include OECD *murāba®a*, emerging market *murāba®a*, emerging market credit-enhanced leasing opportunities, global equity funds, regional equity funds, principal-protected funds, *sharī^ca*-compatible themed funds based on either sector or country funds, and most commercial banking services. Other product propositions are available, including OECD leasing programs, private equity in OECD markets (such as an initiative by First Islamic Investment Bank), corporate finance advisory, and infrastructure finance. More quality issuers and a greater focus on *takāful* and retail banking products in OECD markets are needed. Products that may be seen in the future include OECD home

financing, *sharīʿa*-compliant money market instruments, and private equity in IDB member countries. This effort is being strategically led by the IDB through its subsidiary ICD and Gulf Finance House. Other new products include convertible *ijāra*, preferred shares, and variable risk securitization. Thus new frontiers keep changing with the evolution of Islamic finance.

IV. ROUTES TO RICHNESS

The history of the frameworks for financial instruments shows that the macroeconomic framework, the regulatory supervisory framework and the accounting framework have all been created for conventional financial instruments. Islamic financial instruments are generally not even acknowledged in the financial infrastructure and regulatory frameworks of IDB member countries and OECD markets.

Historically, Islamic finance has its roots in IDB member countries, which were generally emerging markets breaking free of their colonial legacies and searching for new economic models. Most chose state-control-based economic models. Thus Islamic finance had its roots in state-controlled macroeconomies with little room for private sector initiatives. Over the years, Islamic finance has adjusted to this framework and infrastructure, which have, themselves, expanded to accommodate Islamic financial instruments, but generally only on an exceptional basis. A mainstream industry cannot be build on exceptions alone, and therefore there is a need to create an infrastructure for Islamic finance in both IDB member countries and other markets with Muslim communities. Such a framework should include not the regulatory and supervisory framework for Islamic financial institutions, as well as deal with issues such as risk weightage, stamp duties, ownership covenants, withholding taxes on leases etc. Once this country framework has been created, it should be widened to create a cross-border framework through IDB and non-IDB countries. There is a need for global *sharīʿa* standards, allowing products to migrate from one market to another without needing clarification. The initiative taken by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) to create a *sharīʿa* standard for Islamic financial instruments is encouraging in this regard. The regulatory framework should take the unique needs of Islamic financial institutions and instruments into account. For example, Islamic financial institutions ought to be allowed to invest their statutory reserve funds according to their *sharīʿa* investment principles. Similarly, Islamic financial instruments should be given a risk weightage no greater than that given to similar conventional instruments. This is essential to create a level playing field. The Islamic finance industry itself can build industry institutions such as accounting and auditing organizations, international associations, and programs such as the Harvard Islamic Finance Information Program (HIFIP). These industry initiatives are important as they will help to build the richness and the reach of Islamic finance.

V. INDUSTRY EFFORTS AND COMMUNITY INITIATIVES

The efforts of the industry and community, such as those of the pioneering *sharīʿa* scholars who support efforts to build richness with their guidance and supervision need to be saluted. The leadership role of the Islamic Development Bank in establishing the ICD, the IDB infrastructure fund and its whole range of initiatives is also praiseworthy. The Bank has taken its role as a leader of the industry with great enthusiasm and seriousness. It is incumbent upon all industry members to support such initiatives. The Accounting and Auditing Organization for Islamic Financial Institutions is playing a pioneering role by creating the accounting and *sharīʿa* standards for Islamic financial instruments. Similarly, community organizations such as the Islamic Society of North America and the Muslim Council of Britain play an important role in building awareness of Islamic finance and educating the regulators. It is important that a coalition of professionals, *sharīʿa* scholars, and community leaders coalesce to talk to regulators, in order to take Islamic finance to the next stage of evolution.

The route to richness lies in affiliation and strategic alliances. There is an increasing need for research and developmental projects in which *sharīʿa* scholars, leading universities, and practitioners should come together to pertinent issues. While there are a number of examples of this collaboration, more such initiatives are needed. Collaboration and partnership between the public and private sector, and between conventional and Islamic financial institutions is essential, as is the need for investors to partner with asset managers. The latter will allow for the transfer of technology and know-how from established institutions into the emerging world of Islamic finance. Additionally, attracting quality issuers is important for IDB member states and OECD markets alike. Good issuers have to be proactively originated, otherwise institutions will be confined to dealing with second-tier issuers.

There is a need to harmonize standards among institutions, and to take the best from conventional institutions. The most important route to richness lies with culture, people, and training. We can replicate tangibles but never intangibles. It is important to invest in people and their training, so that a strong, innovative, and open

culture is created; a culture in which there is a realization that every business opportunity competes with Islamic finance, and the final competitors are the consumers themselves. It is time that Islamic financial institutions asked themselves what they are to do for consumers that they cannot do for themselves.

VI. Expanding the Reach of Islamic Finance

The reach of Islamic finance can be expanded by following several measures, including increasing market share in home markets, opening up new markets, reaching the unreachable and by embracing e-commerce. In order to increase market share in home markets, first and foremost practitioners of Islamic finance must build credibility. Creditability is built by creating a culture of transparency, *sharīʿa* credibility, earning power, enhancing legality, improving the quality of service, providing richness based on added value, and above all, educating customers. The market share of industry can be built by supporting industry initiatives such as conferences, seminars, workshops, associations, and research programs. It is also important to reach out to other communities. Islamic finance is rooted in inclusiveness, not exclusivity, and institutions must reach out to other communities and welcome them into the fold. Islamic financial institutions should strive to increase the embedded capital of the local market in which they operate. This can be accomplished by participating in project finance, and infrastructure finance, and by increasing the embedded capital of local markets. Finally, practitioners can increase market share by achieving mainstream relevance.

A second measure toward expanding the reach of Islamic finance is opening up new markets, which requires educating regulators, working with community organizations and supporting industry initiatives such as AAOIFI, the international association of Islamic banks, IAIB/IBC and programs such as HIFIP. It also requires working in association with credible partners, respecting local traditions and demonstrating a long-term commitment to new markets. These initiatives can pave the way toward improved growth and evolution.

To reach the unreachable, in this context, means to strive to tap markets that may seem difficult or unprofitable. Today there are significant Muslim communities in the United Kingdom, United States, Germany, France and India, which form the untapped markets of the future. Here institutions can adopt a partnering approach with local institutions that provide access to the markets, while Islamic financial institutions provide structure and the *sharīʿa* authentication.

This brings us to an extremely important initiative: accessing clients through the Internet and thus taking the issue of reach to a whole new dimension. Reach can be significantly enhanced by embracing e-commerce wholeheartedly and with total commitment. E-commerce is not about glittering Web sites and storefronts, but about connectivity and common information standards. There are opportunities in the business-to-business as well as business-to-consumer areas. Several new e-commerce initiatives have been launched: iHilal.com and islamiq.com are only two of the new entries in this field, as the third generation of Islamic financial institutions. It is essential that they all talk to each other to create common information standards and connectivity, and decrease searching and switching costs for customers.

A successful e-commerce proposition needs, first of all, credible shareholders who are committed to the industry. It needs to be an alliance of synergistic partners providing both reach and richness. It should be an enabling business design and certainly a “value for money” proposition, with low searching and switching costs. It should provide richness both in terms of the product proposition and services. It should certainly be very easy and convenient to use. Above all, a successful e-commerce proposition should be based on the partnership culture: partnership within the entity, as well as with clients.

VII. Conclusion

When one looks to the future, new levels of reach and richness are visible, and reachable. The current size of the Islamic financial market, around $180 billion, is just a beginning. Although there is much potential to enhance both the reach and richness of Islamic finance, major challenges in gradually building and enabling the supporting framework persist. Meanwhile, the Internet offers new opportunities to expand the reach of Islamic finance.

Meeting the Competitive Challenge

Marketing Leadership in Islamic Financial Institutions

Essam Mahmoud* **and Gillian Rice†**

ABSTRACT

The competitive challenge for Islamic financial institutions is especially strong. This paper argues that, in order to succeed, the institutions need marketing leadership. Taking into account the special characteristics of the institutions, the paper provides a framework showing how to nurture marketing leadership. Several studies have shown the importance of a marketing orientation to business success. A marketing orientation is an organizational culture that effectively and efficiently creates the necessary behaviors for the creation of superior customer value. To implement a marketing orientation, marketing leadership is critical throughout the institution—at all employee levels and in all departments. Only then can employees collaborate on developing a sustainable competitive advantage.

I. INTRODUCTION

The competitive environment for Islamic financial institutions today is intense. The globalization of conventional banks and their entry into Islamic financing poses a strong challenge to the smaller, more locally focused Islamic institutions. Some of these institutions have gained credibility in domestic and international capital markets (Iqbal and Mirakhor 1999). Nevertheless, Ariff (1988) labels Islamic banks as complacent, acting as though they had a captive market. One threat is competition from global banks; Ariff (1988) mentions another threat is the fact that many Muslims shift their funds between conventional and Islamic banks and thus display weak levels of loyalty to the latter. Kahf (1999) highlights a series of problems in Islamic banks: a lack of standardization of *sharīʿa* opinions, low levels of know-how on the part of management and staff, a lack of creativity in financial engineering and marketing, and inadequate sensitivity to customer satisfaction. Perhaps because of such problems, Henry (1999) describes Islamic banks as stagnating now, after a period of rapid growth. Ironically, this is occurring as the liberalizing economies in many countries provide numerous opportunities for Islamic banks. This paper tackles the issue of how Islamic banks can improve their performance by developing their customer base and competing successfully against global banks. Our focus is on the marketing of Islamic banks.

Several studies have shown the importance of a marketing orientation to business success (for example, see Kohli and Jaworski 1992, Narver and Slater 1990, Ruekert 1992, Slater and Narver 1994). Many conventional banks in the USA and Europe, for example, now embrace the marketing concept. In emerging markets, banks are also attempting to improve their marketing orientation. In the Arabian Gulf countries, retail banks are beginning to focus on the customer with different services and promotions targeted to each of the female, youth, and expatriate segments, for example (Goswami 1999).

We advocate the development of a strong marketing orientation by Islamic financial institutions. In particular, we are concerned with the implementation of marketing through "marketing leadership." The paper is organized as follows. First we explain the marketing concept. Then we present a framework that can be used to focus discussion and plans as to how an Islamic institution can adopt marketing leadership. In the subsequent sections, we describe the framework in some detail. In the final section we draw conclusions and implications for managers of Islamic financial institutions.

II. THE MARKETING CONCEPT

The marketing concept is a business philosophy implying that the long-term purpose of the firm is to satisfy customer needs for the purpose of maximizing corporate profits (Ruekert 1992). Many years ago, Drucker (1954) argued that creating a satisfied customer is the only valid definition of business purpose. Marketing is broadly defined by the American Marketing Association as: "the process of planning and executing the conception, pricing,

* Professor, King Fahd University of Petroleum and Minerals, Dhahran, Saudi Arabia.

† Associate Professor, American Graduate School of International Management, Glendale, Ariz.

promotion, and distribution of ideas, goods, services to create exchanges that satisfy individual and organizational goals" (Bennett 1995). In the context of Islamic banks, Kotler's (2000) "*societal* marketing concept" appears particularly relevant: "…the organization's task is to determine the needs, wants and interests of target markets and to deliver the desired satisfactions more effectively and efficiently than competitors in a way that *preserves or enhances the consumer's and society's well-being*" [italics added]. The societal objectives are additional to the organization's other objectives. The societal marketing concept is compatible with Chapra's (1992) view of Islamic banks as organizations that have a social welfare role rather than a profit-maximizing role. Siddiqi (1981) also emphasizes that the individual profit motive is not the chief propelling force in Islam; social good should guide entrepreneurs in their decisions, besides profit. Yet organizations like Islamic banks should not use their commitment to societal objectives as an excuse for poor business performance (New Horizon 2000).

The Abu Dhabi Islamic Bank's promotional material states the following commitment to economic development. "Through serving our customers better, the bank aims to be a significant part of the nation's economic and social growth and development in the years to come." Ariff (1988) discusses the role of Islamic banks in stimulating economic development; Islamic banks are concerned with the viability of a project to be financed and not with the size of the collateral and therefore might finance a project on a profit-sharing basis that would be turned down by a conventional bank.

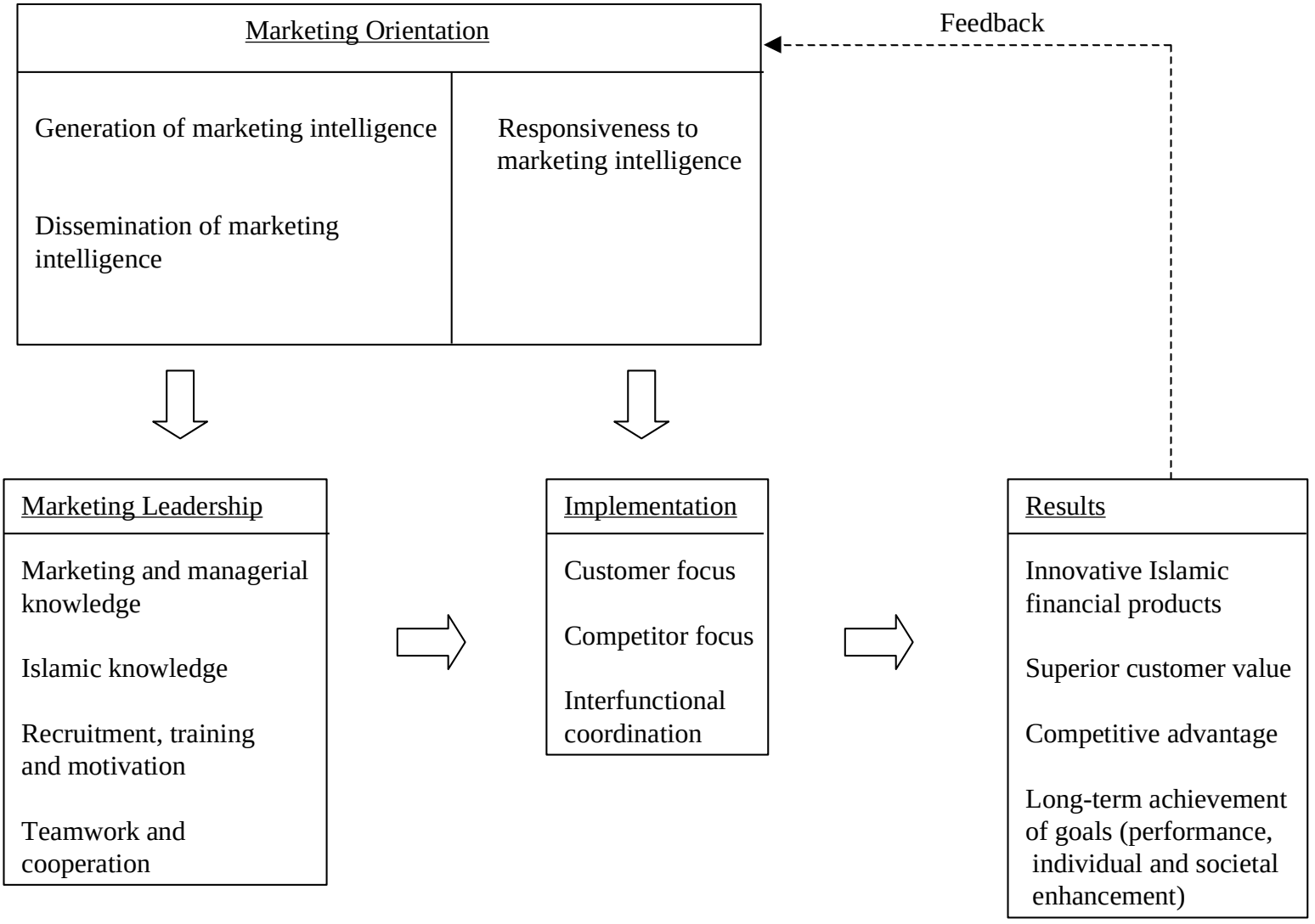
The mission of Islamic banks serves well the small entrepreneurs and rural businesses that do not have access to credit in the mainly urban-based conventional banking system. Nevertheless, in practice, according to Ariff (1988), case studies of Islamic banks show that the structure of the banks' clientele has been skewed in favor of the more affluent portion of society, because the Islamic banks are also usually located in the large urban centers. Additional evidence from Egypt and Malaysia suggests that Islamic banks' portfolios appear to be concentrated more in the trade, retail, finance and service sectors than in the more productive capital intensive industrial sectors of the economy (Hamwi and Aylward 1999). It appears that a societal marketing approach has not been implemented successfully by these organizations. Therefore, an important challenge remaining for Islamic institutions is how to implement and benefit from marketing leadership.

III. Implementing Marketing Leadership in Islamic Institutions

In Figure 1 we present a conceptual framework that illustrates the key features of implementing marketing leadership in Islamic financial institutions. The first feature, marketing orientation, comprises the generation of, dissemination of and responsiveness to marketing intelligence. The second feature, leadership, is vital so that the organization can use the marketing intelligence to develop products, customer value, a competitive advantage, and ultimately achieve the organization's long-term goals. For Islamic institutions, note that leadership means using knowledge in the areas of Islamic principles and the *sharīʿa* as well as in marketing and management in order to recruit, train and motivate others to work in teams to achieve goals. The third feature, implementation, is based on responding to the marketing intelligence. It involves focusing in a balanced way on customers and competitors and coordinating actions across the various functions of the organization.

Only with good Islamic knowledge at all organizational levels can the institution provide the desired results: innovative Islamic products and the appropriate types of customer service required for a minimum level of competitiveness. The framework implies that positive results will flow only from good, balanced implementation of strategies, which are in turn dependent on marketing leadership and a marketing orientation. The creation of superior customer value leads to enhanced shareholder value (Srivastava et. al. 1998). Achieving business success means that an Islamic bank can more easily fulfill its social mission, in accordance with the societal marketing concept discussed above. Results provide feedback that is absorbed through the intelligence-generating feature of market orientation. Details of the four main parts of Figure 1 (marketing orientation, marketing leadership, implementation, and results) are presented below.

FIGURE 1. IMPLEMENTING MARKETING LEADERSHIP IN ISLAMIC INSTITUTIONS



IV. A MARKETING ORIENTATION

The term "marketing orientation" has been defined in various ways, which are all consistent in theme. A marketing orientation is an organizational culture that effectively and efficiently creates the necessary behaviors for the creation of superior customer value (Deshpande and Webster 1989).

Kohli and Jaworski (1990) describe a marketing orientation as the organization's generation of, dissemination of, and responsiveness to market intelligence. Before collecting information about the marketplace, however, it is essential to have a clear sense of purpose and mission of the organization. Wheatley (1999) argues that when an organization has a strong identity, this can be viewed as organizational "self-esteem," and the organization is less vulnerable to its environment; rather, it can shape its environment. Having a clear identity means the most useful and relevant information can be determined and sought from the environment.

Marketing intelligence includes information on customers, competitors, and marketing management practices. For Islamic financial institutions, additional market intelligence comprises information on regulations in the financial marketplace and details of the *sharīʿa*. The information can be sought in formal or informal ways. Examples of formal methods include marketing research studies such as surveys of customers and key industry informants, formal education in Islamic subjects relevant to financial issues, development of databases containing customer records, Islamic financial rulings and organizational performance. Informal intelligence generation includes networking at conferences and seminars dealing with Islamic and financial topics, monitoring of industry publications and reports, participating in "communities of practice" (for details, see the section "Marketing Leadership") and observing competitor behavior.

The intelligence generated must be disseminated to others in the organization; thus, a culture of "sharing" must be nurtured. The development of such a culture is part of the responsibility of a leader, as discussed in the next section. Information can be shared in formal ways such as written reports and informal ways such as networking. This can be accomplished via an intranet as well as by frequent face-to-face interaction. Being responsive to the marketing intelligence implies implementation of strategy; this issue is dealt with in the section on "Implementation."

David Packard of Hewlett-Packard remarked that marketing is too important to be left to the marketing department (Kotler 2000). Indeed, marketing information should be sought from everywhere and then available everywhere so that many people can interpret and act upon it. For Islamic financial institutions, the intelligence emphasis of the marketing orientation means that all employees should focus on gathering and synthesizing knowledge from the outside (from the market, competitors and the Islamic community), and simultaneously, on building and sharing both managerial and Islamic knowledge on the inside.

V. MARKETING LEADERSHIP

The encouragement of knowledge creation is a key function of marketing leadership. Knowledge and competencies have emerged as the key drivers of competitive advantage because intangible assets (such as brand identity, reputation, customer loyalty, and technical know-how) have become the main basis of competitive differentiation in many sectors (Teece 1998). Thus, knowledge and skills in marketing, Islamic principles and the *sharīʿa* are important assets for an Islamic financial institution.

Traditionally, leadership was viewed as "direction from the top" and an organization's management assumed sole responsibility for results. Today, organizations are more concerned with leadership by those who are responsible for developing new products and providing customer service, for example. This kind of leadership is best thought of as "behavior" and not as a "role" (Wheatley 1999). Thus, leadership can be vested in many people in the organization. According to Capezio and Morehouse (1995), "self-directed leadership" challenges every organizational member—regardless of level—to help solve problems, improve quality, increase market share, and create the kind of work environment that encourages people to do their best.

In an Islamic financial institution following the societal marketing concept, it is vitally important that all organizational members understand the meaning of their work. Effective leadership provides employees with the guiding vision, values, and beliefs. Research has demonstrated the enduring strength and resiliency of companies that have strong values (Collins and Porras 1993).

Western cultural beliefs like individualism, competition, and a mechanistic worldview can hamper organizational change efforts, the formation of successful teams and sharing of knowledge (Wheatley 1999). In contrast, features of Islamic culture—collaboration, sharing, and an ecological view of life—can provide organizational advantages to Islamic financial institutions. The Islamic value system stresses truth, justice, and brotherhood; there is a definitive direction and a harmonious and conducive motivational atmosphere for sharing

(Hassan 1997). In Islam, the life of the individual is inseparable from the life of others and working in a dynamic team is encouraged. Hassan (1997) stresses that the love for an organization and its goals is a strong motivating factor to work hard. If the Islamic financial institution follows the societal marketing concept and honestly emphasizes the enhancement of individuals and society in its mission, then organizational leaders should have no difficulty in mobilizing teams and motivating employees. Nevertheless, success demands that all employees understand the mission and this is where Islamic education goes hand in hand with marketing and managerial education. A serious problem faced by many Islamic financial institutions is the employees' limited knowledge of Islamic principles. Rapid growth of the institutions has meant that employees have often been hired away from conventional banks; the employees' knowledge of banking may be good, but innovative Islamic financial product solutions cannot be developed by staff who lack adequate knowledge of Islamic principles. Furthermore, the front-line employees who have contact with customers can only provide superior customer service if they have specialized Islamic banking knowledge, not merely banking knowledge. The intangibility of financial services means that products are often difficult to understand. Consequently, customers interpret good service in terms of the knowledge, commitment, and attitude of the staff (Tang and Zairi 1998).

Because the levels of knowledge vary among employees, the training approach taken by the Canadian Imperial Bank of Commerce (CIBC) may be useful. CIBC abolished formal training in classrooms and gave employees the initiative and responsibility to learn what they need at a particular point in time (Stewart 1999). The bank facilitates continuous learning by providing access to books and software in a "Learning Room," permitting employees to "shadow" colleagues in order to learn, and supporting employees who wish to take formal courses.

Another valuable method of facilitating learning is the "community of practice," which is a voluntary and informal gathering of people who meet to share and discuss topics of mutual interest. It is a group of people informally bound together by shared expertise and passion for a joint enterprise (Wenger and Snyder 2000). A community of practice is a social form of learning and as such should be particularly encouraged and facilitated by the senior managers of an Islamic bank. It is not enough for an organization to develop individual talent in an employee; employees may be lost to competitors. A good leader ensures that information is shared and developed in a social context so that knowledge is kept inside the organization (Stewart 1999).

Targeted recruiting of employees is a method of increasing the organization's knowledge and capacity for innovation. In an Islamic financial institution, the targeting of people with varied skills and experience (for example, Islamic banking, conventional banking, expertise in different financial specialties, knowledge of the *sharīʿa*, knowledge of the latest marketing techniques, experience with organizational change methods) so that there is both cohesiveness and diversity among employees, can lead to "creative abrasion." Too much cohesiveness (shared context, ideas and language) leads to "groupthink" but diversity without cohesiveness results in disorder. The right balance of cohesiveness and diversity means that minds can meet on common ground to explore and negotiate their differences, generating new ideas in the process (Cohen 1998).

Ruekert (1992), in a study of five operating divisions of a large U.S.-based Fortune 500 high technology company, found that marketing orientation is positively related to the degree of market orientation in organizational support processes such as recruiting personnel, the provision of training, and the manner in which employees are rewarded and compensated. Furthermore, as the degree of market orientation increased, the job satisfaction, commitment to the organization and the trust in management by individual employees also increased. This suggests that a marketing orientation on the part of leaders encourages others in the organization also to develop a marketing orientation.

VI. IMPLEMENTATION

To implement a marketing orientation, an organization must have a customer focus, a competitor focus, and coordinate strategies across functional boundaries (Narver and Slater 1990). A customer focus is defined as anticipating, responding to and surpassing customer expectations with respect to products and service. Building relationships with customers leads to the growth in the stock of "customer capital" (Stewart 1999). Customer retention is critically important because it can cost five to six times more to attract a new customer than to keep an existing customer (Lloyd-Walker and Cheung 1998).

One systematic approach to building customer capital means that those customers who are more important in helping the bank achieve its goals receive higher levels of customer service and staff attention than those who are less important. However, the minimum level of service offered should still be exceptional in order for the institution to remain competitive. Thus, one basis for developing differentiated strategies for different groups of customers is the "value" of the customer group.

Other ways of segmenting customers are additionally useful. For example, banks can segment on the basis of demographic variables such as family life cycle, age, and gender, as well as on the basis of client status (corporate vs. individual clients). Income is another segmentation variable: some Islamic financial institutions focus on high-net-worth individuals. For the small Muslim investor in the UK, there is the *ßalāl* Mutual (with a minimum investment of 250 pounds sterling) (Wilson 1999).

Islamic financial institutions have traditionally segmented on the basis of the Islamic offering, using the Islamic nature of their services as the differentiating point, and on the basis of geography, usually confining their activities to particular geographic areas. The changing competitive and customer environment means that the "Islamic market" can no longer be viewed as one homogenous entity. Information is needed about the potential market and how it might be segmented. Henry (1999) emphasizes that we do not know the proportion of Muslims that tolerate interest as a matter of necessity and whether their attitudes might be changing. He comments that some people avoid banks completely and others might be ready to switch from a conventional bank to an Islamic alternative. Kahf (1999) reports that, in Jordan, Bangladesh and Turkey, the Islamic banking movement has been able to mobilize fresh deposits primarily from cash kept at home by millions of religious persons who never wanted to deal with conventional banks because of the *sharīʿa* prohibition on interest. It is also possible that non-Muslims may be attracted to do business with Islamic banks (Euromoney 1998). Iqbal and Mirakhor (1999) argue that Islamic products are needed that attract investors and entrepreneurs to the risk-return characteristics of the product instead of to whether it is Islamic or not.

In Malaysia's multireligious and multicultural environment, Islamic banks deal with situations in which the demand for and the supply of excess funds are no longer generated on the basis of faith alone, but also in the light of factors such as the return on deposits, the cost of financing, and convenience (Rosly 1999). The first step in developing new products is to understand the customer thoroughly and for this, marketing research and information gathering are essential (the intelligence generation aspect of marketing orientation). For example, information should be sought about the characteristics of existing customers of Islamic banks, the customers who patronize both Islamic and conventional banks simultaneously or switch between them, and customers who could be attracted by Islamic bank offerings but are currently banking at conventional banks only. Managers should compare the profiles of these customers and study their attitudes toward the various types of services offered by Islamic and conventional banks.

In countries such as the USA and UK, which contain substantial Muslim minorities, their dispersion makes the issue of reaching them through branch banking problematic. However, there is an excellent opportunity to use the Internet for Islamic financial services.

Branding is important in engendering customer confidence and in building relationships with customers on the basis of an emotional connection. For example, when the United Bank of Kuwait was renamed the Islamic Investment Banking Unit in 1995, it introduced its own logo and brand image in order to stress its distinct Islamic identity (Wilson 1999). A bank's *sharīʿa* advisory board plays a role in this brand identity. The popular late Shaykh Al Sha'rawi appeared in advertisements for the Al Rayyan institution in Egypt (Galloux 1999). Wilson (1999) attributes part of the failure of the Al Madina Equity Fund in the UK to the fact that the *sharīʿa* committee was not well connected in the country. He argues that for the large global financial institutions there is a steep learning curve with respect to offering Islamic products because the technical understanding of Islamic finance is but one aspect; a real appreciation of diverse Muslim cultures and a respect for Islam are also essential. Thus, in terms of building brand credibility with Muslims, some Islamic institutions could have an advantage over the global conventional banks.

Alliances between Islamic banks and major Western financial institutions have become one way that Islamic banks can achieve the minimum size necessary for feasible operations (Kahf 1999). Wilson (1999) provides examples (Ibn Majeed Emerging Market Fund, *ßalāl* Mutual) where such efforts have included branding by the Islamic institutions rather than the Western partners. This provides credibility for the Islamic nature of the product offering.

Day and Wensley (1988) emphasize the importance of achieving a balance between the customer focus and the competitor focus. The objective is to gather intelligence on both customers and competitors and learn quickly how to do better than the competitors at serving the customers. In the banking industry, competitive advantages based on new products, new pricing strategies or automated technologies no longer hold, as these are so rapidly matched by competitors (Wilkinson and McCabe 1996, Tang and Zairi 1998). Benchmarking is a systematic way to identify "best practices" of competitors, and even organizations in other industries, with respect to products, services and processes that can be adapted and integrated into an institution's current operations (Bear and Brindley 1997, Capezio and Morehouse 1995). Benchmarking also provides an opportunity for an organization to audit its own standards and operations. It can then set attainable goals based on its knowledge of competitors.

As customers become more knowledgeable and demanding, the quality of service is often the differentiating factor between competing banks, Islamic or otherwise (Tang and Zairi 1998). Service quality improvements are often part of total quality management (TQM) initiatives (Mahmoud et. al. 1992). Quality management refers to a management process that is coordinated to ensure that the organization consistently meets and exceeds customer requirements. TQM engages all departments and levels of the organization to focus on systematic management of data in all processes in order to cut costs and pursue continuous improvement (Capezio and Morehouse 1995). High employee participation and empowerment are key features of TQM. Atif Abdulmalik, the chief executive of Bahrain's First Islamic Investment Bank, emphasizes the importance of such participatory management approaches in Islamic banks (New Horizon 2000). Indeed, this kind of interfunctional coordination is a key facet of implementing a marketing orientation. The capacity for successfully developing new products and processes in an organization is linked to interfunctional coordination. For example, in a meta-analysis of 782 studies, Damanpour (1991) found a positive association between internal communication (the extent of cross-functional communication and coordination) and organizational innovativeness. Although empowerment and participation by all is important in TQM, this should be balanced by leadership and example at the senior levels.

VII. RESULTS

The results of successfully implementing a marketing orientation and marketing leadership throughout an organization should result in competitive advantage based upon the development of new Islamic financial products and superior customer value. As performance improves, so should the ability to meet long-term goals for individual and societal enhancement.

VIII. CONCLUSION

An Islamic financial institution should build on its strengths and start from the premise of desiring to do better with respect to marketing. Every organizational environment is different and therefore a contingency approach is advised. A first step is to understand the organization's particular environment through employee interviews, focus group discussions, and observation. An evaluation of the external environment should also be conducted. This process will identify the most relevant opportunities and challenges for the institution. Top management must be committed to change and must lead though example. When the organization's mission is clarified, all organizational members can be empowered to gather and disseminate marketing intelligence and seek knowledge in all relevant areas, including Islamic principles. Cross-functional teams should work together to develop and improve processes and products, all the while keeping in mind customer needs, competitors' offerings, and the societal and economic development goals of the institution.

Where there are minimal differences between products across competitors in such a highly regulated industry, it is essential to provide customer value that is grounded in intangibles: service, staff attitude and knowledge, care and trust, brand image, and a positive contribution to society. The ability to provide such intangibles depends directly on the people assets in the organization and the stock of knowledge or intellectual capital therein.

Not all customers have the same requirements and provide the same returns to the organization. Therefore, different programs must be developed for various customer segments. The institution should seek to build its share of business with the best customers; that is, encourage the best customers to give it more of their business. Ultimately, the institution should not perceive its role as completing transactions with individual customers, but as nurturing partnerships with customers. Such a perspective is compatible with the societal marketing concept as well as with Islamic values of trust and brotherhood.

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Islamic Finance

A Quarter-Century Assessment

Ibrahim Warde*

ABSTRACT

The year 2000 marks the end of the first quarter century of modern Islamic finance. This paper analyzes the performance of Islamic financial institutions, revisits successes and disappointments, identifies current challenges, and maps the road ahead. Islamic finance is a success, no longer an uncertain experiment, but a reality, a large and rapidly growing industry. Nonetheless, Islamic finance has its shortcomings: it has not yet fulfilled its original intention of becoming an original and innovative system based on risk sharing and bringing social and economic benefits to the Islamic world. Widely accepted interest-free instruments have yet to be devised. Scandals and other problems have raised serious ethical and religious issues. This paper places these shortcomings in a broader perspective. Most problems of Islamic banks are unavoidable growing pains, and many venerable conventional banking institutions have not proven themselves always to be exemplars either of probity or of strategic acumen. From that standpoint, many of the disappointments of Islamic finance are part of an unavoidable trial-and-error process. Finally, this paper lists the challenges—religious, economic, regulatory, strategic, and political—faced by Islamic institutions and suggests new directions. New directions calling for research encompass areas—the moral economy of Islam, Islamic economic cultures, and the Islamic moral hazard—that many analysts, steeped in literal and legalistic interpretations, tend to shun.

I. INTRODUCTION

In 1975, the Islamic Development Bank became operational,[1] and the Dubai Islamic Bank, the first modern, non-governmental, Islamic bank, was created. The year 2000 thus marks the first quarter century of modern Islamic finance. This milestone calls for a comprehensive assessment of the experience. This paper will analyze the performance of Islamic financial institutions, revisit successes and disappointments, identify current challenges, and attempt to map the road ahead.

II. A BALANCE SHEET: SUCCESSES AND FAILURES

The most obvious thing is that Islamic finance has the merit of existing. Islamic finance is thus a success, considering that it is no longer an uncertain experiment, but a reality: it is now a $230 billion-plus industry.[2] It has grown at rates approaching 20% per annum in recent years and is likely to keep growing at a rapid clip. In many parts of the Islamic world, Islamic banks have been among the most dynamic elements of the banking sector.[3]

The two important questions however are the following: has the industry met its original objectives? Does it offer features that the conventional banking sector is not likely to provide?

To answer these questions, we need to look at four dimensions of Islamic finance:

1. product innovation;
2. economic benefits;
3. ethics; and
4. the elimination of interest.

A. Product Innovation

The rationale behind the creation of modern Islamic finance was to create an original and innovative system, based on risk sharing, that would bring social and economic benefits to the Islamic world.

This principle is at the core of Islamic banking's philosophy. The sharing of profit and loss is at once the most authentic form of Islamic finance, since it replicates the kind of transactions that were common in the early days of Islam.[4] It is the form most consistent with Islam's value system and moral economy. As it happens, it is

* Lecturer, University of California, Berkeley, Calif.

also the most modern. Indeed, venture capital and merchant banking—both among the fastest growing segments of contemporary finance—would be conventional-banking equivalents of profit-and-loss sharing arrangements.

One of the criticisms of collateral-based lending at a fixed, predetermined rate of interest is that it is inherently conservative. It favors the rich and those who are already in business, and is only indirectly concerned with the success of the ventures it finances. In contrast, under profit-and-loss sharing, Islamic institutions as well as their depositors link their own fate to the success of the projects they finance. The system allows a capital-poor but promising entrepreneur to obtain financing. The bank, being an investor as opposed to a lender, has a stake in the long-term success of the venture. The entrepreneur, rather than being concerned with debt servicing, can concentrate on a long-term endeavor that in turn will provide economic and social benefits to the community.

In the early years of Islamic banking, most institutions plunged with great enthusiasm (and virtually no experience) into partnership finance. The result was, to say the least, disappointing, and rather than learning from experience, most institutions have decided to steer clear from *mu∞āraba* and *mushāraka*.

The vast majority of Islamic operations are in the areas of trade finance, mark-up operations and leasing. Such modes of financing, while accepted by Islamic scholars—sometimes without great enthusiasm, because they do not bring significant social and economic benefits to the community, and tend to mirror conventional finance—were once perceived as stopgap operations allowing banks to generate income while building resources and partnership-finance experience.

Hence the great disappointment of Islamic finance: despite double-digit growth rates, the relative share of profit-and-loss sharing (PLS) operations such as *mu∞āraba* or *mushāraka* has been steadily dwindling. Initially the *raison d'être* of the industry, these forms of partnership finance now account for only about 5% of the operations of Islamic financial institutions.

B. Economic Benefits

Islamic finance was supposed to bring a wide range of economic benefits—mobilization of savings, productive investment, and, more generally, economic development.

In the process of transforming savings into investments, Islamic financial institutions are different from conventional lenders in that they must take social and developmental factors into account. In that respect, Islamic banks are expected to play the role once played by state banks and development agencies. These functions, as described by the Handbook of Islamic Banking, can be summarized as follows:[5]

- Broad social-economic benefits: investment policies must reflect the needs and the aspirations of the majority of the population, which must in turn be included in the development process. To help ensure adequate supply and affordability, banks must favor projects in the food, housing, and health services sectors.
- Job creation and focus on promising economic sectors: the emphasis should be on adding value as well as those sectors favored by national plans and objectives. Such sectors include agriculture, industry, and technology-intensive activities because of their potential for job creation, improvement of the balance of payments, and the promotion of technology and education.

There are as yet no comprehensive or comparative surveys of this subject, but anecdotal evidence as well as a number of case studies suggest that such ambitious economic promise does not materialize. Nor is there convincing evidence that Islamic institutions have drawn into the world of productive finance people who had shunned it for religious reasons. Elias Kazarian's study of Egyptian banks suggests that much of the increase in Islamic bank deposits occurred at the expense of conventional banks (and was driven by the increase in the remuneration of accounts), that most of the activities of Islamic banks have been in large cities as opposed to the countryside, where they most needed,[6] and that the main customers were likely to be the well-to-do, and not the poor or the lower middle class.[7]

Despite Islamic banks' obtaining support and special privileges (such as guarantees against nationalization, they have behaved like risk-averse agents. Their early goal of concentrating on profit-and-loss sharing was soon abandoned. The objective of penetrating to the hinterland and serving the rural areas was not met.

Most evidence highlights the tendency of Islamic banks to invest in short-term commercial transactions as opposed to industry or agriculture. In the Sudan, an agricultural country, only about 4% of the investments were allocated to agriculture while 90% went to import-export operations.[8] In Egypt, statistics compiled between 1979 and 1991 compared Islamic banks unfavorably with conventional banks on productive domestic investment. Not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it in foreign currency.[9]

Judging from the change (or lack thereof) in the level of economic development in those countries that have actively promoted Islamic finance (principally Pakistan, Iran, and the Sudan), it can safely be said that the promised economic benefits have largely failed to materialize.

C. Ethics

The other major dimension of Islamic finance relates to ethics. While ethics is at the center of Islamic finance, scandals and other problems have plagued a number of institutions, raising serious ethical and religious issues.[10]

Yet, paradoxically, the demand for Islamic products is primarily driven by ethical concerns. Indeed, the main impetus behind the current boom in Islamic finance lies in the very excesses of global finance.[11] Just as current business excesses have spawned a preoccupation with ethics, the amorality of contemporary finance has generated an interest in imposing morality on finance. And while Western or Judeo-Christian finance has become thoroughly secularized (the religious origin of many financial institutions has long receded from the public consciousness),[12] the idea of Islamic finance was bound, at a time of rising pietism,[13] to strike a chord. Insofar as Islam holds a positive view of economic activities while providing for a strict ethical framework, Islamic finance offers the potential for a fruitful compromise between finance and ethics.

D. The Elimination of Interest

Islamic financial institutions have not been able to devise a truly interest-free system. Yet paradoxically, it is a much less important issue today than it was 25 years ago. For one thing, the volume of interest-based transactions has lessened considerably. As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income.

In addition, many financial operations, such as the creation and sale of derivatives, do not directly involve interest. Many financial institutions now derive as much as half of their revenues from fees as opposed to interest.[14]

In addition, Islam's adaptive mechanisms (discussed in the third part) have been used to tolerate, in many instances, the use of fixed interest. So, although Islamic banks have not innovated much in the area of interest-free finance, they have not been overly stifled within an interest-based financial environment.

E. Conclusion

By not embarking on a path of true financial innovation and by not fulfilling their original promise from the standpoint of economics as well as ethics, Islamic institutions raise the inevitable question: Is Islamic finance necessary? Arguably it is, since it can still fulfill its original objectives. And at a time when Islamic countries are overhauling their regulatory systems and entering the global economy, it can provide a much-needed ethical framework as well as useful correctives to the excesses of contemporary financial practices.

The shortcomings of Islamic finance should also be placed in a broader perspective. For one thing, most of the problems encountered by Islamic banks can be looked upon as unavoidable growing pains. The gap between promise and performance can be attributed to the youth of the industry. It would thus be unfair to judge Islamic institutions too harshly, especially since many venerable conventional institutions have not proven, in recent years, to be exemplars either of probity or of strategic acumen. From that standpoint, many of the disappointments of Islamic finance are part of an unavoidable trial-and-error process.

The following pages single out some of the issues and challenges that Islamic financial institutions should address.

III. Issues and Challenges

The main issues still to be addressed and the challenges to be met can be grouped into five categories: religion, strategy, economics, regulation, and politics.

A. Religion

Two contradictory sets of issues must be addressed. First is the issue of diversity. Any religion that has survived for 14 centuries and has some 1.2 billion followers throughout the world must have some measure of flexibility and diversity. Common perceptions to the contrary, Islam is anything but monolithic. Muslims constitute the majority in some 50 countries in Africa, the Middle East, and Central, South, and Southeast Asia. They are a minority, often a fast-growing one, in most parts of the world, including Western and Eastern Europe, Russia, the Americas and Australia. Their diversity is religious, racial, ethnic, political, social, economic, and cultural. Despite the unifying language of the *umma*, Islam is fragmented and decentralized, with no standard, official clergy and no

Vatican. Only a few countries—most notably Iran—have a tradition of an autonomous hierarchically structured clergy. Most people are familiar with the Sunni-Shīᶜa divide. But there is a far greater diversity of religious groups, beliefs, and practices than that. These differences can be attributed to religious schisms, but more commonly they are due to differences in historical paths as well as exposure to outside influences.

Islamic finance reflects that diversity. Financial experiments have taken place wherever Islamic communities exist. They are usually driven not, as often thought, by political Islam, but rather by the rise in pietism that has been occurring throughout the Islamic world.[15]

Diversity is a double-edged sword. While it leads to varied experimentation, it tends to foster mutual recrimination, if not accusations of heresy. Indeed, doctrinal consensus has proven elusive. Coordination and homogenization are complicated by disagreements among *sharīᶜa* boards as to what activities are permissible, as well as rivalries between countries and financial institutions. Yet there is a need for coherence, if not uniformity, and to avoid an anything-goes attitude. There is also a need to create a secondary Islamic market.

B. Strategic and Competitive Issues

The Islamic financial market is increasingly competitive, and growing pains have accompanied rapid growth. There are indeed considerable strategic, managerial and cultural challenges facing Islamic banks.

1. Competition from Conventional Institutions

Where once Islamic institutions had the Islamic market to themselves, they now face, on their own turf, competition from conventional institutions. Today there is hardly a major international financial institution that does not have, if not an Islamic subsidiary, at least Islamic "windows" or a range of Islamic products. Since such institutions usually enjoy superior expertise and technology, they have distinct competitive advantages over Islamic institutions.

2. Fragmentation

In addition, the Islamic financial community is highly fragmented; it lacks industry-wide norms and a true secondary market. The managerial task is not eased by the imposition of complex secular and religious norms of national and transnational scope.

3. Liquidity

At the time of the 1991 Gulf War, Islamic banks in the Gulf lost 40% of their deposits. This highlights one of the weaknesses of Islamic finance. Lacking a deposit insurance program that can reassure depositors and prevent massive withdrawals, Islamic institutions cannot depend on the flexibility afforded either by a secondary market, or by a ready discount window. Opportunities for securitization are limited, and there is no true Islamic interbank market to help fund daily liquidity. In contrast, conventional banks can reassure their depositors by providing deposit insurance, and they have the flexibility to manage assets and liabilities by reselling loans to other financial institutions, by transforming such loans into tradable securities using the discount facilities of their central bank, or by borrowing at interest.

4. Staffing

One of the most vexing managerial issues is the lack of qualified personnel. Bank officers must possess not only the management skills appropriate to a conventional institution but also considerable religious training. The need (admittedly mostly theoretical) for expertise in profit-and-loss sharing also requires that the Islamic banker combine the skills of the commercial banker with those of the venture capitalist—which further reduces the pool of available talent.[16]

5. Marketing

To attract and retain customers, Islamic institutions need to sharpen their marketing skills.[17] At the heart of the marketing effort lie a few basic questions: Who are the actual and potential customers of Islamic financial institutions? What are their motivations and behavioral characteristics? What should banks do to reach them? Should the institution compete primarily on the basis of religious credentials or products and service?

C. Economics

Promoters of Islamic finance have argued that Islamic finance is not only consistent with capitalism (i.e., with a market-driven allocation of resources), but that it is in many ways better suited to a dynamic economy. More specifically, Islamic finance could bring about more efficient mobilization of savings, a more equitable and just

distribution of resources, more responsible and profitable lending, as well as less volatile business cycles and more stable banking systems.

This of course is the theory. The difficult part has been to translate the broad principles of Islamic finance into concrete reality. More specifically, in order to contribute to the process of economic growth and development, banks must learn how to transform savings into real investments, and how to do it efficiently—transforming small deposits into larger loans, acting as risk arbitrageurs among investments with different rates of return and risk levels, devising an attractive mix of financial instruments, etc. Overall, there are four sets of economic issues and challenges they must meet: the mobilization of savings, economic development and fund allocation, Islamic capital markets, and using Islamic tools to shape macroeconomic policies.

As far as the first two are concerned, as we saw earlier, the available evidence, though scant, suggests that Islamic institutions still have a long way to go. As for creating and nurturing Islamic capital markets, countries such as Malaysia and Bahrain have made significant strides. The use of Islamic tools to shape macroeconomic policies has barely started, as Islamic institutions and governments are hampered by their misgivings about fixed interest rates.

Advocates of Islamic banking argue that tools that do not rely on interest rates can be just as effective as those that do. Among such tools are the modification of reserve requirements for banks, the manipulating of budget surpluses or deficits, the imposition of new lending ratios (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or refinance ratios (which refer to the central bank's refinancing of a portion of the interest-free loans made by commercial banks).[18]

Similarly, in connection with public borrowing, a number of concepts have been devised, among them issuing bonds based on the *mu∞āraba* principle: fixed interest would be replaced by a rate that would vary according to the economy's growth and inflation rate. One complication is that governments do not have the same criteria of profitability as the private sector, and social rates of return have yet to be made operational in a way that can satisfy investors.

D. Regulation

Of special importance are the regulatory regime to which Islamic institutions are to be subjected—how they are to be regulated and whether they are to be given special status—and the compatibility of Islamic norms with emerging global norms.

As for the first issue, the question is whether Islamic institutions should be regulated in the same way as conventional institutions. On the one hand, the one-size-fits-all approach helps achieve macroeconomic and regulatory coherence, but it does not recognize the specific features of Islamic finance. On the other hand, the special treatment given to Islamic institutions raises the issue of fairness and equity, since it can amount to special privilege or, conversely, discrimination.

Another complication arose well after the creation of the first modern Islamic institutions. In the 1970s, regulators, outside of the political limelight, still performed tasks mostly of a technical nature. National regulators also enjoyed wide autonomy. This is why, in the early years of modern Islamic banking, ambitious Islamic regulatory schemes were devised. There was talk of an Islamic Central Bank, of a global *zakāt* fund, and of other collaborative schemes.[19] Scholars then believed in the possibility of achieving a unique Islamic approach to bank regulation.[20] Most of these ideas were never put into practice: they were simply overtaken by events. Today, regulators have lost the margin they once enjoyed for maneuvering. Most of the norms and practices of financial regulation have been established internationally, with little input from regulators outside the industrial world.

Once confined to developed countries, the new rules of global finance are now extending to the rest of the world. By October 1998, regulators worldwide were committed to implementing the "Core Principles of Banking Supervision" issued in 1997 by the Basle Committee on Banking Supervision. Similarly, since March 1999, the 102 signatories of the December 1997 Free Trade in Financial Services Agreement (under the aegis of the World Trade Organization) have been expected to liberalize their financial markets.

Today, all countries are urged to comply with new international rules, as well as liberalize their markets and open their financial sector to foreign competition. Islamic regulators thus face a daunting task for which they are singularly ill prepared: they must engage in consolidation and reform in the face of considerable obstacles before domestic banks confront the onslaught of foreign competition.

E. Politics

Both at the national and at the international level, Islamic institutions have been caught in a political crossfire. In recent years, Islamic financial institutions have on occasion been suspected of having a political agenda, domestically working to establish a fundamentalist Islamic regime, or internationally financing or serving as

a conduit for international Islamic terrorism, or even for the development of an "Islamic bomb." Indeed, and against much of the available evidence, Islamic finance is usually associated with the radical brand of political Islam.[21] Every book on Islam has a page or paragraph or two devoted to Islamic finance, often with no distinction made between Islamic politics and finance. A recent French book entitled *The* Fatwā *against the West* implies, for example, that the main, if not the sole, purpose of Islamic financial institutions is to finance terrorism.[22]

Do Islamic banks really have a domestic or international political agenda? Do they play a role in promoting radical Islam and international terrorism? The short answer is that they usually do not, but their opponents point to their resources to show that they have the potential to create mischief. The suspicions surrounding Islamic banks are implicitly justified by a flawed syllogism: political Islam at the domestic and international level requires financial resources, Islamic banks are committed to Islam and have vast financial resources; therefore Islamic banks are likely to advance the political goals of potentially subversive Islamic groups.

At the international level, Islamic financial institutions are all the more likely to be scrutinized, since the "war on terrorism," just like the "war on drugs," is now being fought in large part on the financial terrain-figuring out the financial flows involved and tracking them nationally and internationally.[23]

The rationale for the financial focus of most recent anti-terrorist legislation is twofold. First, tracing financial flows can untangle money puzzles and yield a great deal of information about subversive and otherwise shadowy groups. Second, the use of economic and financial tools—embargoes, asset seizure, and the like—can starve terrorism. Although there is not much evidence that Islamic banks harbor more terrorism-related funds than conventional ones, suspicions can hamper their operations and growth.

IV. The Road Ahead

In Islamic finance there is a vast gap between theory and practice, while research still offers Islamic bankers relatively little guidance. This section offers tools to help narrow the gap. It places Islamic finance in its real-world context, focusing on Islam's adaptive mechanisms and suggesting areas for future research and inquiry.

A. Contextualizing Islamic Finance

The majority of the writings on Islamic finance fall in one of two categories: they are ahistorical, discussing Islamic finance as if there were no outside constraints; or they are somewhat frozen in time, looking at the world as it was in the early years of modern Islamic finance, that of the 1970s, when Islamic finance was first updated. In order to understand why Islamic finance came into being and how it has evolved, we need to focus on political, economic, and ideological context.

A fruitful approach would consider modern Islamic finance from the standpoint of two movements toward aggiornamento.[24] The first occurred in the early 1970s, at the intersection of two important developments in the Islamic world: the rise of pan-Islamism and the oil boom. The 1967 Six-Day War marked the end of the secular, pan-Arab Nasserite movement and the start of the regional dominance of Saudi Arabia, under the banner of pan-Islamism.[25] With the creation in 1970 of the Organization of the Islamic Conference (OIC), the idea of updating traditional Islamic banking principles—an endeavor that had preoccupied a few Islamic scholars, particularly in Pakistan, for a number of years—was soon on the agenda. And in the wake of the quadrupling of the oil price, the 1974 OIC summit in Lahore voted to create the inter-governmental Islamic Development Bank (IDB), which was to become the cornerstone of a new banking system inspired by religious principles. In 1975, the Dubai Islamic Bank, the first modern, non-governmental Islamic bank, came into existence. Soon afterwards, similar institutions started proliferating, as did research institutes focusing on Islamic economics and finance.[26] The International Association of Islamic Banks (IAIB) was created to establish common norms and standards. In 1979, Pakistan became the first country to embark on a full Islamization of its banking sector, followed by in 1982 Sudan and in 1983 by Iran.

The first paradigm of modern Islamic banking was established in those years. Islamic jurists reinterpreted a rich pre-capitalist legal tradition to suit the requirements of the modern era. The main difficulty was that, though commerce had always been central to the Islamic tradition (the Prophet Muhammad was himself a merchant), profits from purely financial transactions were viewed with suspicion. The Qur'an states, for example, that despite their superficial resemblance, profits from commerce are fundamentally different from those generated by money lending (2:275). More specifically, Islam prohibits *ribā*. Literally meaning "increase," the term has been variously interpreted—sometimes as usury (or excessive interest), more often as any kind of interest. Though major scholars—including the current head of Egypt's Al-Azhar, one of Islam's oldest and most prestigious centers of learning—have condoned the use of certain forms of interest, the majority of Islamic scholars still equate *ribā* with interest of any kind.[27]

While accepting the notion that time has to be calculated into prices, Islamic scholars objected to any risk of the lender's exploiting the borrower by exacting a fixed, pre-determined rate of interest-based, a prohibition, incidentally, which Islam shares with other religious traditions.[28] In the early days of Islam, the dominant form of finance consisted in a partnership between lender and borrower, based on the fair sharing of both profits and losses—a logic similar to today's venture capital, where financiers link their fate to that of firms in which they invest. For instance, in medieval Arabia, wealthy merchants financing the caravan trade would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was stolen, lost, or sold for less than cost.[29]

But just as new standard practices were finally established, the first movement toward aggiornamento in Islamic finance was becoming obsolete. Forays into profit-and-loss sharing were disappointing, and Islamic finance began to be seen as an exercise in semantics: Islamic banks were no different from conventional banks, except in their use of euphemisms to disguise interest.[30] The image of Islamic banks was also tainted by the failure of Islamic money management companies (IMMCs) in Egypt in 1988 and by the collapse of the Bank of Credit and Commerce International (BCCI) in 1991.[31] It became the fashion to dismiss Islamic banking as a passing fad, one associated with the oil boom and the fleeting belief in a New International Economic Order (NIEO).

In reality, Islamic finance was on the verge of a major boom, albeit after major changes. Indeed, the world of international finance was being turned on its head as a result of deregulation and technological change. At the same time, political, economic, and demographic forces were transforming the Islamic world.

Whereas the traditional world of finance, dominated by commercial, interest-based banking could raise potentially troublesome theological issues, the new world of finance, characterized by the blurring of distinctions between commercial banking and other areas of finance, the diminishing importance of interest income, and financial innovation, formed the basis of a new aggiornamento that was barely noticed in the literature.

Neo-liberalism and an emerging Islamic ideology were converging. Two areas where the Islamist critique of statism and the "Washington consensus"[32] converged are most significant. First is the Islamic commitment to private property, free enterprise, and the sanctity of contracts. In many countries, Islam became the tool of entrepreneurs seeking to get around restrictive regulation and an instrumental factor in privatization and deregulation—and the best excuse for disengaging the state from the economy. In their efforts to downsize in line with the dictates of neo-liberalism, governments also relied on the "privatization of welfare" (through reliance on *zakāt* and other religiously-based redistribution schemes) advocated by Islamists.

There was a similar convergence in the area of finance. Indeed, among the characteristics of the global financial system that has emerged since the 1980s are the downgrading of interest (and the concomitant rise of fees as a major source of revenue for financial institutions), the creation of new financial products, and the blurring of the lines between finance and other business endeavors.[33] The lesser importance of interest, once the cornerstone of financial revenues, allowed Islamic bankers to sidestep the controversial *ribā* issue. As for the financial innovation made possible by deregulation, it fostered the creation of tailor-made Islamic products. Until the 1970s, financial institutions could sell only a narrow range of financial products. With the lifting of constraints on the products that financial engineers could devise to suit every need—religious or otherwise—Islamic products could be created. The process of slicing and splicing allows, for example, the principal components of a bond to be split and sold separately. In sum, the world has reverted to a system of bankers without banks, often based on the principles of partnership finance, where the financier is no longer a lender but a partner.[34]

Today the fastest growing segments of the industry are outside the range of traditional banking products and in areas of finance that were either initially dismissed as Islamically unacceptable—such as insurance or *takāful*—or that barely existed at the time of the first aggiornamento—micro-lending and Islamic mutual funds. Indeed, investing in Islamically acceptable stocks (those shunning unethical or highly indebted firms, or associated with gambling, the sale of alcohol, and other prohibited activities) are becoming increasingly popular, just like their secular counterparts, socially responsible investments.[35]

These two stages of aggiornamento have resulted in sharply differing perspectives. While the early years of Islamic finance were dominated by oil producing Arab states (primarily Saudi Arabia[36] and to a lesser extent Egypt and Pakistan), the second aggiornamento reflects the diversity of the Islamic world. A wide range of Islamic products is now available in at least 75 countries. Even countries that have Islamicized their entire financial systems have done so under entirely different circumstances and in vastly different ways.[37] A majority of the financial institutions do not even belong to the International Association of Islamic Banks (IAIB). And much innovation and scholarship now originates within Muslim minorities outside the Islamic world.[38]

B. The Question of Religious Interpretation

Many scholars at the time of the first aggiornamento, steeped in literal and legalistic interpretations, engaged in unduly narrow interpretations. With the new aggiornamento, the focus has somehow shifted, from literalism to a search for the spirit, or moral economy, of Islam. This section focuses on the adaptive mechanisms that can allow Islamic finance to thrive in the global economy.

In contrast to the first aggiornamento, which had been dominated by literal, legalistic and scholastic interpretations, the *ijti®ād* now underway focuses on the compatibility of modern financial instruments with Islamic principles. Rather than focusing exclusively on *usūl al-fiqh* (the principles of Islamic jurisprudence) and parsing medieval contracts, there is a new emphasis on the spirit of the law, or its moral economy. This modernist slant disavows the view that whatever did not exist in the early days of Islam is necessarily un-Islamic.[39] Challenging common perceptions that Islam is rigid and fossilized, this section discusses the adaptive mechanisms that have allowed Islam to survive over the centuries in a variety of social settings.

It should be noted first that Islamic commandments are not as unbending as would superficially appear. Traditional Islamic injunctions are not framed as simple dichotomies, but along a continuum, thus allowing a certain degree of flexibility. In the early Islamic community, actions (either for the community as a whole, or for every single member of it) could be regarded as obligatory (*wājib*), meritorious (*musta®abb*), morally neutral (*mubā®*), reprehensible (*makrūh*), or forbidden (*®arām*).

Most injunctions also contain dispensations and exceptions, thus showing considerable pragmatism. Travelers and ill persons could postpone their fasting during the fasting month, Ramadan, and those for whom fasting would be an unbearable hardship could dispense it, compensating instead with good deeds such as feeding a poor person (2:184-185).[40]

As Islam expanded, it came into contact with many different cultures, and this made it necessary for Islamic jurisprudence to produce legislation on problems for which there were no clear legal precedents. The principles of Islamic jurisprudence (*usūl al-fiqh*) provide for a set of elaborate rules for interpreting the *sharī^ca*. But the existence of such complex rules did not preclude adaptive mechanisms.

The principle of *talfīq* (patching) would for example authorize judges to choose an interpretation from schools of jurisprudence other than their own if it seemed to fit the particular circumstances of the case. More generally, three principles allow for departures from existing norms: local custom (*^curf*), the public interest (*maÆla®a*), and necessity (*∞arūra*). The *sharī^ca* can thus be made to reach an accommodation with societal changes, thus allowing for innovation, exceptions, and loopholes—provided they are properly justified.

In administering justice during the Umayyad era, governors took into account the customs and laws of newly conquered territories; likewise, the cosmopolitanism of the Abbasid era resulted in considerable diversity. With the weakening of Arab influences in later centuries, syncretism was unavoidable. To put it differently, the farther removed in time and space from early Islam and its birthplace, the stronger the influence of indigenous customs is likely to be.

And as Islam encountered new challenges, especially following its 19th-century encounters with capitalism and the West, the concept of *maÆla®a*, translated as the general good, or public interest, began frequently to be invoked. On the basis of that classic principle, a jurist confronted with rival interpretations of a passage from the Qur'an or the *®adīth* can choose the one he deems most conducive to human welfare. Islamic modernists such as Mohammed Abduh and Rashid Rida have made *maÆla®a* the key principle for deciding the law where Qur'an and *®adīth* give no clear guidance. The principle of *talfīq*, combined with independent *ijti®ād*, has been extended to allow a systematic comparison of all classic schools of law for reaching a synthesis combining the best features of each. Some *fuqahā'* have even argued that the general interest may override a revealed text.[41] So Muslim thinkers theoretically have had wide latitude to reason independently from first principles, and a modern Muslim nation could thus enact "a system of just laws appropriate to the situation in which its past history has placed it."[42]

A related concept is that of *∞arūra*, or overriding necessity. Otherwise questionable innovations may be justified by the notion, tacitly accepted by all *fiqh* schools, that "necessity permits the forbidden" (*al-∞arūra tubih al-mahzurat*). In its dietary injunctions for example, the Qur'an specifically authorizes transgressions caused by necessity (2:173).[43] On various occasions, the Qur'an has disavowed any divine intent to cause hardship (2:286).[44] For example, a person who would otherwise starve would be allowed to eat pork. One version of the doctrine holds that a mere "need" (*hāja*) may, if it affects many, be treated as what would be a dire necessity if it affected only one.[45] In Iran, the scope of *∞arūra* was considerably expanded. It has been invoked to waive the primary rulings of Islam if the very existence of the state was threatened, or, in the words of the Ayatollah Khomeini, in instances where inaction would lead to "wickedness and corruption."[46]

This has happened frequently in Iran since the Islamic revolution. Most economic policies, including in areas of bank reform, private property, and foreign trade, have been characterized by frequent departures from traditional doctrine justified on the grounds of *zarura* (the Persian transliteration of ∞*arūra*).[47]

In the global economy, the overriding necessity of market can prevail in the same way. *Øarūra* has been invoked to justify interest on loans on the grounds that Muslims had to be able to compete with other peoples not subject to the same strictures.[48] Keeping interest-bearing balances in foreign banks could also be justified as consistent with the norms of the international economy. Similarly the necessity of economic development has been invoked in Egyptian *fatwā*s authorizing interest.[49] Typically however, *fatwā*s invoking ∞*arūra* add that certain types of unlawful profit should be purified, that is, used for religiously meritorious purposes, that Muslims should work toward finding an Islamically-acceptable alternative, and that when this is accomplished, the *raison d'être* for the dispensation will be extinguished.

All this explains why, contrary to the assumptions of the first aggiornamento, Islamic finance is such a diverse phenomenon.[50] A better understanding of the adaptive mechanisms can give decision-makers more flexibility while ensuring adherence to the moral economy of Islam.

V. CONCLUSION

In conclusion, I would like to single out three research areas that students of Islamic finance steeped in literal and legalistic interpretations tend to shun. The first deals with innovation in global finance: it is essential that new instruments developed by conventional financiers be analyzed for compatibility with the spirit, not the letter, of Islamic law.

The second area is culture. Cultural issues are made even more complicated by the diversity of the Islamic world, yet understanding them is crucial to developing original instruments as well as successfully creating adequate mechanisms for sharing profit and loss.

The third area is the Islamic moral hazard. The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behavior.[51] By the same token, one could identify an Islamic moral hazard in that the very introduction of religion to finance can foster unscrupulous behavior. As we saw earlier, scandals and ethical lapses have plagued many Islamic banks. Yet, in the early years, there was an assumption of virtuous behavior on the part of Islamic banks, their employees, and their customers. In the words of Hamid Algabid, "At the beginning, confidence was the rule. The good faith of the participants could not be questioned, since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith."[52] In reality, religion can be a double-edged sword, since it often attracts the wrong element while lowering the guard of the bankers and regulators. This is an unsettling issue, but one that needs to be addressed if Islamic finance is to fulfill its potential.

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[1] The Organization of Islamic Conference (OIC) summit voted in 1974 in Lahore to create the inter-governmental Islamic Development Bank (IDB), which was to channel aid from rich Islamic countries to poor ones, and become the cornerstone of a new banking system inspired by religious principles.

[2] http://www.islamicbanking-finance.com.

[3] Khalaf, Roula. "Dynamism Is Held Back by State Control: As Family Dynasties Stifle Creativity in Most of the Industry, the Islamic Sector Is Showing Signs of the Greatest Vibrancy." Financial Times. April 11, 2000.

[4] Udovitch, Abraham L. Partnership and Profit in Medieval Islam. Princeton: Princeton University Press, 1970. p. 170-248.

[5] Based on *Al Mausua al Ilmiya wa al Amaliya lil Bunuk al Islamiya* (Handbook of Islamic Banking) 6. Cairo: International Association of Islamic Banks, 1982.

[6] Sadowski, Yahya M. Political Vegetables? Businessman and Bureaucrat in the Development of Egyptian Agriculture. Washington: The Brookings Institution, 1991. p. 201.

[7] Kazarian, Elias. Islamic Versus Traditional Banking: Financial Innovation in Egypt. Boulder: Westview Press, 1993.

[8] Medani, Khalid. "Funding Fundamentalism: The Political Economy of an Islamist State" in Beinin, Joel and Joe Stork (eds.). Political Islam: Essays from Middle East Report. Berkeley: University of California Press, 1997. p. 169.

[9] Kazarian, *supra*. p. 217-226.

[10] Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 2000. Chapter 8.

[11] Warde, Ibrahim. "La Derive des Nouveaux Produits Financiers." Le Monde Diplomatique. June 1994.

[12] A couple of relatively recent examples illustrate the point. In late-19th-century Germany, Frederic Raiffesen, a Protestant, and in early-20th-century Canada, Alphonse Desjardins, a Catholic, created mutual savings societies out of a

moral/religious impulse (neither of them was a banker) to save poor farmers from the clutches of moneylenders. See Taillefer Bernard. Guide de la Banque pour Tous: Innovations Africaines. Paris: Karthala, 1996. p. 19.

[13] Sadowski, Yahya M. " 'Just' a Religion: For the Tablighi Jama'at, Islam Is Not Totalitarian." The Brookings Review 14(3) (Summer 1996). pp. 34-35.

[14] Warde, Ibrahim. Foreign Banking in the U.S. San Francisco: IBPC, 1999. p. 32.

[15] Warde, Ibrahim. "The Paradoxes of Islamic Finance." Le Monde Diplomatique. October 2000.

[16] Galloux, Michel. Finance Islamique et Pouvoir Politique: Le Cas de l'Egypte Moderne. Paris: Presses Universitaires de France, 1997. p. 65.

[17] Warde, Ibrahim. Comparing the Profitability of Islamic and Conventional Banks. San Francisco: IBPC Working Papers, 1997.

[18] See Ariff, Mohammed (ed.). Monetary and Fiscal Economics of Islam. Jeddah: International Center for Research in Islamic Economics, 1982; particularly Ariff, Mohammed. "Monetary Policy in an Interest-Free Islamic Economy: Nature and Scope."; Uzair, Mohammed. "Central Banking Operations in an Interest-Free Banking System."; and Siddiqi, Mohammed. "Islamic Approaches to Money, Banking, and Monetary Policy: A Review."

[19] Najjar, Ahmad Muhammad Abd al-Aziz. One Hundred Questions and One Hundred Answers Concerning Islamic Banks. Cairo: International Association of Islamic Banks, 1980. p. 8.

[20] Ariff (ed.), *supra*.

[21] Miller, Judith. God Has Ninety-Nine Names: A Reporter's Journey Through a Militant Middle East. New York: Simon and Schuster, 1996. p. 151.

[22] Jacquard, Roland. *Fatwā* contre l'Occident. Paris: Albin Michel, 1998. pp. 157-168.

[23] Filipovic, Miroslava. Governments, Banks and Global Capital: Securities Markets in Global Politics. Aldershot, England: Ashgate, 1997. p. 213.

[24] Warde, Islamic Finance, *supra*. p. 73-89.

[25] Mortimer, Edward. Faith and Power: The Politics of Islam. New York: Random House, 1982. p. 177-220.

[26] Numani, Farhad and Ali Rahnema. Islamic Economic Systems. London: Zed Books, 1994.

[27] See Mallat, Chibli. "The Debate on *Ribā* and Interest in Twentieth-Century Egypt" in Mallat, Chibli (ed.). Islamic Law and Finance. London: Graham & Trotman, 1988. p. 69-88; and Mallat, Chibli. "Tantawi on Banking" in Khalid Masud, Muhammad, Brinkley Messick, and David S. Powers (eds.). Islamic Legal Interpretation: Muftis and their *Fatwā*s. Cambridge: Harvard University Press, 1996. pp. 286-296.

[28] In Christianity, it was only in 1515 that the Church, at the Lateran Council, legitimated interest on secured loans. See Warde, Islamic Finance, *supra*. "*Ribā*, *Gharār*, and the Moral Economy of Islam in Historical and Comparative Perspective." See also Wilson, Rodney. Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought. New York: New York University Press, 1997.

[29] This formula served as a basis for the "commandite" system, which became one of the principal financing mechanisms in French law.

[30] Warde, Ibrahim. "The Revitalization of Islamic Profit-and-Loss Sharing: Lessons from Western Venture Capital" in Proceedings of the Third Harvard University Forum on Islamic Finance. Cambridge: Center for Middle Eastern Studies, Harvard University, 2000.

[31] Though not itself an Islamic bank, BCCI had in 1984 set up an Islamic Banking Unit in London, which at its peak had $1.4 billion in deposits, and had generally made heavy use of Islamic rhetoric and symbolism. More importantly, however, the collapse of the bank brought Islamic institutions into the international limelight and raised questions about the management and regulation of transnational banks. Of BCCI's $589 million in "unrecorded deposits" (which allowed the bank to manipulate its accounts), the major part—$245 million—belonged to the Faisal Islamic Bank of Egypt (FIBE). This amount was supposed to be used for commodity investments, though there was no evidence that such investments were ever made.

[32] Naim, Moses. "Avatars du 'Consensus de Washington.' " Le Monde Diplomatique. March 2000.

[33] As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income. In addition, many financial operations—such as the creation and sale of derivatives and other new products—do not directly involve interest. Some financial institutions now derive as much as half of their revenues from fee, as opposed to interest, income. See Warde, Foreign Banking, *supra*. p. 32.

[34] Udovitch, Abraham L. "Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages" in The Dawn of Modern Banking. New Haven: Yale University Press, 1979. p. 257.

[35] See http://www.islamicbanking-finance.com/funds.

[36] Another paradox worth noting is that although Saudi Arabia was instrumental in creating the modern Islamic banking system, it is one of the least hospitable countries to Islamic banks. The country has only one Islamic commercial bank, the Al Rajhi group. Dar al-Maal al-Islami (DMI), the largest Islamic group, founded by Prince Mohamed, a son of King Faisal, is based in Geneva and operates worldwide (through, among others, its "Faisal Banks" subsidiaries), yet has no commercial operations in Saudi Arabia. To complicate things further, the DMI group has nonetheless been a significant conduit of Saudi money and

influence throughout the Islamic world. One possible explanation for the Saudi ambivalence is the fact that the issue could be politically as well as religiously explosive. Indeed, Saudi Arabia does not officially recognize the notion of interest, yet relies very heavily on interest income from its vast holdings. Recognizing certain banks as Islamic would also make all the other banks "un-Islamic." Saudi banks avoid the use of the word interest, and describe their revenues as "commissions," "service charges," or "bookkeeping fees." See Wilson, Peter W. A Question of Interest: The Paralysis of Saudi Banking. Boulder: Westview Press, 1991.

[37] See Warde, Islamic Finance, *supra*. pp. 112-131.

[38] The best known among these centers is the Harvard Islamic Finance Information Program (HIFIP). See http://www.hifip.harvard.edu.

[39] Vogel, Frank E. and Samuel L. Hayes III. Islamic Law and Finance: Religion, Risk, and Return. The Hague: Kluwer Law International, 1998.

[40] Qur'an 2:184: "But whoever among you is sick or on a journey, (he shall fast) a like number of other days. And those who find it extremely hard may effect redemption by feeding a poor man. So whoever volunteers to do good, it is better for him; and that you fast is better for you, if only you knew."

2:185: "The month of Ramadan is that in which the Qur'an was revealed, a guidance to men and clear proofs of the guidance and the Criterion. So whoever of you is present in the month, he shall fast therein, and whoever is sick or on a journey, (he shall fast) a (like) number of other days. Allah desires ease for you, and He desires not hardship for you, and (He desires) that you should complete the number and that you should exalt the greatness of Allah for having guided you and that you may give thanks."

[41] Carré, Olivier. L'Islam Laïque, ou, Le Retour à la Grande Tradition. Paris: Armand Colin, 1993. p. 15.

[42] Mortimer, *supra*. p. 244.

[43] Qur'an 2:173: "Allah has forbidden you only what dies of itself, and blood, and the flesh of swine, and that over which any other name than that of Allah has been invoked. Then whoever is driven by necessity, not desiring, nor exceeding the limit, no sin is upon him. Surely Allah is forgiving, merciful."

[44] Qur'an 2:286: "Allah imposes not on any soul a duty beyond its scope. For it is that which it earns (of good) and against it that which it works (of evil). Our Lord, punish us not if we forget or make a mistake. Our Lord, do not lay on us a burden as Thou didst lay on those before us. Our Lord, impose not on us afflictions which we have not the strength to bear. And pardon us! And grant us protection! And have mercy on us! Thou art our Patron, so grant us victory over the disbelieving people."

[45] Vogel and Hayes, *supra*. p. 38.

[46] Bakhash, Shaul. "The Politics of Land, Law, and Social Justice in Iran." Middle East Journal 43(2) (Spring 1989). p. 196.

[47] Ibid.

[48] Mortimer, *supra*. p. 245.

[49] Galloux, *supra*. p. 43.

[50] See Warde, Islamic Finance, *supra*. Chapter 6.

[51] See Warde, Islamic Finance, *supra*. Chapter 10.

[52] Algabid, Hamid. Les Banques Islamiques. Paris: Economica, 1990. p. 182.

PART IV

COMMERCIAL PRODUCTS, BUSINESS MODELS, AND OTHER

Introduction

Muhammed-Shahid Ebrahim*

The papers contained in this section provide an opportunity for readers to understand the current state of affairs in the marketplace and serve as a strategic roadmap for the future. The eight articles that follow address a number of diverse topics: equity funds; funding the growth of Islamic financial institutions (IFIs); Islamic financial product development; venture capital financing vehicles; and adapting to the regulatory environment. All these areas are vital for the economic development of the Muslim *umma*.

I. COMMERCIAL PRODUCTS: EQUITY FUNDS

John Bauer, Richard P. Keigher, and Kelley Hicks discuss the strategic choices facing sponsors of Islamic equity funds. These include management of funds (using in-house vs. external resources/outsourcing); design of mutual funds using the various Islamic financial instruments (*istisnā'*, *murāba®a*, *mu∞āraba*, and *ijāra*), active vs. passive (indexation) investing strategies; and *sharī¢a* compliance, which limits investment to companies that operate consistent with Islamic principles and includes designing screens to limit percentages of debt, interest income, and accounts receivable of the invested companies. Despite all efforts at compliance, income from non-®*alāl* sources may remain and will need to be purified. The second issue, the design of funds, is not as crucial as the others, as most Islamic equity funds invest in common stocks, which are similar to what is construed as *mushāraka* because it entails "control rights" (as opposed to *mu∞āraba*, which is devoid of these "control" privileges).

F. Scott Valpey focuses on how his firm (Azzad Asset Management) has structured its two mutual funds in response to demand from American Muslim investors. These funds are a small/mid-cap actively managed fund (Azzad Growth LP), and a blue-chip index fund (Azzad/Dow Jones Islamic Index Fund). The title of the first fund is not entirely accurate, as it is not necessarily a "growth" fund but invests both in "growth" as well as "value" stocks. Furthermore, it does not make sense to pay management fees for the two actively managed portfolios when one can do the same with an index fund of small/mid-cap stocks. The author describes how an Islamically approved portfolio is construed using the "seven pillars of *sharī¢a*-based investing" in a way similar to that of Bauer et. al. Finally, the performance of the actively managed fund from early 1998 to mid-2000 is contrasted with the S&P 500 and the Russell 2000 indexes to demonstrate that "investors do not sacrifice performance when investing according to their religious principles and beliefs." The analysis contains a number of problems, however. The S&P 500, which is composed of large corporations, is not an appropriate benchmark when one is investigating the relative performance of small/mid-cap stocks. Second, some statistical analysis should have been done to demonstrate the above result, rather than providing merely bare numbers. Finally, the author does not indicate the transaction costs of investing in the funds managed by his firm, in terms of sales load, annual management fees, Section 12(b) fees, etc.

Naseeruddin Khan discusses the same issues as Valpey but with an eye toward Middle Eastern investors. The bulk of equity funds in that region are marketed by Middle Eastern banks and managed externally by fund managers in the United States, Western Europe, or Japan. The author discusses the various mutual funds marketed by his employer (AlBaraka), under the umbrella of Al-Tawfeek Company, including a Special Islamic Certificate of Deposit (under the AlBaraka General Fund), the Leasing Fund (GCC and international), and equity funds (specializing in global vs. regional Europe/Asia). The ex-post returns of these funds are contrasted with those of various stock indexes to conclude that Islamic equity funds do "measure up." As in the previous paper, the analysis is un-scientific and the transactions costs of the various funds are not provided.

In these three papers on equity funds, one startling fact emerges: although around $90-100 billion is invested in Islamic equity funds (as cited by Bauer et. al. and Valpey), the bulk of this sum is invested in Western capital markets. This outflow of funds is due to the fact that capital markets in the West are highly developed and efficient, while those of most Muslim countries are not. This discrepancy can seriously impair the economic growth of emerging Muslim economies, as suggested by Yahia Abdul-Rahman and Mike Abdelaaty, whose paper I discuss below. Furthermore, one fact has eluded the minds of overseas Muslim investors: what would happen to these funds in case of an embargo against the various Muslim countries by the tyrannical powers that continue to enslave them?

* Assistant Professor, Department of Real Estate, National University of Singapore, Singapore.

Would these funds be frozen and/or expropriated? The way to redress this situation is to develop capital markets, institutions, and instruments in the Muslim world in order to retain these capital resources, as described in Ebrahim (2001).

II. BUSINESS MODELS

A. Funding the Growth of Islamic Financial Institutions

The emphasis of the paper by Abdul-Rahman and Abdelaaty is on alternative ways that Islamic financial institutions can fund their growth in the United States. The authors first describe the global Islamic banking experience from a historical perspective. They further dwell on two American Muslim institutions that primarily serve the entire market. One is Muslim Savings and Investments (MSI), an affiliate of the Islamic Circle of North America (ICNA). The second is American Finance House – LARIBA, with which the authors are affiliated. The potential market for Islamic home mortgages and automobile loans is estimated to be $1.25 billion, which is expected to grow to over $3 billion by 2025. The issue boggling the minds of IFIs in the United States is: How can this growth be funded?

Various ways of raising funds for this anticipated growth are considered to avoid emulating mainstream (*ribāwī*) banking. These include using:

1. deposits in *al-wa∞ī*ᶜ*a* accounts
2. interbank borrowing by IFIs
3. warehousing facilities, resorting to lines of credit
4. securitization of assets
5. asset-selling

The authors mention that the first (using deposits) requires approval from a jurist, while the second and the third methods need some form of creative "financial engineering." The last two form a good set of viable alternatives. I agree with the authors on the first three alternatives discussed, and feel that financial engineering using interbank borrowing and warehousing facilities can be undertaken by using the methodology described in Ebrahim (1999). The last two techniques can only be used if the IFI uses *ijāra*/*mu∞āraba*/*mushāraka* as a financial facility for homes or automobiles. If a *murāba®a* facility is used, then the last two techniques cannot be used due to the *fāqih* (jurist) injunction against *bayᶜ al-dayn* (sale of debt).

Finally, the authors explore another alternative: funding the anticipated growth by forming strategic alliances with large or globally based Islamic banks, or with conventional (*ribāwī*) banks. Although the authors cite the stance of Malaysian jurists permitting the second option, it should be noted that in countries such as Brunei it is still not permitted, even though Brunei is culturally and religiously similar to Malaysia (see also Ebrahim, 2001).[1]

Overall, Abdul-Rahman and Abdelaaty present one of the best papers of this section, presented lucidly from a practitioner's perspective. To appreciate this paper, one needs to reflect on the Islamic financial architecture from an academic perspective and on the strengths and shortcomings of current Islamic banking practices. A good reference is again Ebrahim (2001). Even though the example cited there is that of Brunei Darussalam, it can be extrapolated to many Muslim countries. The Achilles' heel of the current Islamic banking system is the weak investment banking sector, which, according to Ebrahim (2001), fails to complement the retail (commercial) banking sector. In this context, it makes sense that Abdul-Rahman and Abdelaaty reinforce the importance of financial engineering and the need for an "Islamic substitute for fixed-income (bond)" securities. However, the authors have some strong views with which I do not entirely agree. For instance, they state that "investing in the stock market … does not directly impact the economy of the community." I can understand the frustrations of IFI personnel, who find it difficult to compete with Western capital markets. Nevertheless, the authors have a point to make, and that is that the Muslim *umma* needs to make conscientious efforts to fund community projects lest the outflow of funds from Muslim countries to the West continue, to the detriment of the development of the Islamic world.

B. Islamic Financial Product Development

Fred Crawford reinforces the issue of developing equity funds from the perspective of customer needs, perceptions of brand names, and product differentiation of fund sponsors. The author recognizes the importance of innovative financial product design but feels that institutions that recognize and meet the needs of the customer will be successful.

Thomas R. Gainor covers a whole range of affairs pertaining to the development of Islamic investment products. It necessitates that additional steps be undertaken due to the special needs of the Islamic investor. It is customer driven and encompasses areas from the conception of an idea to its culmination as a final product for the end user. Gainor, like many others in this section, writes primarily from a practitioner's perspective and incorporates his personal experience. Finally, he reinforces a team approach to product development, one involving *sharī¤a* scholars, Islamic financial advisors, and Western institutions specializing in asset management services.

While elaborating on research and development, the author casually discusses the very controversial issue of adaptation vs. Islamization without making any deliberating comment. I believe that this is a very important issue, for the bulk of Islamic financial products (such as those construed from *murāba®a*) are merely adapted from conventional (*ribāwī*) vehicles, whereas there should have been some serious efforts at redesigning the facilities. The rationale behind this is due to the fact that Islam, an Abrahamic religion, has its own particular features that differentiate it from the other Abrahamic religions, Christianity and Judaism. Thus, in the current environment, Islamic financial engineering must play a crucial role in the process of retaining the capital resources of the *umma* in Muslim nations in order to invigorate their growth rather than that of the West.

C. Venture Capital Financing Vehicles

Aamir Khan and Tariq Al-Rifai discuss venture capital in the context of Islamic finance. First, they acknowledge the vital role that venture capital companies play in the economic advancement of most developed economies. Then, they dwell on how the conventional venture fund is structured using a myriad of financial instruments, such as preferred stock, and using covenants (agreements) and the concept of vesting in order to protect investors in a deal. Finally, they extend the mainstream practice to an Islamic framework. This study discusses a very important issue, but its treatment of the Islamic aspect of venture capital using preferred stock is very superficial and weak. The authors need to be aware of two vehicles for funding Islamic deals, which are discussed in Ebrahim (1999): growth- and income-oriented *mu∞āraba*; and growth *mu∞āraba*.

III. ADAPTING TO THE REGULATORY ENVIRONMENT

Finally, Jameel Aalim-Johnson elaborates on the interaction between financial-services legislation, regulation, and the influence wielded by the industry on the ensuing process. The goal of the author is to inform Islamic financial institutions in the United States that they have to develop the political savvy to address their concerns through the legislative process. The paper addresses the current regulatory environment by defining the roles of various Federal agencies, the role of the financial services industry in influencing the development of legislation, and the issues in financial regulation involving conflicts of interest between federal agencies and institutions. The author concludes by citing the example of the United Bank of Kuwait (a previous employer of mine), which received regulatory approval from the Office of the Comptroller of the Currency (OCC) for its lease-based home mortgage program. Furthermore, the Internal Revenue Service (IRS) agreed to treat a portion of the lease payment as tax-deductible, in the same way it treats interest payments on *ribāwī* mortgages. The moral of the article is that for IFIs in the U.S. to survive, they need to develop the sophistication to influence legislation that impacts their livelihood.

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—— and Tan Kai Joo. "Islamic Banking in Brunei Darussalam." International Journal of Social Economics 28(4) (2001). pp. 314-337.

[1] Incidentally, one of the juristic opinions cited is that of Dato' Professor Mahmoud Saedon bin Awang Uthman, a native Bruneian, who is currently the Vice-Chancellor of the University of Brunei Darussalam. His opinion may have changed to reflect the official views of the state of Brunei Darussalam.

The Relationship between Legislation, Regulation, and the Influence of the Private Sector

A Congressional Perspective

Jameel W. Aalim-Johnson[*]

ABSTRACT

Though nearly all federal regulatory agencies are a part of the executive branch of government, and most (except the Federal Reserve, or the Securities and Exchange Commission) take their day-to-day directions from the White House, the authority of these agencies is derived from the legislative branch of government. In essence, Congress passes the laws that govern the financial services industry and the financial regulatory agencies have the responsibility to carry out the "will of Congress" or "Congressional intent." The financial services industry is in no way a passive player in the development of regulation. The industry, particularly its major players, is very influential in the development of legislation that will affect their livelihood. If *sharī'a*-based financial institutions and instruments are to be accepted in and grow in the U.S. marketplace, its advocates will have to develop the political sophistication to have their concerns considered by the legislature.

I. INTRODUCTION

Nearly all financial instruments and institutions in the United States of America are regulated by the Federal and/or state governments. Regulating the financial services industry protects the consumer/investor from fraudulent financial practices that can erode consumer confidence, facilitates safety and soundness practices of financial institutions, and allows the government to utilize financial institutions through which to conduct monetary policy.

Most of the major regulatory laws that have governed the banking and securities industries were written beginning in the 1930s in response to the market crash of 1929 and the subsequent run on the banking system that caused numerous bank failures. During this period Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 to restore investor confidence in capital markets by providing more structure and oversight. The Glass-Steagall act was passed to create firewalls between depository institutions and other financial or commercial enterprises. The Federal Credit Union Act authorized the establishment of federally chartered credit unions in all states.

Though all federal regulatory agencies are a part of the executive branch of government, and most (not including the Federal Reserve, or the SEC) take their day to day directions from the White House, the authority of these agencies is all derived from the legislative branch of government. The specific regulations and the authority to enforce them are given to these agencies by the two bodies of the U.S. Congress, the House of Representatives, and the Senate. Each body of Congress is organized into various committees that have primary jurisdiction to review and recommend the regulatory functions of each agency. In essence Congress passes the laws that govern the financial services industry and the financial regulatory agencies have the responsibility to carry out the "will of Congress" or "Congressional intent."

II. THE CURRENT REGULATORY ENVIRONMENT

The following are the federal regulatory agencies, the financial instruments/institutions they regulate, and the congressional committees of jurisdiction.

The Commodities Futures Trading Commission (CFTC) oversees all markets in futures contracts and options on futures contracts through regulation of self regulatory organizations, i.e., futures exchanges. The Agriculture Committees have jurisdiction. As unusual as it seems for a committee responsible for agricultural issues to have jurisdiction over high finance, this is based on historical developments. Early futures contracts were all for agricultural products.

[*] Washington Chief of Staff, Office of Representative Gregory W. Meeks, Washington, D.C.

The Federal Deposit Insurance Corporation (FDIC) oversees and administers the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). BIF covers insured deposits of all commercial banks and a few thrift institutions. SAIF primarily covers insured deposits of savings institutions. The FDIC also regulates state-chartered banks that are not members of the Federal Reserve System. As part of its insurance functions, it has backup regulatory authority over banks and thrift institutions. The Banking Committees have primary jurisdiction.

The Federal Reserve System (FRS) is the central monetary authority of the United States. It formulates and conducts monetary policy; regulates bank holding companies, state-chartered member banks, and international banking operations; and operates national payments systems. It is the top-level umbrella regulator of new financial holding companies under P.L. 106-102, the Gramm-Leach-Bliley Act. The Banking Committees have jurisdiction.

The National Credit Union Administration charters and regulates federal credit unions. It also regulates state-chartered credit unions that are federally insured. It governs the National Credit Union Share Insurance Fund and the Central Liquidity Facility that provides liquidity to credit unions. The Banking Committees have jurisdiction.

The Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) are in the U.S. Department of the Treasury. The OCC charters and regulates national banks and their newly authorized financial subsidiaries. The OTS charters federal thrift institutions and is the primary federal regulator for both federally and state-chartered thrift institutions and for thrift holding companies. The Banking Committees have jurisdiction.

The Securities and Exchange Commission (SEC) regulates investment banks, investment advisers, mutual funds, brokers, and organized trading in corporate securities (stocks and bonds) and options on those securities. It oversees securities related self-regulatory organizations and issuers of new corporate securities. Among the SROs, it oversees the Securities Investor Protection Corporation, a broker-funded insurance fund that insures investors against broker failure. The SEC will oversee new investment bank holding companies and certain securities activities of banks under the Gramm-Leach-Bliley Act. The primary committees of jurisdiction are the House Commerce Committee and the Senate Banking Committee. These two committees also have primary jurisdiction over insurance legislation, though there is no federal insurance regulator.

Government Sponsored Enterprises (GSEs) are regulated by various agencies. The Federal Housing Finance Board regulates the Federal Home Loan Banks. The Office of Federal Housing Enterprise Oversight (OFHEO) is a part of the U.S. Department of Housing and Urban Affairs (HUD) and oversees the financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Banking Committee has primary jurisdiction.

The U.S. Department of Justice has authority independent of other regulators for both antitrust and fair lending statutes. Congressional jurisdiction over these two issues is exercised by the Judiciary and Banking Committees, respectively. The Judiciary Committees also have primary jurisdiction over bankruptcy legislation.

III. THE ROLE OF THE FINANCIAL SERVICES INDUSTRY

The financial services industry is in no way a passive player in the development of regulation. In a government designed by the people, for the people, the industry, particularly its major players, is very influential in the development of legislation that will affect their livelihood. Industry's opinions and experience is very much sought by members in the development of major and minor legislative initiatives. Consulting with industry during legislative development is critical in avoiding "unintended consequences." Unintended consequences can occur when legislators enact laws in a vacuum without understanding how new or changed regulations to improve one element of an industry can negatively impact another element of industry.

Unfortunately, various factions of the same industry can have diametrically opposed views on the same legislation depending upon their market niche or their structure. Depending upon the strengths of the various industry factions, disagreement on the purpose of a bill or its details can delay passage indefinitely. This was no more evident than in the development of the Gramm-Leach-Bliley bill also known as HR 10 in the House and S. 900 in the Senate.

For numerous years, the financial industry has been lobbying congress to overturn the Glass-Steagall Act, which created the firewall between commercial banking and other financial services. The financial services sector, particularly the commercial banks were insisting that they needed Glass-Steagall overturned to remain competitive with foreign banks that were not subject to such restrictions. The various industry players that would be affected by H.R. 10/S. 900 were the commercial banks, thrift institutions, insurance companies, securities brokers, investment banks and commercial entities that owned or had an interest in owning thrift institutions. The three key regulators were the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. The public

interest was personified in the form of community-based organizations that had utilized bank's Community Reinvestment Act commitments to benefit their constituencies. All stakeholders were nearly unanimous in their agreement that Gramm-Leach-Bliley needed to be passed in concept. However, sharp disagreements among the various factions over individual bill provisions revealed that the "devil was in the details."

IV. ISSUES IN FINANCIAL REGULATION

A. Treasury vs. The Feds

In developing the legislation that would allow banks to affiliate with other financial service entities there was disagreement about whether the affiliation should be solely through an affiliate structure with all entities being structured as subsidiaries of the bank holding company, or should banks be allowed to be parents of subsidiaries. The Feds favored the former and Treasury favored the latter. The House Banking Committee made it clear that it expected the regulators to come to an agreement before it would move the legislation. A compromise was reached that would allow securities firms to be subsidiaries of banks, but insurance firms would have to be affiliates directly under the holding company. The Feds would be the ultimate regulator of the holding company.

B. Commercial Banks vs. Thrift Institutions

Thrift institutions (savings banks) had been allowed to be purchased by non-financial commercial institutions such as Sears and General Motors. Commercial entities such as these were critical during the savings and loan crisis when they saved the taxpayers over one billion dollars by infusing their own cash into the S&Ls. Many new commercial entities were making applications for their own thrift charters. The commercial banks opposed any new thrift charters by commercial entities since it had already been agreed that commercial banks would have no affiliation with non-financial commercial entities. That decision by the committee had been partially spurred by the occurring Asian financial crisis where Asian financial entities had been pouring bank capital into their failing non-financial commercial affiliates. The influence of the commercial banks prevailed and it was decided that there would be a moratorium on any new commercially owned thrifts.

C. Community-Based Organizations vs. Senator Phil Gramm (Banks in the Middle)

Senator Phil Gramm, who is Chairman of the Senate Finance Committee, is an ardent opponent of the Community Reinvestment Act, which became law in 1977. The act, also known as CRA, stipulates that since banks are recipients of federal support through their access to the discount window and deposit insurance they had a responsibility to reinvest funds in the entire service area from which they received deposits. Banks that did not meet CRA requirements as determined through examination by the OCC would not be allowed to expand its branch network and other penalties. Phil Gramm has often asserted that community-based organizations (CBOs) were using the CRA to shakedown banks for donations, referring to it as extortion.

Under the proposed legislation in the House, banks would have to have satisfactory CRA ratings if they wanted permission to affiliate with other financial institutions. Those who had an unsatisfactory rating would need to submit a plan on how they would rectify improve their standing before being allowed to affiliate.

CBOs wanted to expand CRA to cover insurance companies and investment banks that chose to affiliate with commercial or savings banks. Phil Gramm wanted to scale back CRA by increasing the time between examinations and eliminating public comment when banks submit expansion applications. The banks' position was to stand pat. They supported CRA in its current form and saw no need to scale it back or expand it beyond the proposed legislative language regarding the criteria for affiliation.

After a pitched battle in the press, a compromise was reached in conference between the House and the Senate. Congress would maintain the current affiliation criteria, slightly increase the periods between examinations for small banks, unless regulators felt there was a reason to examine sooner, and banks and CBOs that made written deals to support the CBOs in grant and/or loans of a certain size would have to report those deals and resulting expenditures to bank examiners.

D. Conclusion

The involvement and influence of the industry in the development and passage of the biggest piece of banking legislation since the 1930s should be clearly noted in the above examples. If *sharī'a*-based financial institutions and instruments are to be accepted in and grow in the U.S. marketplace, its advocates will have to develop the political sophistication to have their concerns considered by the legislature. This means pulling together to form associations, hire government relations staff, and contract with lobbyist who will fight for their interest.

Though the process to maturity will be slow at first, *sharīʿa*-based institutions will eventually take their place as influential entities in the making of financial law.

V. CONCLUSION

As outlined in the beginning of this paper, nearly all financial products and institutions in the U.S. are subject to federal or state regulation. *Sharīʿa*-compliant financial products are no exception. Current regulatory law generally does not conflict with *sharīʿa*-compliant financial products, as they are no different from conventional products except for the elimination of *ribā* and *gharār* elements. Companies such as the United Bank of Kuwait have received favorable regulatory rulings from the OCC in relation to their home-financing product. In addition the IRS has agree to treat a portion of the lease payments as tax deductible the same way they look at interest payments on conventional home financing. However, current regulations can hamper the ability to develop *sharīʿa*-compliant commercial banks because of prohibitions on equity investments by deposit institutions.

Although some regulatory hurdles can be resolved directly by opinions from the regulator, those are limited to situations that are determined to not be in conflict with legislative intent. Any regulatory hurdles that cannot be resolved through the regulating agency because of legislative intent can only be resolved through changes in the law.

Passing legislation that is favorable to the Islamic financing industry will only take place with education and lobbying efforts to members of the legislature by players in the Islamic financing industry. Ultimately, the industry will have to establish permanent lobbying institutions to monitor and influence the development of regulatory law to safeguard the long-term health and growth of Islamic finance in America.

ADDENDUM

Online information sources:

http://www.house.gov	U.S. House of Representatives
http://www.senate.gov	U.S. Senate
http://www.sec.gov	U.S. Securities and Exchange Commission
http://www.occ.treas.gov	Office of the Comptroller of the Currency
http://www.ots.treas.gov	Office of Thrift Supervision
http://www.ncua.gov	National Credit Union Association
http://www.cftc.gov	Commodity Futures Trading Commission
http://www.fdic.gov	Federal Deposit Insurance Corporation
http://www.federalreserve.gov	Board of Governors of the Federal Reserve System

The Capitalization of Islamic Financial Institutions in the United States

Yahia Abdul-Rahman* **and Mike Abdelaaty†**

ABSTRACT

This paper discusses the experiences of MSI, Albaraka, the United Bank of Kuwait, and American Finance House – LARIBA in the United States. It also covers the sources of capital available to finance the growing needs of those interested in no-interest financing alternatives. The pros and cons of relying on foreign capital as compared to local capital resources in the U.S. are highlighted. Strategies to raise capital to finance and capitalize the extremely under-financed non-interest industry in the U.S. and the rest of the non-Islamic world are proposed. *Sharī'a* experts' opinions in light of the conditions and environment prevailing in the United States are documented.

I. INTRODUCTION[1]

Islamic (LARIBA) financing was first offered to the Muslim community in the United States in 1986-87 by two companies in California: Muslim Savings and Investments (MSI, now headquartered in Houston, Texas) and American Finance House – LARIBA (AFH; http://www.lariba.com). Since that time demand for Islamic financing has grown. In response to this growth, new companies came to the scene. The most significant of these was Al-Baraka Bancorp (a wholly owned subsidiary of the Jeddah-based Dallah Al-Baraka), which started in California, and is now headquartered in Chicago, Illinois. Al-Baraka's entry brought additional liquidity to the poorly capitalized private Islamic finance companies. Most recently, in mid-1998, the United Bank of Kuwait (UBK) started financing mortgages using the lease-to-purchase model in a program called Al-Manzil. In early 2000, however, the United Bank of Kuwait decided to terminate its operations in the United States and focus on the United Kingdom and Bahrain. MSI and American Finance House – LARIBA now are the two major companies serving the U.S. market for Islamic financing products.

We believe that the greatest challenge facing these companies in the coming years will be raising sufficient capital to meet the growing demand. While traditional means of raising capital may be employed, they often do not meet *sharī'a* standards. The global challenge for Islamic finance thus takes the form of raising capital in a manner that abides by the regulatory standards of various countries, as well as the rules of the *sharī'a*. We estimate that to meet Islamic financing demands in the United States alone, the industry needs to raise roughly $2 billion, $1 billion for mortgage financing and another $1 billion for financing automobile, equipment, and other business purchases.

This paper, therefore, reviews conventional capitalization methods, with a view to developing Islamic alternatives. To motivate this review, this paper begins by highlighting the volume of unmet demand for Islamic financial services, and proceeds to discuss capitalization strategies for generating sufficient liquidity to satisfy this demand.

II. A CONSERVATIVE ESTIMATE OF THE AMERICAN DEMAND FOR ISLAMIC FINANCIAL SERVICES

The primary market segment for Islamic finance companies in the United States is the small segment of American Muslims who refuse to participate in *ribā* under any circumstance. Many of those households have sufficient cash savings to purchase an automobile or household appliance, but insufficient to buy a house without resorting to mortgage financing. Consequently, such households are typically debt-free. It is estimated that this segment represents approximately 2% to 5% of the observant Muslim community, and consists mostly of professionals. It is the moral responsibility of Islamic and investment/mortgage bankers to cater to the needs of this "Puritan" segment of the community. The term "Puritan" is used here intentionally, as it conveys the core principles of American democratic participatory freedom and virtue, through industriousness and property ownership.

* Founder, American Finance House – LARIBA, Pasadena, Calif.
† President, American Finance House – LARIBA.

A. The Number of Households

A conservative estimate places the Muslim population of the United States at 6 million Muslims, or 1.5 million households. It can be assumed that 50% of those households can afford to buy and maintain a home, thus giving an estimated 750,000 households that either own or may wish to own a home. If assumed that 20% of these households wish to live according to Islamic law; i.e., praying regularly, attending Friday (*jumᶜa*) prayers and *ᶜĪd* prayers, paying *zakāt*, and performing ®*ajj*, then we have 150,000 households that potentially will use Islamic alternatives to conventional mortgage financing. Finally, assuming that 5% to 10% of this number consists of "Puritans," as defined above, it yields a final estimate of 7,500-15,000 households needing an Islamic alternative. Ten thousand households is a very conservative estimate of the minimum market size for Islamic mortgage financing.

This market segment has a unique profile. Such individuals are extremely pious. They run cash-only households, use banks only for safekeeping of deposited funds, and refuse to accept money market interest. They carry no debt, and fulfill their obligations on time. They are honorable, extremely successful, and reputable. They do not boast about their success and accumulated savings, since humility is valued. They are extremely particular about details of ®*alāl* and ®*arām* (permissible and forbidden actions, respectively). They do not trust easily, but once their trust is earned, it is earned fully. They are the most creditworthy members of the community. Such individuals can only be identified by Islamic bankers through extensive knowledge of the community at the grassroots level.

B. Market Size

The median price of homes in the United States varies widely from one state to another. A conservative estimate of the median house price in California, for example, is $250,000, compared to $150,000 in Texas. For purposes of this analysis a conservative benchmark price of $150,000 per house is used. If one assumes that 70% of the value of the home is to be financed, then the average Islamic financed amount comes to $105,000. A market of 10,000 households thus represents a demand of about $1,050 million. As the Islamic mortgage concept gains credibility and develops a proven track record, the market can be expected to grow further by attracting younger Muslims, and encouraging older middle-class Muslims to re-finance their homes in an Islamic manner.

If it is further assumed that each household buys one car (often a household owns at least two cars) at a median price of $20,000, then the potential market for car leases in the U.S. is approximately $200 million.

It is also important to note that the population of American Muslims is expected to reach around 20 million by 2025, mainly due to the growth in the number of children born to first-generation Muslim immigrants. This new generation will assume better and more affluent positions in the American infrastructure than their parents, which will improve financing prospects. We believe that the market potential for Islamic home mortgages could reach at least $3 billion. This does not include other community Islamic financing needs, such as automobile financing, small-business financing and construction financing.

III. HISTORICAL OVERVIEW

Islamic banking and financing has grown from a small emerging industry serving one village in Egypt (where it was initiated by the late Dr. Ahmad Al-Naggar) in the late 1960s, to a small but important factor in world financial markets. There are many reasons for the phenomenal growth of demand for Islamic banking, of which the two most important are: (1) The vast capital resources available to many Muslim oil-producing countries in the Middle East; and (2) the initiation, in the early 1960s, of a movement to educate Muslims about the prohibition of *ribā*, when many Muslims became aware of the seriousness of dealing in *ribā*. Many Muslims, in India, Pakistan, the Gulf countries, Malaysia, Turkey, as well as other countries, have become adamant about avoiding *ribā*.

Unfortunately, this aversion to *ribā* began at a time when the Islamic banking and finance industry was unable to handle the resulting demand for *sharīᶜa*-compliant financial services, and the vacuum was filled by unqualified and inexperienced marketers and industrialists. A case in point was the movement of pseudo-Islamic "savings mobilization companies" in Egypt like Al-Rayan and Al-Saad. These companies offered higher returns and helped, to some extent, in recycling people's savings in the local economy. However, due to inexperience, domestic and international political considerations, and operating blunders, they quickly faltered. Their failures dealt a blow to the reputation and credibility of the Islamic banking movement. In the late 1970s, the Islamic Development Bank (IDB) was established as an analog of the World Bank for financing Islamic countries' needs. Islamic banking was introduced officially by many governments (most notably, Malaysia in the early 1980s) as well as private Islamic finance companies around the world in the late 1970s and early 1980s.

Many international conventional banks are now trying to gain a significant share of the Islamic finance market, which has been estimated at $50–80 billion. Most of these funds are now handled in Europe, mainly in the London financial markets. In 1996, Citibank started "Citibank Islamic" in Bahrain to provide marketing of syndicated financing of major projects in many Muslim and non-Muslim countries. Moreover, Citigroup is currently providing limited Islamic financing services to Islamic finance and investment institutions and high-net-worth Muslim investors and entrepreneurs out of its international operations in New York City and San Francisco.

In the 1990s, the Bahrain Monetary Authority started attracting Islamic banks and financial institutions to its shores. Bahrain has since become the international Islamic banking capital of the world. In the process, new steps to regulate Islamic banks and their operations, financing policies, and auditing standards were taken. It is widely believed that Islamic banking will emerge as an important player in the international banking industry in the twenty-first century.

Islamic banking services in the twentieth century focused primarily on institutional financing of large deals. Most of these deals were in the West. The greatest challenge major Islamic banks face today is learning to complement institutional activities with activities that serve Muslims at the grassroots level. Kuwait Finance House is a case in point, but it is unfortunate that this trend did not catch on in the rest of the world. Islamic banks can and will be able to serve communities better, by providing better services, financial products, and instruments to the average Muslim. In doing so, the first steps toward creating a liquid Islamic capital market will evolve.

The historic boom in equities markets in the USA, Europe, and Asia attracted a large portion of the liquidity of many Muslim investors at all levels: institutional, large, and small. This trend was enhanced by the introduction of Islamic mutual funds and stock market indexes such as the Dow Jones Islamic Market Index and The International Investor's (TII) indexes. The marketing expertise of the mutual fund industry and the world investment banking and brokerage industry successfully attracted large sums of money away from the real purpose of and spirit of Islamic banking, financing, and investing. The authors believe that investing in the stock market should never be the *only* investment strategy of a typical portfolio. Investing in the community, while offering lower financial returns on investment, must be included in any well-designed and balanced portfolio. After all, investing in the stock market carries a much higher risk and does not directly impact the economy of the community.

Islamic banks worldwide have not yet been able to provide competitive financial instruments and products to stem this trend. Thus, they have failed to attract a significant portion of funds being invested worldwide by Muslims.

IV. LEARNING FROM THE EXPERIENCES OF OTHERS

If Islamic banking is to reach its potential, banks must follow a basic road map similar to the one conventional banks have followed over the past 600 years. The five main steps are:

1. The mobilization of small-scale savings, and their prudent reinvestment in the community. This provides small-scale savers a low-risk vehicle for earning a return on their savings, while encouraging overall community growth and development. In an Islamic framework, such investments will also abide by the *sharīʿa*, further helping support the ethical and social foundation of the community.
2. In its quest to accomplish these goals, the Islamic banking industry must be aware of the competition posed by conventional banks. This will force the nascent industry to develop instruments that not only abide by the *sharīʿa*, but also seem financially attractive to Muslim homeowners, automobile buyers, and professionals seeking business financing.
3. Islamic financial institutions can gain credibility by highlighting the basic structure of asset-based Islamic finance, thus reducing the risk of "runs on the bank" and other financial disasters.
4. The portfolios accumulated during the re-investment of funds in the community, in mortgages, leases, and financing, can be securitized in order to create liquidity to allow the expansion of an Islamic bank's financing portfolio and investment activities.
5. Larger Islamic banks can act as wholesalers for smaller banks. Thus, large banks can capitalize on their high liquidity and potentially lower overhead costs, and small banks can capitalize on their grassroots informational advantage.

V. A BRIEF HISTORY OF ISLAMIC BANKING IN AMERICA

Muslim Savings and Investments (MSI) and American Finance House – LARIBA offered Islamic financing and investment services for the first time in America in 1986-87 from the State of California. The two companies offered Islamic home mortgages, car leasing, and equipment leasing.

MSI is considered the Islamic investment arm of the Islamic Circle of North America (ICNA), a major national Muslim organization in North America. The company has since moved from California to Houston, Texas. MSI's funding came from ICNA members, who invested by buying shares, or as a liability against the company. MSI was also funded through the use of a set of diversified limited partnerships that are registered with the Securities and Exchange Commission (SEC).

American Finance House – LARIBA was the first company to offer diversified retail financing services to the community in all fields. It first offered Islamic mortgages using the *murāba®a* (cost-plus) model in 1987. It first wrote Islamic mortgages in California and the U.S. in 1987, for a home in Madison, Wisconsin. Company funding is provided by a limited number of successful businesspersons in the community, who own the company and are capable of meeting any unexpected demand for liquidity. A few sophisticated investors fund the rest of the company and receive a distribution based on the return on its portfolio. All funds come from local community resources that have known each other for a long time.

After a brief visit by Shaykh Saleh Kamel (the owner and founder of Dallah Al-Baraka) to Los Angeles in 1987, Dallah Al-Baraka opened a wholly-owned subsidiary called Al-Baraka Bancorp in 1988. The company relied mainly on the financial and capital resources of Dallah Al-Baraka, its parent. The company also provided "warehousing lines" and "take-out" relationships with some Islamic finance companies in the U.S. and Canada. To a limited extent, this helped these companies expand their activities in the areas of Islamic mortgages and automobile and equipment leasing. In early 1989, the new management in charge of Dallah's U.S. operations decided to change its emphasis to focus on investing in large real estate ventures and industrial projects, reducing its original focus on the community. Al-Baraka Bancorp moved to Chicago and invested heavily in overpriced real estate markets around the country.

In mid-1998, the United Bank of Kuwait (UBK), a British-chartered bank owned by a consortium of Kuwaiti banks, started an Islamic mortgage program, Al-Manzil, through its federally licensed branch in New York City. UBK management invested large sums of money on legal fees in order to obtain approval of its business model from United States banking regulators and the Internal Revenue Service (IRS). Intensive, high-profile, and expensive advertising and promotion campaigns were conducted throughout the country, with some success. In early 2000, UBK decided to terminate its U.S. market operations and to focus on Europe and Bahrain. No formal announcement was made as to what happened and how the bank intended to handle the servicing of the lease-to-purchase agreement, although it held title to all the homes it had financed.

Many other smaller Islamic finance and leasing companies tried to start financing operations, but either stayed very small or discontinued their operations because of a lack of capital and experience.

Reflection upon the experiences learned since 1987 reveals the following important lessons:

1. A local Islamic finance company cannot meet its capitalization needs by merely forging a link with a major Islamic organization such as ICNA or ISNA (the Islamic Society of North America).
2. The association of an Islamic finance company with a large organization with an indigenous political culture may be detrimental to its growth and prosperity. In a finance company, decisions must be made on a purely technical and professional basis.
3. Smaller, community Islamic finance companies do not have the large front-end capital resources to support the necessary marketing, sales, and management capabilities and the overhead support that are commanded by large multinational banking, investment, or real estate firms.
4. Community investing might not be as lucrative to large Islamic banks as investing in the stock market or large real estate deals. The large Islamic banking institutions, because of their understandable lack of knowledge and commitment to the local community, opt for higher returns whether or not this benefits the local community.
5. International Islamic banks, like all prudent business entities, seek the highest returns possible. Thus the planning horizon of these banks is very short, which does not meet the long-term requirements for a strategic commitment to develop Islamic capital markets in the United States.
6. International Islamic institutions understandably prefer dealing with a well-established American firm in leasing, real estate, or other financing activities over dealing with a smaller and less experienced community-owned company.

7. Large international Islamic financial firms compete with community-owned finance companies. The large non-U.S. Islamic bank or finance company is in the business of gathering assets from its local markets to invest directly in the U.S. The community-owned company does the same, but chooses to invest back into the community. If the non-U.S. company invests with a community-owned company, its return on investment will not be large enough to cover overhead and pay a decent return on its investors' money.
8. There is an element of distrust due to lack of knowledge and of familiarity on the part of community-based as well as non-U.S. entities.

VI. THE TASK AHEAD

The authors believe that the capitalization problems of the emerging Islamic financial industry in the United States can be solved if the financial institutions succeed on the following two fronts:

1. Make investing in community-based companies attractive to large non-U.S. Islamic banks.
2. Toward that end, community-based companies need to increase the rate of return generated by local community Islamic finance.

A. Identifying the Needs of Large Non-U.S. Islamic Banks

International Islamic banks can be classified into two groups: banks with excess funds, and banks with limited funds (adequate only for their local needs). This discussion focuses on Islamic banks with excess funds that need to be invested prudently. Many of these are located in the Gulf countries.

The objective of the strategic investment department of the larger non-U.S. Islamic bank is to increase the return on total bank assets without increasing the risk of investing. In this regard, conventional (*ribā*-based) bankers typically diversify investments among: (i) real estate, (ii) business financing, (iii) retail financing, and (iv) fixed-income investments. Many non-U.S. Islamic banks and investment companies have a diversified investment and financing portfolio, with investments in real estate, stocks, and other businesses, and these tend to be long-term investments. These banks, however, need short-term and medium-term investment vehicles that are Islamic and low-risk, and that substitute for the fixed-income investments in a typical portfolio. Small community-based Islamic banks can potentially satisfy this need.

B. Identifying the Needs of Small Community-Based Islamic Banks

Smaller Islamic finance companies in America need to do three things (the third item is discussed below under "Warehousing Facilities"):

1. Expand assets under management to a critical mass of $25-50 million. Such funding may be raised through a private and/or a public offering. A public offering resulting in trading on a U.S. exchange may also allow Islamic mutual funds to include financial services companies in their portfolios.
2. Develop Islamically permissible means of leveraging raised capital. Many conventional means of leveraging invested equity are adaptable to Islamic law, while others require significant adjustments. Yet others are totally inappropriate. Determining which means fits each category requires further analysis that can be left for later discussions.

Capital leveraging is one of the most common strategies employed by Islamic financial institutions to increase capital availability, financing powers, and return on invested capital. Through borrowing, these institutions can, with a limited capital base, increase the volume of financing services provided, thereby increasing return on shareholders' capital. This strategy is very attractive and extremely rewarding under normal market conditions. However, in case of sudden market changes, such as an increase or decrease in interest rates, or a sudden economic slowdown, leveraging can be detrimental to the company. History shows that excess leveraging has bankrupted many companies. Obviously, this practice is not acceptable from a *sharīʿa* point of view. However, several other types of leveraging may be adaptable to Islamic jurisprudence. They include deposits or non-equity investments, interbank borrowing, securitization, and asset sales. The following sections briefly describe each type.

1. Deposits/Non-Equity Investments

The largest type of leveraging is the practice of accepting customer demand deposits or non-equity investments practiced in conventional banks. These funds are placed with financial institutions for the purpose of participating in the returns of the financial institutions' activities. The funds placed constitute a liability against, and

a claim on, the assets of the financial institutions. The flexibility and return potential of this type of leveraging makes it very attractive for both the depositors/investors and the financial institutions. This practice was further encouraged by regulatory bodies in the U.S. that control and oversee such financial institutions. Examples are the public and regulatory bodies such as the Federal Depository Insurance Corporation (FDIC) and the National Credit Union Share Insurance Fund (NCUSIF) for banks and credit unions, respectively. Those bodies guarantee the principal investment/deposit amount placed in their respective regulated financial institutions.

Unfortunately, most Islamic financial institutions are non-regulated institutions and, as such, are not allowed by U.S. law to take deposits. Moreover, even if they were allowed to accept deposits, they are at a disadvantage in competing with conventional banks because they cannot offer such federal protection to their depositors/non-equity investors. This makes it more difficult to access this source of funding.

Also, for Islamic banks to use this instrument effectively, sufficient consensus needs to be reached among the jurists and the Muslim community regarding the depositary's authorization to invest such deposited funds. Thus, two sets of regulatory frameworks need to be developed for deposits in Islamic banks: one federal, the other Islamic.

2. Interbank Borrowings

Another type of conventional leveraging involves borrowing from other banks or regulated financial institutions. This could include borrowing from and entering into repurchase agreements with local financial institutions. Borrowing from these sources is typically short- to medium-term and can be secured or unsecured. The borrowings can be structured to fit the needs of the borrowing institution. Given the regulated nature of these entities, the cost of borrowing (i.e., the interest rate) is often based on LIBOR (the London Interbank Offering Rate) plus a negotiated margin to reflect the term and the risk of the transaction.

Creative efforts at Islamic financial engineering are needed in order to develop an Islamically permissible analog of this procedure for Islamic financial institutions.

3. Warehousing Facilities

Warehousing facilities are available to such non-bank financial institutions as mortgage banks, credit unions, and finance companies. These facilities are lines of credit limited to funding specific secured financing transactions, primarily home mortgages, and to a lesser degree automobile and equipment financing. These facilities are usually short-term and are drawn upon to fund financing transactions that meet predetermined credit criteria, with the understanding that the facilities will be repaid within 30-90 days. The proceeds used for repayment are usually obtained from the sales proceeds of the papers (portfolios) of the financing transactions. Providers of warehousing facilities include conventional banks and special asset-based lenders such as General Motors Acceptance Corporation (GMAC), General Electric Acceptance Corporation (GEAC), and Countrywide Funding Corporation.

These lines of credit usually carry a variable interest rate equal to LIBOR plus 1% to 4%. They are secured by the underlying financings (e.g., mortgage deed or lien on vehicle registration) as well as by the corporate or personal guarantees of the non-bank financial institutions. The rates charged on these lines of credit are usually equal to or higher than the rates earned on the underlying financing transactions. Hence, they cannot be relied upon as a permanent source of funding. Non-bank financial institutions most often utilize these facilities to increase the volume of business they underwrite in order to increase financing fees.

This type of financing could be available to Islamic financial institutions. However, the interest rates charged would not meet Islamic jurisprudence, and therefore Islamic financial engineering is needed to provide an Islamically permissible analog.

Finally, the smaller Islamic finance company in the United States needs to:

3. Find an Islamic securitization vehicle for the portfolios of small community-based Islamic banks. Such a securitization vehicle could be developed along lines similar to Fannie Mae's and the securitization of real estate portfolios through mortgage-backed obligations (MBOs), collateralized mortgage-backed obligations (CMOs), or collateralized credit card debt securities.

4. Securitization

Securitization involves the packaging of similar fixed-rate obligations (home loans, auto loans, credit card debt, etc.) for the purpose of selling publicly traded securities to individual and institutional investors. The safety and liquidity of these instruments allow the issuing financial institutions to realize a gain on the sale of the underlying transactions. Moreover, securitization helps eliminate the ongoing credit exposure and fluctuation in returns that are characteristic of the original financing transactions. Due to the costs of structuring and marketing

such transactions, securitization is often available only to financing lenders that operate at very large volumes. Lenders that wish to securitize their assets but are unable to generate the sufficient volume must consolidate their portfolios with others: by selling their financing portfolios to larger lenders; or by acquiring other small lenders' financing portfolios in order to reach the desired volume.

5. Asset Selling

Asset selling is an option embraced by many lenders, particularly small- to medium-size mortgage bankers and finance companies, that are unable to generate the sufficient financing volume. These entities rely on underwriting transactions for the express purpose of selling the transactions to larger buyers, large financial institutions and public bodies such as Fannie Mae and Freddie Mac. Both buyers and sellers agree in advance on the criteria under which the transactions will be sold and the documentation required for the sales. The sale price is a function of the return at the time of the sale on the financing transactions being sold. For example, a transaction that carries a 10% rate of return when the current interest-rate environment would ask for 8% would be selling at a premium (profit to the seller) of approximately 12 to 20%. The opposite is also true: if general interest rates increase after the transaction is booked and before it is sold, the transaction can only be sold at a discount or loss to the seller.

If structured to comply with Islamic law, this option seems to be the most viable alternative for Islamic institutions originating home and auto financing transactions. If small community-based Islamic financial institutions in the U.S. can provide securitization and leveraging instruments that abide by Islamic law and agree with U.S. government regulations, they can provide large non-U.S. Islamic banks the proper incentive and investing vehicle to participate in the U.S. Islamic finance industry.

VII. GUARDED OPTIMISM

It is important for Islamic bankers to understand that conventional liquidity instruments were developed over many years to meet specific needs in particular financial settings. Islamic bankers face the challenge of and the responsibility to:

1. Understand the needs for which such instruments were developed.
2. Offer solutions and creative ideas to meet the needs of the market in a *ribā*-free setting.
3. Manufacture and market competitive new Islamic products that meet the market's needs, test the products, and solicit opinions regarding their legality (from the standpoint of the U.S. regulatory framework as well as of Islamic jurisprudence) from lawyers, jurists, and Islamic financial practitioners.
4. Finally, compare products to their conventional counterparts in order to identify useful niches or correct harmful deficiencies.

Unfortunately, this usually is not done. Many Islamic bankers take conventional instruments, dub them "®*alāl*" or "®*arām*," and, in some cases, force an Islamic "dressing" onto them to make them seem acceptable. Islamic jurists label such practices Hiyal (tricks to circumvent Islamic law). Most scholars denounce Hiyal; Imam Ibn Taymiyah dedicated an entire section of his *fatwā*s (Islamic legal judgments) to condemning a variety of their uses. This does not mean that the use of any conventional financial instrument automatically qualifies as Hiyal. Rather, many financial instruments originated by conventional banks can easily be modified to achieve concord with the *sharīʿa*.

Certificates of deposit (CDs) can illustrate this approach. In a conventional bank, one way to manufacture a CD is to consider a portfolio of loans arranged by the bank and then match that portfolio with a portfolio of CDs. The interest rate paid to the CD investor is lower than the average return of the portfolio; this difference is the interest rate spread. The bank gets the liquidity needed to expand its portfolio and makes a profit in the process, while the CD investor is guaranteed a given interest rate and the preservation of his capital.

American Finance House – LARIBA devised "SPIN CDs" (specific investors' CDs). AFH presents the investor with a specific portfolio, such as *ijāra*-based automobile leases, and explains the expected rate of return in order to assure the small investor that the CDs are backed by assets and can be expected to provide a given return. Using this approach, AFH can plan its liquidity because it fixes the maturity. Moreover, the creation of more liquidity allows AFH to finance additional projects in a *ribā*-free manner while preventing any unexpected run on the finance company.

Other such innovative solutions that abide by the *sharīʿa* are needed to solve the liquidity difficulties of Islamic banks in the United States and worldwide.

VIII. Potential Alliances with Large International Islamic Banks

An alliance between small Islamic finance companies in the United States and large non-U.S. Islamic banks can help develop Islamic capital markets in the U.S. and elsewhere. Marketing alliances between international Islamic banks and U.S.-based investment banks and brokerage houses can provide an important complement to a typical investment portfolio for the corporate cash management that many Islamic businesses need. Such alliances can also provide appropriate vehicles for the retirement planning of Muslims and non-Muslims in an Islamic and socially responsible manner.

The institutional cash management and/or retirement portfolio of a typical Islamic bank would then include:

- cash that can be invested in an Islamic short-term or money market mutual fund;
- stocks and/or mutual funds (such as the Dow Jones Islamic Market Index, the TII Islamic Indexes of America, or custom-built modifications of the S&P 500 index) that comply with the *sharīʿa*; and
- an Islamic substitute, such as Islamic MBOs, CMOs, and/or securitized lease obligations, for the fixed-income portion of a portfolio. This is a very important and sorely needed substitute because of the difficulties faced by the treasury of an Islamic institution in reducing investing volatility and risk. Islamic bank managers currently must choose between investing banks' idle cash in conventional short-term money market instruments, earning *ribā* returns, or forgoing any returns. In order to circumvent this dilemma, managers resort to one or more of the following options, depending on the institution's *Sharīʿa* Board:

    1. Refuse to take interest.
    2. Accept interest and use it for charitable purposes. This approach is based on the *fatwā* of some scholars.
    3. Invest in precious metals such as gold in "cash and carry" forward contracts that are based on LIBOR.
    4. Keep track of the lost opportunities for money market interest, and be rewarded by conventional banks with services and interest-free facilities, the economic value of which should balance out the lost interest.

The above is a list of fallback measures taken by many Islamic banks to minimize their losses relative to their conventional counterparts. While some of these measures may not technically be prohibited from a *sharīʿa* point of view, they should be viewed as but temporary maneuvers that pave the way for genuine Islamic products. The ultimate goal must be for Islamic bankers of the future to follow Islamic law in spirit as well as letter, but without sacrificing competitiveness in financial markets. It is the *duty* of Islamic bankers to develop and/or find such profitable Islamic financial products.

IX. Potential Alliances with Conventional Banks

Forming alliances with conventional banks might become an important strategic option for small Islamic finance companies in case it becomes difficult to form alliances with large Islamic banks. Moreover, such alliances widen the potential reach of Islamic banking services to all members of the community. Numerous synergies could result from alliances between conventional and Islamic institutions, whereby both can ultimately serve all consumers. The time has come to offer an Islamic banking window as a complimentary banking and financing service to the community. This window should be offered on a stand-alone basis, as an alternative to the current conventional system. The free-market system will be the judge of the real value of this *ribā*-free system to the average consumer in America.

Conventional banks that offer Islamic banking windows would:

1. Apply the strict American regulatory and supervisory environment to Islamic banking practices, products, and services. This will add credibility to the Islamic banking approach and will make its products more reliable and acceptable in the market.
2. Create a larger pool of bankers of all faiths and levels training and experience and who are conversant in conventional as well as Islamic banking. This will enlarge the pool of banking experience, expertise, and creative abilities for the manufacture of new products and services for the Islamic banking industry.

3. Create the foundation for the beginning of a new banking service—"Islamic banking—that is affordably offered nationwide by a large and sophisticated network of banks.
4. Encourage the Muslim community to participate, with its wealth, in the American economic system, without violating its religious beliefs. This will have a great social impact on the growing American Muslim community and encourage savings.
5. Create an atmosphere of healthy competition between conventional and Islamic banking products. This should benefit both systems as well as the consumer.

X. Legal and Juristic Issues Related to Islamic Windows in Conventional Banks

The problem of dealing with conventional and Islamic financing models within the same institution has troubled many Muslim jurists and members of the Muslim community. The issue is how one can justify, from a jurisprudential point of view, owning a financial institution that deals with *ribā* while simultaneously offering an Islamic banking window. In fact, many puritans and strict Muslims regard this a clear case of hypocrisy and believe that it should never be allowed. This problem has been investigated at length by a number of jurists and scholars, first in Malaysia and later in the Middle East. The following paragraph summarizes the opinions rendered by qualified Muslim scholars on the subject.

The Central Bank of Malaysia (Bank Negara Malaysia) sought the views of three jurists on the permissibility of establishing an Islamic banking window as an additional but unique service offered by a conventional bank. The jurists involved were Almarhoum Tan Sri Ahmad Ibrahim, Dr. Mahmoud Saedon Awang Uthman from International Islamic University Malaysia, and Tuan Haji Mohammad Shahir Ahmad from the Department of Islamic Affairs in the office of the Prime Minister of Malaysia. These view of these scholars is that "a conventional bank, whose operations are conducted on the basis of interest, *is not prohibited from* operating an Islamic window." The conclusion was based on a rule in Islamic legal theory (*usūl al-fiqh*).

XI. Conclusion

Even the most conservative estimate suggests that a huge demand for Islamic investment and financial products remains unmet in the United States. This demand is created by the underserved segment of the population that chooses to live in accordance with the requirements of Islamic law. This demand encompasses the most basic needs, such as financing of homes, automobiles, and businesses. The handful of entities catering to this demand is characterized by its local ownership, small size, and limited capacity. These attributes explain their inability to meet this demand. The incidence of local ownership has led to the stability of firms such as American Finance House – LARIBA and MSI. By contrast, larger foreign-owned firms, despite their ample resources and capacity to meet the demand, lack the corresponding commitment to local communities in the U.S. and require much higher returns than prudent investing can generate.

In order to increase the availability of Islamic financial services, local Islamic financial institutions must increase their capacity in one of the following ways:

1. Access the capital markets. This can be done by arranging a private and/or a public offering. The target customers would include local individual and institutional investors and foreign institutional investors.
2. Leverage capital by borrowing. This can be done through creatively structured facilities, from large international Islamic banks or local conventional institutions. Such facilities include warehousing facilities, take-out commitments, and lines of credit with rates of return tied to the returns generated by certain portfolios. The local Islamic financial institutions can provide the lending institutions with avenues for diversification and sources of secured fixed income.
3. Ally with investment and brokerage firms in the U.S. This allows the packaging of similar fixed-rate obligations (home loans, auto loans, credit card debt, etc.) for the purpose of selling publicly traded securities to individual and institutional investors. This would allow the Islamic institutions to originate more financing transactions without having to hold such transactions on their balance sheets.
4. Ally with conventional banks. This includes offering Islamic banking windows, as a complimentary banking and financing service, within conventional banks. Such windows would offer insurance and investment management services similar to those that the conventional banks currently offer.

It is also recommended that Islamic banking and financial institutions cooperate with each other and specialize in specific banking services, in order to strengthen and further develop the industry in the twenty-first

century. The strengths of each institution would determine their specialties: retail Islamic banks would cater to the financing needs of local communities; wholesale Islamic banks would serve medium-size to large institutions and corporations; and mega-Islamic banks would serve for their smaller brethren as regional banks of last resort.

The authors firmly believe in the viability of and prospects for the fields of Islamic finance and investment. However, in order to reach the full potential for meeting the large demand for such services, it is crucial to restructure and creatively work to attract capital and investment.

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Islamic Equity Funds

Opportunities and Challenges for Fund Managers

John Bauer[*], Richard P. Keigher[†], and Kelley Hicks[‡]

ABSTRACT

Due to the moral and financial guidelines of the *sharī'a*, Islamic investing brings challenges not associated with creating and distributing other mutual funds. Credibility that an Islamic fund is *sharī'a*-compliant is essential in order to attract potential Muslim investors. This is especially difficult for newcomers to establish in the Islamic world, and most fund managers are not successful at it. Moreover, many Islamic institutions with *sharī'a* credibility lack the resources to create and manage their own mutual fund. As both fund management expertise and *sharī'a* credibility are necessary, it is difficult to succeed in the Islamic market. Many questions must be addressed when a manager elects to create an Islamic fund. Should a *sharī'a* supervisory board be appointed, and who shall be its members? How should *sharī'a* principles and guidelines be applied in the fund management process? Should one actively manage a portfolio or follow an index? Who and where is the market? How will the fund be distributed?

I. INTRODUCTION: THE ISLAMIC INVESTMENT MARKET

As competition for assets intensifies, fund managers are looking for new markets to penetrate. One of those markets is the Muslim market. The size of the Islamic investment market has been estimated at more than $100 billion,[1] while demand for Islamic investments has been growing at 12%-15% per year.[2] In order to tap into this potential new client base, many fund managers are looking to create and distribute Islamic funds. This has resulted in an explosion of Islamic funds over the past five years. Presently there are over 80 Islamic funds, 70% equity and 30% non-equity. Islamic fund promoters are found in most major international markets: 48% are located in the Middle East, 30% in Europe and North America, and 22% in Asia. Due to the moral and financial guidelines of the *sharī'a*, Islamic investing brings challenges not associated with other funds, and because credibility is especially hard for newcomers to establish in the Islamic world, many fund managers are unsuccessful. Conversely, many of the banks that have credibility lack resources to manage their own fund. As a result, the Islamic market is a difficult one to succeed in because both expertise and credibility are necessary.

II. INVESTMENT ISSUES IN THE CREATION OF AN ISLAMIC EQUITY FUND BY A FUND MANAGER

If the manager elects to create an Islamic fund, many questions particular to Islamic investing must be addressed. For example: determining who the market is and where they are located, what types of products will be offered, whether to actively manage or follow an index, the practical application of *sharī'a* principles in fund management, and how the fund will be distributed to the Islamic community. All of these questions raise issues, the successful addressing of which determines a fund manager's ability to penetrate the Islamic investment market.

When fund sponsors are considering the creation and distribution of an Islamic fund, the first decision is whether to out-source the management of the portfolio or to perform that function in-house. Of the over eighty existing Islamic equity funds, most outsource the portfolio management to third parties.[3] The reasons to outsource are lack of key resources (knowledge, credibility, funding). Many of the Arab banks that have credibility in the Islamic community lack the resources and knowledge base to manage their own fund, and because the Islamic market is fast moving and complex, long-term focus and in-depth understanding are necessary. Outsourcing provides these banks with the fund management expertise that they lack, and at the same time, outsourcing is cheaper to implement. Conversely, many fund managers that do have expertise in portfolio management do not have credibility in the Islamic community. Without this credibility and a strong, reputable presence in the market, investors will be reluctant to invest in the fund.

[*] Marketing Director, SAMBA Capital Management International, London, United Kingdom.
[†] Managing Director and Chief Investment Officer, SAMBA Capital Management International.
[‡] Intern, Duke University, Durham, N.C.

Both fund managers and distributors must have a *sharī*ᶜ*a* board in order to gain credibility; creating a *sharī*ᶜ*a* board and screening stocks are both costly and time-consuming ventures. Outsourcing to a specialist Islamic banking firm provides perceived value by bringing authenticity and a venerable reputation as well as a less costly, lower risk alternative. For institutions without the resources to manage a fund or without credibility in the Islamic community, outsourcing is a viable way to approach the Islamic investment market.

If a fund manager has both established credibility and resources, it is to their advantage to manufacture their own fund, obviating the need to pay another manager. In addition, the firm can then make the fund available for distribution by other institutions, bringing in additional capital and profits to both. Creating a fund is the best option when the company not only has established credibility in the Islamic investment community but also has a broad knowledge of the fund management business.

Once a manager decides to create an Islamic fund, there are many crucial choices to make. The first decision is the type of product to offer. There are four major types of funds that can be created: *istisnā'*, *murāba®a*, *mu∞āraba*, and *ijāra*. *Istisnā'* funds are contracts of acquisition of goods by specification or order, where the price is paid progressively, in accordance with progress of job completion. *Murāba®a* funds are funds in which a bank purchases goods for a client, which are then sold to the client with a mark-up. Repayment, usually in installments, is specified by the contract. *Ijāra* funds invest in leases. This is a contract under which a bank buys and leases out, for a rental fee, equipment required by the client. Ownership remains with the bank, and terms are dictated beforehand. Lastly, *mu∞āraba* funds are agreements between two parties: one, which provides 100% of the capital for the project and another who manages the project. Profits are distributed according to a predetermined ratio. These can be equity funds, property funds, and commodity funds. Islamic fund managers select the type of fund that either fits the customers' needs or about which they are most knowledgeable.

III. Active or Passive Portfolio Management?

If an equity fund is selected, then a decision must be made whether to actively or passively manage the fund. This decision has much to do with the personal style of the fund manager. Passive management is when the fund is invested according to an index, such as the Dow Jones Islamic Market Index (DJIM). In Islamic investing, indices, such as the Dow Jones Islamic Market Index, track *sharī*ᶜ*a*-compliant stocks from around the world. For example, the DJIM starts with 2,700 stocks and then eliminates those that fail to meet *sharī*ᶜ*a* guidelines, including financial ratio filters.[4] After screening, a pool of approximately 640 stocks qualifies and the individual stocks are selected for the portfolio.

There are two approaches to portfolio management: active or passive (indexing). In the past few years, investors have been increasingly interested in tying their assets to indices rather than relying on active portfolio management.[5] When the market is performing well, indices tend to mimic that behavior. As a result, managers that follow an index make profits for the investor. This is a cheaper way to invest because the fees are lower. But indices can also be seen as "tyrants" where "to be underweight [in a stock] is to be in danger of dismissal."[6] Passive fund managers often have to follow the index rigidly, even when other market information would advise against the index's investments. This is because they make few value judgments, but blindly accept all newcomers to their benchmark. Because benchmarks choose the stock with the fastest rising price gain, index followers essentially follow price momentum. Index followers cannot invest in a blend of different types of stocks.

As opposed to passive managers, active managers do not follow and index. Each fund manager provides personal attention to the investor and then "actively" chooses what securities to buy or sell. These managers use the indices as benchmarks by which to measure the fund's progress or to measure the market climate. When creating a fund, it is important to pick an appropriate market for comparison. With active management, the goal is always to make money for the client, as opposed to beating an index. Active managers attempt to outperform the index in a good market. In a bad market, active managers ideally can pick the pockets of profitability and opportunity, therefore performing much better than the index. Active management carries a higher risk, with the possibility of greater profits.

IV. Liquidity Management

Fund managers must carry cash balances in order to have the ability to respond to withdrawals of cash by investors at very short notice. They also need to derive income from these short-term funds in order to contribute toward the fund earning competitive returns to investors.[7] Because interest income is prohibited under the *sharī*ᶜ*a*, investment of short-term funds in a *sharī*ᶜ*a*-compliant manner becomes problematic. With the investment of liquid funds, there is the problem of a lack of Islamic interbank markets. It is also difficult for Islamic funds to deposit and

borrow liquidity because of a lack of "acceptable instruments, proper credit ratings, operational standards, *sharīᶜa* compliance, and market practice."[8] As a result, Islamic funds try to minimize liquid funds for customer withdrawals and investment needs for fear of earning a low or no return on them.[9]

The obvious solution to the problem is to create a fund comprised of *sharīᶜa*-compliant instruments that produce a money market return (i.e., LIBOR) and that have daily liquidity. There are very few of these vehicles available and few traditional fund managers have the skill sets to manage such a fund. While *murāba®a* funds do exist, most fail to pass the *sharīᶜa* and liquidity tests. One example is the ABC Clearing Company, where assets are invested in *murāba®a, ijāra*, and other *sharīᶜa*-compliant instruments providing "cash" returns with daily liquidity. This fund is an example of a way to make profits above what leaving cash on the table.[10] One word of caution, there are some regulatory jurisdictions that do not allow investment into "non-transferable" securities such as *murāba®a*, thus taking this option away.

V. *SHARĪᶜA* COMPLIANCE

Developing an Islamic fund has many challenges particular to Islamic investing. The first step toward *sharīᶜa* compliance is the creation of a *sharīᶜa* advisory board by either the fund's sponsor or the fund manager. This board is an independent body of specialized jurists in *fiqh al-muᶜāmalāt* or Islamic jurisprudence. It may include one expert in the field of Islamic financial institutions. The board is appointed by the Fund Company and should consist of at least three people, with the option of seeking expert consultants. The board should not include directors or significant shareholders of either the sponsor or the fund manager. The selection of respected members of the community is essential because this board will bring reputation and credibility to the fund.[11] The Board issues guidelines of *sharīᶜa* investing that are provided in the form of a *fatwā*. First, Islamic funds must comply with *sharīᶜa* guidelines that prohibit investment in companies who's primary business are not consistent with *sharīᶜa* principles such as alcoholic beverages, tobacco, entertainment, hotels and leisure, financial services, and pork products.[12] One of the key elements of Islamic investing is the avoidance of interest. Stocks that do not meet specified financial parameters are excluded, examples of which are limits on debt, interest income, and accounts receivable.

In order to comply with the guidelines, stocks must not only be screened initially but also constantly updated as to compliance. (A company might buy or sell something overnight, becoming incompliant.) This screening may be done in-house by the fund manager or outsourced to a specialist such as Dow Jones or The International Investor.

Another guideline of *sharīᶜa* investing is purification. There may be stocks that pass the screens but do generate income that is not *sharīᶜa*-compliant. Interest income is an example. Each quarter the fund manager or his designate must determine how much of the income is impure and determine what proportion of the dividend must be earmarked as such. Some *sharīᶜa* boards insist that impure income be donated to charity. In this case the amount of impure income for each stock must be determined and then deducted from the dividend. The *sharīᶜa* board then gives the sub-fund manager a list of approved charities to which the deducted amount is donated. Pure income is then credited to the fund and the net asset value (NAV) is adjusted accordingly.[13] Other *sharīᶜa* boards allow impure income to be credited to the fund and simply reported to investors so that each may decide how they want to deal with it.

The *sharīᶜa* supervisory board will issue an annual report stating whether the institution's contracts and related documentation are in compliance with the *sharīᶜa*.[14] In addition, quarterly reviews of the portfolio are made.

VI. DISTRIBUTION

Most fund managers are "manufacturers" of investment products and rely on other institutions to distribute them. In order to be successful in attracting assets, Islamic finds must be distributed by institutions with good access and relationships in Muslim markets. There are several ways to accomplish this:

- To sponsor, manage and distribute the fund through a network in Muslim markets. This is the best alternative although one that few fund managers can achieve. Saudi American Bank through Samba Capital Management International is one of the exceptions, doing both the manufacture and distribution of Islamic funds.
- To create and manage the fund but appoint distributors. Most fund managers take this approach although it has met with limited success. Examples are Fleming Asset Management, Citi Islamic Investment Bank, Global Asset Management, and Permal Asset Management.

- To sponsor and distribute the fund but outsource the fund management. This approach is very common in Muslim markets. Examples include National Commercial Bank (Wellington), Al-Rajhi (UBS), Faysal Islamic Bank of Bahrain (recently renamed Shamil Bank of Bahrain) (BNP), and Arab National Bank (Schroeder SSB).

The alternative that a fund manager selects depends upon its structure and resources.
Once that decision is made, several factors are critical for success:

- *Product design and selection*. Ideally, a distributor should have a "family of Islamic Funds" with a choice of risk levels and liquidity so that clients can match the best product(s) to their need.
- *Quality of the relationships maintained by the distributor*. At this point, reputation and credibility are paramount. Reputation determines the level of trust by existing clients and access to new clients. The existing client base must be not only willing to invest in the new fund but also trust his investment business to the distributor.
- *Reputation of the* sharīᶜa *board in the market*. Familiarity of one or more members of the *sharīᶜa* board helps to build confidence with potential investors that the fund is *sharīᶜa*-compliant.
- *Quality of the regulatory oversight and ability to obtain prompt approval in key target markets*. When preparing to distribute the fund, managers must decide where to register the fund. This is partially based on where the target market is located and type of fund. If much of the market is in Europe, the fund should be registered in Europe. Luxembourg registration increases credibility although the fund still must be approved by each respective country's central bank and Luxembourg registration makes the process much easier. Alternatives to Luxembourg include the Channel Islands, Cayman Islands, Bahrain, Bermuda, and others. Unfortunately, it is difficult to register equity funds in the Middle East unless the distributor is a local bank or other financial institution. Those registered in the Middle East cannot be distributed in Europe until central bank approval is obtained in the targeted countries.
- *Product knowledge and skill sets of relationship officers*. Employees of commercial banks must be trained to deal with Islamic clients and must understand Islamic investing. Even more basic, most banks' staff do not have the skill sets to effectively market investment products. Some remedies to this problem include launching one product at a time and having staff focus only on that one product; placing Islamic investment specialists out in the field on a full time basis to support the distributor's staff; use of sales incentives to motivate staff to learn about and market mutual funds.
- *Ability to access multiple distribution channels*. There are several alternatives: distribution through another institution's retail and private banking networks; use of independent contractors who act as wholesalers to high-net-worth individuals or other financial institutions that may distribute and sell the fund to their clients; the Internet, a relatively new channel, can be used to penetrate the market. Estimates of potential markets for *sharīᶜa*-compliant financial markets are in the range of 1.5 billion Muslims worldwide controlling well over $100 billion of available funds.[15] This is probably 1-2% of the potential market.[16] It is thought that many of these Muslims can be reached through the Internet. This is a developing business that is in its infant stages of development.

VII. CONCLUSION

Fund managers that wish to capitalize upon opportunities and penetrate the Islamic investment market have many choices to make. The most general question is whether to create or outsource a fund. This choice should be based on the company's credibility in the Islamic world, the prior expertise in the fund management field, and the financial resources available to them. After this decision has been made, the personal investment style of the manager dictates whether investment will be active or passive. An investor should look at which style suits the individual's risk and investment capital levels. A slew of additional choices only affects Islamic funds.

Fund managers must carefully track their compliance with the tenets of Islam, as dictated by a *sharīᶜa* board and its guidelines. These issues include screening, liquidity management, and purification. Finally, the fund has to be carefully registered and distributed with an eye on the largely untapped Muslim population. If all of these aspects are successfully addressed, a new market can be accessed. Although Islamic fund management is more complex and has more rules and guidelines than mainstream investing, the potential opportunities in the market are great.

[1] Creating Online Self-selection Investment Portfolios for Islamic Investors Worldwide: Product Partner Information Guide. Jersey ii-online Ltd., 2000.

[2] The FTSE Path to Islamic Investment: Introduction. London: FTSE International Ltd., 2000.

[3] Global Equity Trading Fund. London: Samba Capital Management International, 2000.

[4] Dow Jones Indexes. Princeton: Dow Jones Indexes, 2000.

[5] Siddiqui, A. Rushdi. "Investment Strategies in a Changing World." Presentation at the Samba Annual Global Investment Conference. Kingdom of Saudi Arabia. May 23, 2000.

[6] Coggan, Philip. "The Tyranny of Indices." Financial Times. June 12, 2000.

[7] El-Kafsi. "Liquidity Management." Presentation at the Islamic Investment Products Conference. May 21, 1998.

[8] Ibid.

[9] Ibid.

[10] El-Kafsi, *supra*.

[11] Yaquby, Nizam. "Regarding Auditing Standards for Islamic Financial Institutions Related to *Sharī'a* Supervisory Boards." Presentation at the Islamic Investment Products Conference. May 21, 1998.

[12] Global Equity, *supra*.

[13] Ibid.

[14] Yaquby, *supra*.

[15] Creating Online Self-selection Investment Portfolios, *supra*.

[16] Ibid.

Developing Financial Products in Islamic Finance

Fred Crawford*

ABSTRACT

For much of the last decade, Middle East banks and investment companies have tended to opt for in-house managed, proprietary products under the assumption that their domestic customer base prefers mutual funds developed and managed "in-house." These banks have struggled to provide quality mutual fund sales, marketing, asset management, shareholder record keeping, fund administration, and compliance, all within an organizational framework and culture that often misunderstands the product. Conventional wisdom would suggest that Web-enabled technologies tilt the balance toward the "buy" as opposed to the "build" option. Any financial services company seeking to offer Islamic funds should still consider three fundamental issues. First, what are the attitudes and habits of customers toward Islamic investment and to the institution offering Islamic funds? Second, how important is brand to the Islamic customer? Third, what skills or competencies can differentiate one from one's competitors? Innovative Islamic products that rigorously comply with Islamic investment principles are the threshold standard, but success will come to those institutions that first recognize and serve the fundamental needs of the customer. Build rather than buy decisions, taken in this context, stand a greater chance of success.

I. INTRODUCTION

Successfully growing the Islamic mutual fund market hinges on a "buy and build" approach that pays particular attention to giving the Islamic investor "equal value" (no "conscience penalty") and avoids propping the product on the ethical leg alone. Eighteen months ago, the National Commercial Bank engaged in a healthy debate with a local competitor in the Islamic funds market. "The problem with you banks," he complained, "is that you tell your customers too much." While NCB[1] strongly endorses moves toward greater transparency and disclosure in Islamic investing,[2] there is a nugget of truth in our worthy competitor's comments.

There is an art to finding the right balance between detailed disclosure and clarity in customer communications, particularly in respect to Islamic investment. Inundating the investor with reams of detail on the subtleties of *sharī'a* investing is, in our experience, insufficient to attract a critical mass of new investors to these funds.

II. THE SAUDI ARABIAN MUTUAL FUND INDUSTRY

In the Middle East, mutual fund awareness and household usage, while relatively low by European and North American standards, is gathering momentum as investors increasingly turn to funds to meet their financial goals. The largest market, Saudi Arabia, witnessed solid 40+% growth in 1999, fueled by a rise in the number of higher quality and innovative Islamic funds.[3] We have observed many institutions increase their marketing spending, seeking to raise their "share of voice" to achieve greater product awareness that would stimulate trial and ownership. With more viable choices available, Islamic fund investors no longer have to sacrifice performance or transparency when opting for *sharī'a*-compliant products.

For much of the last decade, many Saudi and other Middle East banks and investment companies have opted to produce their own-brand proprietary funds under the (often mistaken) assumption that their domestic customer base would not buy their Islamic mutual funds unless they were developed and managed exclusively "in-house." Traditionally, in the Arab world, financial institutions expanding into mutual funds have, for the most part, attempted to develop in-house some or all of the requisite mutual fund components.

However, few of these institutions have achieved the critical mass required to make this business a viable stand-alone economic proposition. Often, institutions can manage only a limited range of funds that is unlikely to meet the full scope of their customers' needs or compete on a world scale. Compounding the problem is that many banks and financial service organizations, and even some regulators, lack the organization, culture, or core competencies required for success.

* Advisor, The National Commercial Bank, London, United Kingdom.

Saudi Arabia's National Commercial Bank has achieved a leadership position in both Islamic and conventional mutual funds in Saudi Arabia and captured a 55% share of the Saudi market through a strategy of "build and buy." Although Saudi Arabia's first mutual fund, in 1979, was a conventional U.S. dollar-denominated money market fund (offered by NCB to the expatriate market), eight years later, NCB launched the first Islamic fund. This was the Al-Ahli International Trade Fund, a low-risk, short-term U.S.-dollar *murāba®a*-based money market fund, which was to be the first Islamic fund in NCB's family of 28 funds. NCB now has 14 Islamic funds, which, with combined assets approaching $4 billion, have a leading global position among Islamic mutual funds.

III. OUTSOURCING

Today the interconnectivity of financial markets and delivery systems has begun to tilt the balance toward the *buy* as opposed to the *build* option. But are Islamic products or the customers that buy them any different? What does it take to succeed in this business? A financial services company seeking to offer Islamic mutual fund products to its market should consider three fundamental issues:

1. The Customer: What are the attitudes and habits of the target market with regard to Islamic investment?
2. The Institution: What values do Islamic customers seek in an institution from which they buy Islamic funds? What skills or competencies do they value that can help differentiate the Islamic funds offering? Can any of these be outsourced?
3. The Product and Brand: How important are product features and brand to the Islamic customer?

Most firm(s) seeking to enter this market focus their efforts on producing innovative Islamic products that rigorously comply with *sharī*ʿ*a* investment principles. But this is only one of several threshold standards that must be met. Success is more likely to come to those institutions that also recognize other fundamental customer needs. *Build* vs. *buy* decisions, taken in this broader context, stand a greater chance of leading to success in the Islamic mutual fund market.

Outsourcing fund accounting, pricing, custody, fund administration, and even shareholder services (shareholder communications, support services, marketing services, and distribution services) is increasingly commonplace in the global mutual fund industry. But among institutions that are considering offering Islamic mutual funds, outsourcing asset management (including *sharī*ʿ*a* screening) may be overlooked. Why is this?

The U.S. financial services industry, and the mutual fund sector in particular, has recognized that it cannot be expert in all asset classes. In a recent report published by the Boston-based Financial Research Corporation (FRC), some $425 billion of assets in the U.S. mutual fund market was identified as managed under "sub-advisory" contracts—representing about 7% of the total industry.[4] About $33 billion was raised in the sub-advised funds segment in 1999, roughly 10% of the industry's total net sales in 1999. The FRC report also noted that 704 of the country's 6700 mutual fund portfolios were managed under sub-advisory contracts.

The arguments outlined by the FRC for appointing sub-advisors are compelling:

1. Fund families cannot consistently add value and outperform across every investment category.
2. Performance in the categories of domestic equity, international equity, government, and money market portfolios outperformed that of internally managed counterparts over three to five year time horizons—even allowing for the incremental advisory fees.
3. The instant track records gained from sub-advisors can help boost sales.
4. Appointing a sub-advisor is often a cost-efficient alternative to hiring (or terminating) a full-time portfolio management and/or research unit.
5. In some markets, brand recognition is crucial, and can be more easily had by bringing a sub-advisor on board.

IV. CHARACTERISTICS OF THE SAUDI ARABIAN ISLAMIC INVESTOR

Is there something unique about Islamic investors (or perhaps the Saudi investor) that limits an organization's freedom to outsource? Not according to six years of customer research undertaken by NCB. Starting in 1994, NCB conducted extensive annual customer (tracking) surveys and analyzed responses to some 40-50 questions relating to all aspects of investing, including the customer's experience with mutual funds in general, the relationship between the customer and NCB (in the specific categories of general attributes, services, funds, communications, and employees), the customer's investment needs, and the customer's own background.

Over the past six years, NCB has measured a rising awareness of and preference for *sharīʿa*-compliant investment. Beyond this, however, it has sought through its research to define a value proposition and identify detailed customer values that could be reflected in a range of new Islamic funds and services that differentiated NCB's Islamic funds from its conventional funds.

We divided the responses into two general categories: a) investors who said they preferred Islamic investments "every time they invested"; and b) investors who said they preferred Islamic investments either "sometimes, depending on their risk tolerance" or "I don't worry too much about this aspect of investing." The 1999 survey generated 3000 responses, representing 8.5% of NCB's fund customer base. Given NCB's 50% share of Saudi fund accounts, this translates to about 4% of the Kingdom's mutual fund customer base.

From the parameters we set, we could find virtually no clear-cut point of differentiation between NCB investors who prefer to invest exclusively in Islamic funds and those who are not predominantly governed by this specific condition. This comes as no major surprise, as the differences we have anecdotally observed seem to be based on the extent to which religious ethics are allowed to permeate personal finances rather than on fundamentally different social and financial goals. Further market research is underway to determine whether this applies to only NCB customers or to the broader market as well.

In the meantime, given this backdrop, we are led to believe that product/service providers that can meet the broad financial goals of the "strict *sharīʿa* investor" without presenting him with an "inferior package" (e.g., no "conscience penalty") would find a receptive market. Again, this was not surprising. A Morningstar analyst, Emily Hall, recently labeled this "a marketing issue," when commenting on the low level ($45 million) of assets of the only two U.S.-registered Islamic mutual funds compared to the investable wealth of an estimated U.S. Muslim population of 6 million.[5]

This observation seems to give rise to the following hypothesis: The differences between a "strict Saudi *sharīʿa* investor" and a "conventional Saudi investor" begin beyond such standard financial parameters as "advice," "liquidity," "capital preservation," "capital appreciation," and so forth. The personal sense of (commitment to) religious ethics appears to do little to color the investor's preference for and reaction to standard financial values such as these. However, it is unlikely that a strict Saudi *sharīʿa* investor will compromise on value or accept a conscience penalty.

Our research has identified fifteen "essential and primary" customer values that we broadly categorize in four areas: staff professionalism, customer communications, institutional values, and fund performance. Only one of these values is specifically linked to *sharīʿa* compliance.

V. Approaches to the Mutual Fund Business

Because the meaningful differences between a "strict Saudi *sharīʿa* investor" and a "conventional Saudi investor" may be buried deep in the realm of personal ethics and morality, it is unlikely that a "formula approach" to investing would be successful in meeting the needs of the strict *sharīʿa* investor. "Strict" probably carries as many different connotations as there are *sharīʿa* investors. Hence, success may lie in establishing threshold standards and then building in sufficient flexibility that would allow for personal choice.

The above hypothesis would support the notion that in organizations that lack extensive manufacturing, asset managing, and/or *sharīʿa*-compliance capabilities, buying and adapting might be the most cost-effective approach to forming a mutual fund. For example, the *sharīʿa*-screening process employed by several Al-Ahli equity funds was developed jointly by NCB, our external *sharīʿa* advisors, NMCC (The National Management Consulting Center, Jeddah), and Wellington Management Company, Boston. This is a "build *and* buy" partnership formula that has worked well for us and, more importantly, for our customers. It has also served as the cornerstone from which important strategic distribution alliances have been established with other institutions, including the National Bank of Kuwait and their successful Al Kowthar funds.

What about Islamic fund investors' attitude to risk? We had also hoped through our research to find material differences between the two customer groups; we did not. This has led us to develop Islamic funds that are not inherently riskier than the broader markets in which they invest.

NCB's Al-Ahli Global Trading Equity Fund, launched five and a half years ago, now exceeds $700 million in assets and is invested in a broadly diversified array of large-cap global equity securities in accordance with Islamic principles. The fund's annualized return of 23.51% (through June 30, 2000), has outperformed the MSCI World Index by almost 6% (5.78%), without subjecting investors to significant incremental risk. Using widely accepted risk measurements such as standard deviation or the Sharpe Ratio, we can confirm the observations of a number of recent articles and studies: Islamic fund investors do not necessarily have to "pay a conscience penalty" by accepting either lower returns or higher risks.[6]

VI. CONCLUSION

If mutual funds can draw from an Islamically screened universe and, on a risk-adjusted basis, outperform broader secular indices, why have Islamic funds not been more widely embraced by the socially responsible investment community? Could it be that we are too narrowly preaching to the converted, or that we are focusing on only one essential customer value—*sharīʿa* compliance—while ignoring some other essential and fundamental investor needs?

We have before us a challenge, as well as an opportunity, to demystify Islamic investing and broaden the appeal and ownership of Islamic funds. Success will come to those who recognize that meeting fundamental customer needs means looking well beyond *sharīʿa* compliance. To succeed, most organizations entering the Islamic fund business must chose the *buy* option and *build* only where they can save time or cost, or create significant value to the customer. Recognizing this is, in our view, a fundamental "task ahead."

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[1] In this paper, "NCB" and "we" are used interchangeably.

[2] Accounting, Auditing and Governance Standards For Islamic Financial Institutions. 1420 A.H./1999 C.E.

[3] Saudi Arabian Monetary Agency, Investment Products Committee (IPC).

[4] Financial Research Corporation. The 2000 Sub-Advised Mutual Fund Report.

[5] Culloton, Dan. "Profiling According to the Words of the Prophet." http://www.morningstar.com: The Council on American-Islamic Relations. March 15, 2000.

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A Practical Approach to Product Development

Thomas R. Gainor*

ABSTRACT

This paper covers a variety of matters that are important in the development of Islamic investment products. While it is not intended to be comprehensive, it covers areas from the inception of the idea through the ultimate delivery of the product to the end user. It is written from the Islamic banker's perspective and attempts to address the issues in a practical "hands-on" manner. Personal experiences in the Islamic product development area are shared. Research and development, the emergence of Islamic funds and alternative investments, and the benefits resulting from the creation of certain indices are addressed in some detail. Considerable emphasis is placed on the interaction among *sharī*ʿ*a* scholars, Islamic financial advisors, and Western institutions specializing in asset management services.

I. INTRODUCTION

This paper covers a host of issues that should be considered in the development of Islamic investment products. While not intended to be comprehensive, it covers issues arising from the inception of the idea through to the ultimate delivery of the product to the end user. The paper covers the "what, why and how" from the perspective of a practitioner of Islamic investment banking. It attempts to address the issues in a practical "hands-on" manner. The author intends to share his personal views and experiences in the *sharī*ʿ*a*-compliant product development area.

II. A THRESHOLD CONSIDERATION

For Islamic banks and those already dedicated to serving this marketplace, the issue of whether or not to serve (invest in) this market is moot. The Islamic bank may, however, be grappling with strategic matters related to maximizing the quality of its service to the marketplace while expanding its business. In that sense, product development is an important area in which the Islamic bank will focus and deploy its resources.

However there are diverse views in the industry. Some, are doubtful about investing in this market in the first place, a second group has adopted a "wait and see" attitude, while there are those who believe in investing today so as to develop the track record that will help them become leaders (pioneers) in this niche business.

The practical aspects of product development therefore become relevant when a prospective participant decides to commit/invest resources to the Islamic marketplace.

III. PRODUCT DEVELOPMENT IN GENERAL

A. Definition and Overview

The term "product development," for purposes of this paper, is defined as "the internal process that a financial organization adapts in order to create a financial product or service for delivery to its customer." Since there is no single process that fits all organizations or products and services, the definition is necessarily broad. The process differs depending on factors such as the financial organization's target customer, its experience and expertise, internal resources, corporate culture, regulatory environment and any number of other internal and external factors.

An organization with extensive experience may have a refined process while a new one might use trial and error. Either way the process is modified and improved with experience and practice over time.

The product development process includes several stages starting from the idea generation or conceptual stage through to the implementation and follow-up stages. While some reference may be made to specific products or services, the core concepts discussed will generally apply to all Islamic products whether they be Islamic mutual funds, unit trusts, closed ended funds, portfolio management, leasing products/transactions, real estate related

* Managing Partner, The International Investor, London, United Kingdom.

products, securitized paper, Islamic indices, capital protected products and other traditional and not so traditional (the flavor of the month) Islamic products.

B. Soliciting Views of Others

The concept "product development" is perceived differently by finance and non-finance professionals in a number of industries including Islamic and conventional finance. The following responses shed some light on the variety in perceptions with respect to this concept;

1. Most believe that the preferred approach is to develop the product in response to the values, needs and desires of the customer. However, engineers (financial or otherwise) often fail to listen to what the customer wants. Organizations sometimes retain outside specialists who generate product ideas through research on the values, needs and wants of the targeted customers.
2. A second approach starts with brainstorming within the organization with the objective of developing a product that should appeal to the customer. In this regard, the product developer seeks to create demand for the product or responds to a perceived demand.
3. An approach some consider best is to use a combination of (1) and (2) above where there is some input from the end user coupled with internal expertise regarding financial engineering, marketing and other disciplines within the project team.
4. The longer the time span from the inception phase to the rollout phase, the more difficult it is to predict from the onset whether the market will be receptive and actually purchase the product. Timing within the "flavor of the month" is crucial since things may change if one is too slow in responding. Coming to market too soon (i.e., before the customer can truly appreciate the product) may also prove problematic. External events such as the publicity surrounding Long-term capital management's affairs and the resulting impact this negative publicity had on hedge funds in general also influence the timing of a particular type of product.
5. While there are certain generalizations about customers, the targeted customers of the product distributor are likely to require some segmentation in terms of factors such as age, sophistication, demographics, risk tolerance, etc. The product developer should target the right product for the right type of customer.
6. Some geographic markets (i.e., the United States with respect to Islamic products) are underserved and one may wish to commence tapping this opportunity by offering straightforward and simple solutions. This contrasts with a provider that perceives a new more exotic product is necessary to capture the attention of a more mature marketplace (e.g. the Gulf Cooperation Council States).
7. Product developers can find themselves in a predicament where the customer is demanding a type of product without adequately appreciating the risks involved. This situation persists even though the product provider goes to great efforts to educate his customer. The issue of "suitability" is one that the Islamic finance provider must focus on since it owes a high moral obligation to its customer.

C. The Market Environment

The Islamic product provider has a special moral obligation to educate its customer since the latter may or may not be a "sophisticated investor." Education is equally important for the provider. The Islamic marketplace though dynamic and fast growing is still a relatively new industry and reasonably immature.

Education on financial matters is critical since it enables the product developer to respond specifically to the needs of a customer who knows what he or she requires. In this regard the product developer must ask potential customers the right questions in order to effectively draw out the values, needs and wants of the customer. This is a key issue in product development for Islamic banking today because of the immaturity of the market and the global nature of the industry. As the industry continues to innovate and as the barriers to growth are removed or lessened (e.g. through regulation), the confidence of the investors and their participation will gradually rise.

Due to the diversity of the Islamic banking marketplace it is difficult to collect accurate and meaningful data on many attributes such as its current size or predict its short- and long-term future. Estimates indicate a market size of $100–$150 billion growing at 10%–15%. There is however, need to clarify these figures. An analysis by *Failaka International Inc*. indicates for example, that Islamic equity funds have grown at over 50% per year since 1996 with total assets under management estimated at between $5–7 billion, from only $800 million in 1996.

The Islamic marketplace is clearly a niche offering enormous potential. Great strides have been made over the last five years with the introduction of a variety of quality equity funds, capital protected products and other specialized products managed by world-class organizations and indices such as the Dow Jones Islamic Market Index

and the FTSE Global Islamic Index Series. It is also anticipated that there will be Web-based delivery channels sparking further interest and growth.

D. Why Product Development is Important

Product development is not just important, it is a critical in the retention of customers in the face of competition in today's financial services environment. It also obviously acts as a catalyst for generating interest and energy in the development of the Islamic financial services industry as it seeks to realize its full potential. Effective product development creates a synergy between the service providers and the customers. Both gain valuable insights from the interaction. The provider gains a better understanding of the customer's needs while the later becomes a satisfied (and often) repeat customer.

The financial services industry is highly competitive and an inferior product will be rejected. The product must be sound in all regards in order to protect and enhance the reputations of those institutions with whose names it is associated. In some regions where Islamic banking is prevalent, regulatory barriers are being loosened and competition is increasing. Increased competition is generally favorable for consumers as it creates and exerts pressure for change on those institutions that are not customer focused.

Majority of providers who prosper in the industry are those who focus their resources and talents on serving the customer. Product development is an integral component in the quest to serve the customer.

E. What Constitutes a "Successful" Product?

Bottom-line profit, though not the only measurement tool, business is important if the organization is to prosper, grow, retain qualified employees and serve the community. The success of an Islamic finance product must be measured in the context of the strategy and goals of the provider as a whole. There will be short-term targets and longer-term goals that need to be well thought out and understood.

A certain level of assets under management and fees generated may be set as targets. Other goals such as market penetration, expertise gained and the acquisition of long-term intangibles ought to be considered. Management assessment tools such as a balanced score card analysis may be undertaken. Ultimately, the question of whether a particular product is "successful" or not can be answered by understanding why it is in the Islamic marketplace in the first place.

IV. RESEARCH AND DEVELOPMENT

A. In General

The term "research and development" is somewhat analogous to product development. Both include a "development" aspect but a brief discussion of the research component is necessary for proper analysis.

The term "research" conjures up a picture of men in white jackets with test tubes in the laboratory testing a new concept or a new application of an existing concept. In a sense, these technicians are performing a form of "brainstorming." Earlier in this paper there was mention of brainstorming in order to determine what the customer "might" or "should" want. How then does Islamic banking today generate its product development ideas? How is brainstorming done? How can the research process be stimulated or improved with respect to Islamic products and services? Product development is critical and these questions are of paramount importance.

B. Adaptation or Islamization

Much of the research and development that has worked its way into existing products in the marketplace was generated from adapting conventional product to Islamic needs. It may follow that if a product is successful in the conventional marketplace and is then successfully engineered to be acceptable and consistent with the *sharīʿa*, it will be successful in the Islamic marketplace. This logic would hold if one presumed that Islamic and conventional investors had only one critical difference, in the form of *sharīʿa* compliance. However, the paper queries if it is appropriate to characterize investors as "Islamic" or "conventional" in the first place.

This paper is not intended to be critical or supportive of a heavy reliance on the adaptation of conventional financial products. One may properly contend that there is considerable innovation and value addition in reengineering or adapting a conventional product in order to create a new product that incorporates a *sharīʿa*-compliant structure. Others may voice some skepticism regarding a mere transformation that, in their view, is in substance substantially similar to the conventional product.

C. Innovation

Considerable ingenuity and innovation is often exerted in adapting conventional products. The substance of the underlying transaction must be scrutinized as well as its form. Certain structures such as equity ownership or a partnership interest cannot be labeled as Islamic or conventional structures. The point here is not semantics but rather how to think "out of the box," as well as move beyond the adaptation of conventional products to stimulate new ideas, which will help the industry flourish. The following comments provide some of the possible answers.

1. *Sharīᶜa* scholars are among the most qualified group of persons to stimulate ideas and creative thinking and this is clearly happening. The scholars are studying the practical application of concepts in many areas (e.g. equities, options, and other risk management tools, capital protection, *takāful*, arbitration, and the use of trusts).
2. Specialist practitioners, including Islamic Financial Advisors, are integral drivers in this process. They exert considerable efforts in seeking new solutions. They work closely with the Scholars and both gain from each other's views and perspectives in pioneering new concepts that work.
3. Universities and other institutions of higher learning are a rich source of research and innovative original thinking. They are incubators of knowledge and a vital link. I hesitate at listing some of these esteemed universities and institutions for the fear of omitting some out of ignorance. I have had the pleasure of having first hand experience with Harvard University, Loughborough University, and the Islamic Research and Training Institute at the Islamic Development Bank. Many others are making outstanding contributions to the industry.
4. Governmental bodies have done much to support the industry, create opportunities, and provide leadership. Some that come to mind include Bahrain, Abu Dhabi, and Malaysia.
5. Customers and investors are a great source of ideas, especially at the institutional level. As the industry flourishes and customers become more enlightened and aware, the customer will increasingly be an initiator of new ideas. Product developers will need to listen to the customer.

D. Relying on Basics May be Best

Innovation in product development does not necessarily mean the creation of a new exotic offering. Innovation may take the form of a new application of an existing structure or perfecting techniques as technological advances and other developments arise. An example of the former is creating a capital protected product through a *bayᶜ ᶜurbūn* structure. An example of the latter is refining the process of purifying dividend income with respect to company in an Islamic index.

A novel product may not be desirable to the target customer who wants an understandable straightforward investment product. What good is a product that does not sell because investors do not understand it? One must also consider the range of products and services that will be offered and perhaps conclude it appropriate to offer a balanced portfolio solution, such as an Asset Manager type solution. There are challenges in the effective management of any product during its life cycle so the best approach is to keep the matters straightforward and to focus on service.

There are always new opportunities that call for analysis. For instance, the product development group may look at Exchange traded funds, Wrap accounts, Folios and Interpretive Letter #867 issued November 1999 by the U.S. Comptroller of the Currency (discussing *murāba®a* financing) and concludes the need to develop a strategy that brings these concepts to the Islamic marketplace.

V. THE PROCESS

A. In General

Product development is very much a process. It should be comprehensive, well documented and fully understood within the organization. It must have internal cooperation and support from all parties whose contribution is crucial. The "buy-in" of people selling the product and upper management are especially important. The adage, "the chain is only as strong as its weakest link" holds true and hence the importance of strong linkages.

The process should be logical and orderly with clear responsibilities and strong adherence to commitment. All aspects are important from the concept generation through to manufacturing and packaging and to the final launch of the product.

After launching, the ongoing responsibility might no longer fall within the product development area. Ongoing maintenance may be shifted to another unit, such as fund administration or an operations group. Relationship management with the customer clearly plays an important role. The ability as well as the process of

monitoring should be inbuilt and accountable during the product development process. An Islamic product must be closely monitored throughout its existence for compliance with the *sharīʿa*, especially if there is any uncertainty in an existing strategy.

B. A Checklist: Simple and Effective

A checklist is a useful tool. It helps in the planning and coordination of the project plus the identification of potential bottlenecks. It can help those involved to focus, learn from experience and periodically refine the process and the checklist. The checklist also plays a role in confirming compliance with relevant regulations and reassures the product development team.

No detail is too small for this planning checklist, including something as simple as establishing a bank account and designating the authorized signatories on that account. The following items may be found on the checklist along with due dates and the individual(s) responsible for completing each task: the Name of the fund, a budget, a terms sheet, *sharīʿa* review and *fatwā*, entity jurisdiction, classes of shares, status of core legal documents (Memorandum and Articles of Association, Investment Advisory Agreement, Management Agreement, Islamic Advisory Agreements, Placing Agreement, Custodial Agreement, Prospectus, etc.), marketing brochure including translation, launch schedule, stock exchange listing requirements, and the selection of directors.

C. Planning

Up-front planning pays considerable dividends later and it may even demonstrate the need to delay a product or scrap it all together. It is critical not to lose sight of the customer and his values, likes, dislikes and to tailor the product to meet those needs. It is possible to create a product that will appeal to a wide audience such as institutional, retail and high-net-worth individual.

A basic blueprint should be developed. A one or two page Terms Sheet which contains the basic structure, highlights any potential *sharīʿa* issues, sets forth the investment objectives, names the service providers, gets the fees structure, indicate the tenure of the product, and the benchmark by which performance will be measured. Differentiation through the salient features can be highlighted.

It is important to prepare a budget and make sure all necessary internal and external resources are secured. The requirement for some form of outsourcing will be necessary and likely but this depends on the organization and its competencies. A launch date ought to be targeted while setting milestones along the way.

D. The Internal Team

Harnessing internal resources from within the organization is important but this is best done under a team approach since it helps pool resources and expertise. The internal team may include upper management, *sharīʿa* counsel, the product development department, marketing, legal, compliance, internal audit, back office, fund administration, relationship management, treasury, accounting, and asset management.

A qualified workforce is crucial. Teamwork with a real spirit of cooperation and cohesion is essential and this can be established with clearly defined and well-understood responsibilities.

E. When Do You Get the *Sharīʿa* Scholars Involved?

The essence of a *sharīʿa*-compliant product is the *sharīʿa* compliance. Certainly before the product goes out of the door, *sharīʿa* signoff must be complete. Investors often ask for the *fatwā* and perhaps other underlying documents supporting the representation that the product is not inconsistent with the *sharīʿa*.

It is critical to involve the scholars from the beginning, in the middle and through to the end of the whole process as a general rule. This will open timely and meaningful communication between the *sharīʿa* scholars and the product developer and scholars will produce the best result. However, for some products the input ought not be too time consuming as the structure presented is well known and therefore perhaps not even an issue. Since it is clearly a two-way street, the *sharīʿa* scholars may express their views on the most efficient means of communicating matters.

In summary, the scholar must be well informed in advance and incase of any doubts it must be cleared before the launched of the product. This can be facilitated by a close and open relationship with the *sharīʿa* scholar.

F. Putting Together the Project Team

The project team and the internal team are essentially the same when the organization does not outsource and builds the product internally from start to finish (including the *sharīʿa* clearance). This is an unlikely scenario but is not impossible. The more common route is outsourcing through which, the service provider is able to focus

on its own core competencies while acquiring the core competencies of others. This concept is generally well understood and accepted in the industry today.

The goal is to bring together a smooth, efficient, and harmonious team, much like a renowned orchestra. All members should be committed and competent to manage the integration of internal and external skill sets, resources, and expertise. The following team members may participate.

1. *Sharīʿa* scholar: *Sharīʿa* clearance and adherence is critical throughout the whole product lifetime as discussed earlier. The scholar is an indispensable member of the team furnishing it with leadership and authoritative guidance as well as providing *fatwā*.
2. Islamic Financial Advisor: The Islamic Financial Advisor may be the sponsor, coordinator, or its role may be limited in scope to specific areas. The role of this team member may include interfacing with the *sharīʿa* scholar(s), assisting in the application of the *fatwā*. The advisor should provide guidance on Islamic financial techniques and solutions on general and specific business matters with respect to assuring the compliance and promotion of the product.
3. Asset Manager: The selection and monitoring processes are important. The people involved must understand their experience level, record of accomplishment, methodology, and approach. If it is an external party, analyze the organization; its internal compliance, reputation, competitors, disruptions caused by internal restructuring, references and any other information on it. Whether an asset manager has experience in managing Islamic-compliant investments may also be a consideration. There may be benefits in selecting an asset manager with experience in managing Islamic-compliant investments and some familiarity is helpful.
4. Custodian/Registrar/Administrator: These specialists play a significant role in the organization. Some cost highly while others are less expensive but either case, their performance depends on their remuneration. It is necessary to get as much information as possible on their record of accomplishment before they get recruited. Using the same provider for multiple products or funds does create efficiencies.
5. Lawyer: The lawyer's role will involve assistance regarding compliance with the law of the land as opposed to the *sharīʿa*. It is required that the lawyer be commercially oriented, has some familiarity with Islamic concepts or at least recognizes the need to invest time in order to get up to speed, and is responsive. The selection and retention of the lawyer who is best suited for the engagement is based on all the facts and circumstances.
6. Directors: In a separate entity structure, directors, trustees, a general partner or some other position of overall legal authority is required. There has been considerable press given recently to the role and function of independent directors and this should be given some consideration.
7. Distributor/selling agents/marketing group: The personnel charged with the selling are indispensable. If the product cannot sell the venture will certainly fail.
8. Customer: The customer is part of the team since the creation of the product is meant for the end user.
9. Project coordinator: This person helps to pull the whole thing together thus they must have the proper authority. A good manager is one who works well with people in championing a common cause, working under pressure and keeps abreast with all the crucial development in the process. It is also helpful that the occupier of this position is a good problem solver.

VI. Other Matters

A. Distribution

Distribution in the industry generally needs to be strengthened. The choice of the distribution channels used is a strategic decision that is incorporated within the product development process and is integral to the process. The Internet and Web-based deliveries are changing the landscape. Product labeling, brand management, brand recognition, and advertising need to be properly planned and executed.

Should Muslims be the only target? The products are not really "Islamic products" but rather products that do not in their totality require rejection based on *sharīʿa* criteria. Thus one should seek a broader audience with a quality product and superior service.

B. Other Matters

There are perhaps as many different considerations to be aware of as there are products and organizations developing the products. A few matters that often raise questions are:

- What is the best choice of domicile (e.g. Cayman Islands, Luxembourg, etc.)?
- What is the best choice of structure (Limited Liability Company, Master Feeder, *mu∞āraba*, or *mushāraka*)?
- In anticipation of growth, what structure offers the most flexibility in terms of distribution (e.g. a UCITs or Undertakings for Collective Investments in Transferable Securities under the European Community 1985 Directive)?
- What are the rules regarding distribution over the Internet?
- Should the Fund be listed?
- What is the best way to create liquidity for investors?
- What is the best way to reach the Muslim population in the United States?

VII. CONCLUSION

Product development in the Islamic financial services industry is a comprehensive process. It requires additional steps compared to a conventional product because of the additional and special requirements of the Islamic investor.

Product development is preferably customer driven. It is best to determine the values, needs and wants of the customer by reaching out and performing the proper analysis. Results of market research are then acted upon in a timely and responsive manner.

A team approach to product development works best. All members of the team (internal and external) play a critical role in ensuring that the investor receives the best possible product. There are no quick answers. Product development in this industry is difficult work. It is also extremely rewarding and can be fun.

The Role of Venture Capital in Contemporary Islamic Finance

Aamir Khan[*] and Tariq Al-Rifai[†]

ABSTRACT

At the forefront of the emerging "new economy" are the venture capital companies that supply much-needed equity to bring entrepreneurial ideas into reality. Such equity investments at the early stages are a pure form of *mushāraka* financing, not only because of the partnership relationship but also because investors can stipulate how they want their funds used. Given these exciting developments, one must wonder why Islamic financial institutions, for the most part, have shied away from venture capital. This paper is an analysis of this and an overview of the many Islamic venture capital opportunities. It will discuss why Islamic institutions have eschewed venture capital, give examples of Islamic venture capital investments, analyze industry segments and technologies with exceptional growth opportunities, structure an ideal *sharī'a*-compliant venture capital deal, demonstrate opportunities to capitalize on entrepreneurship, and briefly describe some of the players and their roles and responsibilities.

I. INTRODUCTION[1]

Rapid developments in new technologies over the last decade have created enormous amounts of wealth in developed countries. NASDAQ, which is recognized as the world stock market for technology companies has seen its market capitalization grow from $386 billion in 1989 to $5,205 billion in 1999.[2] New technology companies, more commonly referred to as "new economy" companies, are leading the way for future economic growth. At the forefront of this economic shift are venture capital companies. These companies provide much-needed financing to bring the entrepreneurial idea from concept to reality.

This paper aims to describe the venture capital lifecycle from fundraising to structuring and exiting, and ultimately review its application under a *sharī'a*-compliant framework.

II. INDUSTRY SIZE AND KEY STATISTICS

To put the venture capital (VC) industry into perspective, in 1993 there were an estimated $3.9 billion worth of VC deals closed in the U.S. In 1999, there were $46.6 billion worth of deals according to the National Venture Capital Association (NVCA). It was also reported that there were $22.7 billion in VC deals recorded in the first quarter this year alone, which is a 266% increase over the same period last year and a new record.

It is probably not surprising that over 80% of VC funding went to computer-related and communication companies. Computer-related includes Internet companies as well as B2B and B2C companies. Over 85% of these deals occurred in the early or expansion stage of the companies' life cycles.[3]

In a more in-depth study of the industry, professors Josh Lerner of Harvard University and Samuel Kortum of Boston University examined the impact of venture capital on innovation and economic development in their paper "Assessing the contribution of venture capital to innovation."[4] They examined the influence of venture capital on patented inventions in the United States across twenty industries over three decades. Their findings suggest that venture capital accounted for 8% of industrial innovations in the decade ending in 1992. Given the rapid increase in venture funding since then, with the assumption that the potency of venture capital funding remained constant, the results implied that venture funding accounted for about 14% of U.S. innovative activity by 1998.

[*] Controller and Vice President, ABN AMRO Venture Capital & Mezzanine Finance, Chicago, Ill.

[†] Partner, The International Investor, London, United Kingdom. Since reading his paper at the Fourth Forum, Al-Rifai has moved to HSBC Amanah Finance, HSBC Group, New York, N.Y.

III. VENTURE CAPITAL LIFECYCLE

A. Fundraising

Fundraising can be defined as the role played by professional investors who provide equity or equity-linked capital (to be discussed below) to privately held companies. A key element in this equation is the involvement of the private equity investor in monitoring and assessing the company on an ongoing basis.

1. Funding Sources

Funding for venture capital activities tend to come from other corporations, insurance companies, high-net-worth individuals (i.e., angels) and a large portion tends to come from pension funds and university endowments as they are flush with extra cash and are willing to diversify small portions of their portfolios into higher risk investments.

2. Venture Fund Structures

There have been a growing number of venture capital funds in the United States that seek out private equity deals and venture funding. These funds have not only grown in size but also in depth and market coverage. Over two-thirds of all venture capital funding in Asia was sourced from U.S.-based capital in 1994.

These private equity and venture capital funds are usually structured as limited partnerships (LP). The same holds true in developing countries except where it make more legal sense to structure as a corporation, as is the case in Asia.

The general partners in an LP are in charge of raising funds, choosing investments, monitoring transactions and exiting investments when appropriate. In return they are paid a management fee plus a share of profits. Partners play an active role in managing their portfolio of investments. In many cases, the general partner will provide "incubation" assistance to help new companies get on their feet.

B. Investing

As is commonly known, venture capital investors tend to focus on companies in the high technology area. In this section the paper will discuss the identification of potential investments, deal structure, valuation, and exit strategies with the high tech industry in mind.

1. Identifying Potential Investments and Due Diligence

Venture capitalists receive hundreds more investment proposals on their desks than they can select for investment. As a result, screening for the best investments are a major focus of the venture capitalist.

Some of the qualifying criteria they look for include the need for "chemistry" between the venture capitalist and the entrepreneur along with the commitment, reputation, and creativity of management. There are other criteria that are key in the decision-making process such as the size of the market, competition, threat of obsolescence, and the ability to exit. However, venture capitalists point out that the overriding factor in the success of any venture is management.

2. Structuring the Transaction

Investors tend to use a variety of financial instruments to structure a transaction. These include, but are not limited to, different classes of preferred stock, debt, warrants, and in a few cases common stock may be used in conjunction with other instruments. Combinations of two or more instruments or hybrid instruments are also used. These instruments allow the investor to allocate risk, establish ownership rights, control management, and provide them with incentives. As we shall see, keeping management in the company and keeping them motivated is usually the difference between the success and failure of the subject company.

In the following sections the paper discusses six different instruments that are most commonly used in structuring a deal, but we begin with a brief discussion on why common stock is not an effective instrument.

a. Common Stock

Common stock is the most widely held form of equity, especially for publicly held companies. However, it does not carry any special rights outside of those outlined in the company's charter and bylaws. It gives the holder of such stock ownership, but it is at the bottom of the food chain after government claims (i.e., taxes), regulated employee claims (i.e., pensions), debt, and preferred stock. For example, if the company files for bankruptcy, all of the above claims must be satisfied first before holders of common stock see any benefits or claims to company assets. This is the main reason why venture capitalists avoid common stock transactions.

The example below will highlight the case for the venture capitalist and will be used to further describe other instruments.

A newly formed company called Company.com is looking for a venture capitalist to finance its great idea for a new internet portal. Management believes it has developed leading edge technology to capture a sizable portion of web-surfers. Company.com meets with VC Corp., who likes management and the business plan and agrees to provide Company.com with $5 million it requires to get it operational until the next round of funding. Both parties agree to issue common stock for the deal where Company.com holds 50.1% of the firm (to maintain controlling interest) and VC Corp. holds 49.9% of the common stock. Therefore, VC Corp. valued the company at $10 million (rounded figure). Company.com receives a valuation for its tangible assets such as computers, office space, and some intangible assets such as employees, business plan, …etc.

Immediately after the closing, Company.com receives an offer to buy the company for $8 million from BigPortal.com, an internet portal company that is flush with cash and wants to maintain its leadership in the field. Since Company.com can realize an instant gain on its venture and maintains controlling interest, it agrees to sell to BigPortal.com. Company.com immediately receives $4 million for one day's work, while VC Corp. losses $1 million instantly on its $5 million investment.

This situation would have never happened in a real-world transaction since the venture capital firm would have ensured that its investment was protected from such events. However, in this example, VC Corp. could have avoided this tragedy by using several other instruments, such as preferred stock, vesting management's interest in the firm, and using covenants.

The valuation given to Company.com was based on the potential value and not the current tangible value. Venture capitalists bridge the gap between value accretion events while at the same time the entrepreneur's/management's stake should not be perfected until he/she has delivered on the promised value. This is the basis for using instruments other than common stock. Company.com did not earn its equity at the time of the BigPortal.com purchase and that violated the basic principle of reward for performance.

b. Preferred Stock[5]

Preferred stock has preference over common stock in the event of sale or liquidation of the company. Preferred stock has a face value that is paid out before looking at common stock. Typically, the face value of preferred stock in a private equity transaction is the cost basis the venture capitalist pays for the stock. In the example above, if VC Corp. used preferred stock it would have been paid back its original investment through redemption of the preferred shares. Any amount above the preferred redemption would be paid out to common stockholder and divided according to the type of preferred stock used. Redeemable, convertible, and participating convertible preferred stock will be discussed next and we will see the outcome of the sale of *Company.com* to *BigPortal.com* under each scenario.

Redeemable Preferred Stock

Redeemable preferred stock is stock that has no convertibility into equity. Its value, therefore, is its face value plus any dividend rights.[6] Redeemable preferred then acts more like subordinated debt than equity. The stock carries a negotiated term specifying when the investor, most likely the sooner of a sale or public offering, or five to eight years, must redeem it. It is used in private equity transactions in conjunction with common stock or warrants.

In the example above, if VC Corp. issued redeemable preferred stock with a face value of $5 million, plus a split of common stock as before (50.1% held by Company.com and 49.9% held by VC Corp.), the outcome of the sale to *BigPortal.com* would have looked much different. If the company were to be sold, VC Corp. would have redeemed it redeemable preferred stock at its face value of $5 million and the remaining $3 million would have been split according to common stock ownership, hence $1.5 million additional to VC Corp. and $1.5 million to *Company.com*. In effect, VC Corp. would have received its original investment back and kept its equity investment in the company. However, this "double-dipping" effect by VC Corp. would have a negative impact on the company's valuation since it would continue to maintain its ownership of the company without any real investment. This led most private equity deals to go with convertible preferred shares instead to maintain the risk/reward balance mentioned earlier.

Convertible Preferred Stock

Convertible preferred stock is stock that can be converted at the shareholder's option into common stock. In this situation, the shareholder must choose between redemption of his/her preferred shares at face value or convert them into common stock. Obviously if the value of the stake is worth more than the face value of the preferred shares, the shareholder will convert to common stock and realize a gain in value. The issuance of

convertible preferred stock is the most common used financial instrument by venture capitalist and tends to be used in parallel with other instruments.

In this scenario, if both parties agreed to the issuance of convertible preferred stock, VC Corp. would have opted to redeem its shares at face value ($5 million) since 49.9% of the $8 million sale would have been roughly $4 million. *Company.com* would receive the remainder. However, if *BigPortal.com* had offered $12 million for the purchase of the company, VC Corp. would have clear chosen to convert its shares since the value would have increased to $6 million.

Participating Convertible Preferred Stock

Participating convertible preferred stock is the same as convertible preferred stock with the additional feature that in the event of a sale or liquidation of the company, the shareholder has the right to receive the face value and the equity participation as if the stock were already converted. Thus, the shareholder does not have to decide between redeeming or converting since any increase in value over the face amount would be given to the investor in the form of common stock or cash equivalent. Using the previous example, VC Corp. would have received the same in value. The difference lies in what VC ended up having. Under the convertible preferred scenario, VC Corp. would have had to choose between redemption for face value or converting all to common stock. Under the participating convertible scenario, VC Corp. would have received redemption for face value plus common stock for any value above that.

When a company decides to go public, markets expect the company to have a simple capital structure (i.e., only common stock or debt). This is why underwriters insist that all preferred stock be converted before an initial public offering (IPO). To avoid further negotiations between investors and the company, convertible stock usually contains a mandatory conversion clause that specifies that the company can force a conversion as part of an IPO of a certain negotiated size and price. The size and price tend to be high enough to insure that it is in the investor's interest to convert.

It is important to note that the numbers in the examples above were clearly hypothetical. A venture capital firm would never enter into such a transaction unless there is strong potential to earn high returns on its investment, typically between 55% to over 700% annually.

c. Vesting

The concept of vesting states that an entrepreneur's stock does not become his/her own until being with the company for a certain amount of time or until some value creation event occurs (i.e., reaching sales targets or in the event the company receives an offer to sell). Vesting occurs over a period of time (i.e., three to four years) and the stock becomes vested (entrepreneur has ownership) proportionally over that time period. This can be yearly, quarterly, or even monthly.

Previous research has shown that preferred stock transactions do a better job of "reward for performance" since it relies on the investment's terminal value. Also, vesting is a basic contract where for it to be as effective as preferred stock, potential situations and events must be anticipated and written down. The main appeal to having a vesting clause in a contract is because it plays a very important function of preventing management or employees from leaving the company and taking with them valuable resources. If the company is doing well and a key member of management holds valuable stock that would be lost if he/she left before a certain date/event, then the incentive to leave become a lot less.

Therefore, vesting protects the incentive stock from employees that have not held up their end of the deal and retains it for others who have. This also protects the morale of employees knowing that the ones who leave will not receive the same benefits as those who stay.

d. Covenants

Covenants are agreements between the investor and the company and are, by far, the simplest way for the venture capitalist to protect their investment. They include such elementary stipulations such as providing investors with audited financial reports, having board meetings, and paying taxes on time.

Covenants are also used to ensure that the venture is being operated according to the plan and pre-agreed guidelines. Since the venture capitalist is also concerned about changes in control, an agreement may state that the entrepreneur cannot sell/issue any common stock or enter into a merger without approval of the private equity investors or offering stock to the original investors first. Transfer of control is also important to venture capitalist since they put a lot of time and money in investing in the people.

The main reasons for having covenants are to disconnect control on important decisions from owning a majority equity stake. This leaves management to deal with operational issues and investors to deal with the financial matters.

C. Valuation

The valuation of any investment proposal is based on many factors both internally and externally. Internal factors include some mentioned previously such as management's experience, commitment, and reputation along with their ability to attract and keep top talent. The company must also show that it has potential for its products/services and can compete with others.

External factors include both industry-specific and macroeconomic. Industry specific factors include the competitive environment, industry growth, analysis of key players in the field, the value placed on similar ventures, rates of return (previous and expected), and investor demand. Macroeconomic factors include the overall health of the economy, trends on the stock market, and the government regulatory environment.

D. Exit Strategies

Contrary to popular belief, most ventures do not reach the IPO stage. It is estimated that over half get merged or bought out by competitors and other rivals. Some large companies have special venture arms that seek out companies in their industry with promising prospects. Companies such as Microsoft, Intel, Cisco Systems, Nortel Networks, and Sun Microsystems all have in-house venture capital departments. This is common in the high tech business since the leaders have to constantly be on the leading edge of new developments to secure their survival.

Likewise, over 55% of IPOs are not venture-backed, which in most cases means that the company either had internal sources of funding or was an offspring of a larger company.[7] A good example of this was the recent AT&T Wireless IPO, which was the largest IPO to date raising $10 billion.[8]

IV. Bringing It All Together under a *Sharīᶜa*-Compliant Framework

Now that the key elements of a venture capital transaction have been discussed, it is important to look at how this can fit into a *sharīᶜa*-compliant structure. There are a few basic questions that need to be answered to determine this. First, is venture capital an acceptable investment vehicle for Islamic investors? If so, then the next question would be whether or not the structure mentioned above is *sharīᶜa*-compliant. If not, what structure can be used?

A. *Sharīᶜa* Views on Equities

Sharīᶜa scholars are in agreement that venture financing at the early stages of a company's life is a classic form of *mu∞āraba*[9] financing, not only because of the relationship between the provider of capital and the user, but also because investors can stipulate how they want their funds used. A *mushāraka*[10] structure is another tool that can be used be used to finance a venture.

To illustrate the acceptance of equity under *sharīᶜa* let's take a look at the equity fund industry. Prior to 1995 there were only a handful of Islamic equity funds on the market compared to over 100 today. Islamic bankers realized that if they wanted to become a serious alternative to conventional banking, they had to offer similar investment choices as their conventional rivals.

In the early nineties, Islamic bankers were set in developing equity funds where Muslim investors are able to participate in the growth of world equity markets. *Sharīᶜa* scholars had the complicated task of setting the parameters by which Muslims can invest. Today, equity funds are a standard product offered by Islamic institutions.

To sum up the *sharīᶜa* view on equities, the following is a statement issued by a prominent *sharīᶜa* scholar in the Gulf:

> "… If we consider the circumstances of these companies (traded on world stock exchanges), we realize that they constitute an indispensable need in the economic structure of the country, and no state can dispense without them. Moreover, they meet the urgent needs of individuals for investing their savings."

B. The Fundamental *Sharīᶜa* Principle of *Muᶜāmalāt*

This principle, which is clearly defined in jurisprudence, relates to human dealings and contracts along with issues regarding human relations. It simply states that everything is permitted unless clearly prohibited. As such,

private equity and venture capital are perfectly acceptable modes of finance and investment provided they meet certain Islamic guidelines.

The principle of *muᶜāmalāt*, which literally translates into "dealings," should not be confused with the *sharīᶜa* principle of *ᶜibāda*, which literally translates into "worship." The principle of *ᶜibāda* states that everything is prohibited unless permitted and this relates to all issues of worship and not dealings.

Thus, trade and business activity is permitted and is actually encouraged. Since trade and business fall under the principle of *muᶜāmalāt*, entry into business dealings is permitted if they avoid prohibited activities (i.e., paying or receiving interest).

C. Structuring Issues

Although investing in a venture is an acceptable financial transaction, some aspects of the structure mentioned in 3.2.b. are not in line with *sharīᶜa* guidelines. These aspects are mainly related to the structure of preferred stock and shares that act like debt instruments. A *sharīᶜa*-compliant structure aims to balance the risk/reward benefits to all parties involved in a deal. As such, any financial instrument that acts like a debt security where the investor can get a "riskless" reward is prohibited. However, if the burden of risk is tilted unevenly toward the investor, the investor will lose the incentive to participate in an unexpectedly high-risk venture. What can be done to balance the risk in a *sharīᶜa*-compliant venture? Fortunately, as Islamic banking continues to develop, new and innovative financial instruments are being developed to answer these questions. The following aims to offer solutions to two issues, the first regarding the use of preferred stock and the second regarding the use of a discount rate to arrive at a company's valuation.

1. Preferred Stock

In order to minimize the downside risk to Islamic investors, workable Islamic alternative to preferred stock has been suggested, but there is no evidence to see whether or not such an instrument has been used in a venture capital transaction. This "Islamic" preferred stock acts like a pure preference share with predetermined varying profit ratios. There can be no accumulation of profits and no liquidity preference to one investor over another in case of a sale or liquidation. Thus, this is more like common stock with predetermined profit ratios.

2. Valuing Company Using Discount Rate

Since private equity deals are by nature risky transactions for several reasons, true valuation of the deal is crucial to achieve a target rate of return. Conventionally, discounting rates are benchmarked against some risk free security, such as U.S. Treasuries. This is a gray area from an Islamic perspective. However, Islamic investors need not worry about such discount rates since venture capitalist tend to value a company based on (a) returns on a project of a similar risk profile, (b) the average return on a well diversified equity portfolio. This is *sharīᶜa*-compliant.

3. A Workable Solution under Existing Structures

Finally, a simple and ready to use solution is available but may not be an optimal solution for some Islamic investors. The solution is to use a combination of vesting and covenants along with the issuance of common stock. Both vesting and covenants can be easily designed for the Islamic venture capitalist and will avoid costly structuring of untested financial instruments.

Islamic investors can pool their resources into a venture capital fund to seek out lucrative investments, while at the same time, minimize their risk by spreading it across a diversified investment portfolio of companies.

V. Conclusion

Venture capital is a lucrative industry not only for investors but also for the overall advancement and development of economic and innovative commercial activity. Even though some financial instruments used in conventional venture capital structures are not compliant with *sharīᶜa* guidelines, there are alternatives already available and used on the conventional side that can immediately be used by the Islamic venture capitalist. There are also new Islamic instruments being developed to address other investor concerns.

A few Islamic financial institutions have been involved in venture capital deals. Their approach, however, has been that of a provider of funds rather than a lead investor. Such institutions tend to rely on the knowledge and expertise of others and would simply "piggyback" on the transaction. Islamic institutions are slowly realizing the potential of this industry and are more willing to take a leading role in private equity deals.

The potential for purely "Islamic" venture capital is large. There are many Muslim entrepreneurs living in developed countries that are seeking Islamic VC. In Silicon Valley, for example, several high-tech start-ups launched by Muslims have attracted the attention of mainstream VC companies. Since Islamic financing was not available to them, the entrepreneurs opted for conventional financing.

There is clearly an opportunity for an Islamic financial institution to create a niche market that specifically targets Muslim entrepreneurs in high-tech hotbeds like Silicon Valley. This is not to say that there are no opportunities in developing countries. There has recently been a $50 million venture capital fund launched by the Islamic Development Bank (IDB) that is targeting high tech ventures in Muslim countries.[11]

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[1] The authors would like to thank Professor Josh Lerner of the Harvard Business School for sharing his research on private equity and venture capital, and Mansoor Durrani, a doctoral researcher in private equity, of Loughborough University for sharing his thoughts on structuring Islamic venture capital.

[2] NASDAQ. http://www.nasdaq.com.

[3] National Venture Capital Association. http://www.nvca.org.

[4] Lerner, Josh. "Assessing the Contribution of Venture Capital to Innovation." Available on http://www.people.hbs.edu/jlerner.

[5] Lerner, Josh. "A Note on Private Equity Securities." Cambridge: Harvard Business School, 1999.

[6] Typically, private equity deals, because investment are made in new and growing companies, never result in dividends because all profits are "plowed back" into the company for continued growth.

[7] National Venture Capital Association.

[8] http://www.ipo.com.

[9] An agreement between two parties, one party provides 100% of the capital for a venture and the other, known as the *mu∞ārib*, manages the venture using his/her skills. Profits are distributed according to a pre-agreed ratio. Monetary losses are borne only by the provider of the capital, while the *mu∞ārib* loses his/her time, effort, and chance for remuneration. Management is provided solely by the *mu∞ārib*. The *mu∞ārib* does not share in any losses because, according to Islam, a *mu∞ārib* can not lose what he/she did not contribute. *Mu∞āraba* is among the most common modes of Islamic financing.

[10] This is a classical partnership agreement. All parties involved contribute toward the financing of a venture. Profits are shared according to a pre-agreed ratio, while losses are shared according to each party's equity. Management of the venture is carried out by all members, some members, or just one member.

[11] IslamiQ Financial Daily. http://www.islamiqdaily.com.

Do Islamic Equity Funds Measure Up?

The View from Al-Tawfeek

Naseeruddin Khan*

ABSTRACT

The recent growth of Islamic investment funds can be attributed to not only their simplicity and profitability, but also to the growing expertise of *sharī*a* boards and to the availability of Islamic indices. Holdings in these funds—which concentrate on asset classes such as trade finance and commodities, leasing, equities, real estate, and venture capital—undergo a screening process that assesses a company's business line, debt/equity ratio, and fraction of income derived from interest, in order to determine whether the investment is *sharī*a*-compliant. Although this process reduces the potential stock universe by up to 95% and makes diversification more difficult, a case study of Al-Tawfeek reveals that the application of Islamic principles does not necessarily imply a lower return on investment.

I. INTRODUCTION

In the last three decades, the scope of financial services has widened considerably, and new types of financial institutions have emerged to provide new products and services. A major trend has been "disintermediation," wherein the traditional intermediary role of banks has been bypassed by investment management institutions. These offer investors direct participation in primary and secondary markets by pooling their investable funds, enabling them to choose their desired level of risk and earn a commensurate return. The investment vehicle through which this is accomplished is the mutual fund, also known as the investment fund or the unit trust.

Islamic finance has developed in the same period as the growth of mutual funds, and certainly Islamic finance has not gone untouched by it. The Islamic investment fund, defined in the current Islamic banking practice as a joint pool (*mu∞ārabah*) wherein investors contribute their surplus money to earn ®*alāl* profits from investment in strict conformity with the injunctions or precepts of the *sharī*a*, has gained wide acceptance in Islamic finance. According to some estimates, there are more than 100 Islamic equity funds worldwide (Table 1 indicates the recent statistics of the industry).

TABLE 1. ISLAMIC EQUITY INVESTMENT FUNDS

Name of Fund	Fund Promoter	Investment Advisor	Fund Size (US$m)	Return Since Inception
Global Equity Funds:				
AlFanar Investment Holdings	Worms & Cie/SEDCO	Permal Asset Management	120	43.90%
Al Rajhi Global Equity	Al-Rajhi Banking & Inv. Corp.	UBS Asset Management	–	55.01%
Al-Safwa Int'l Equity	Al-Tawfeek Co. for Invest. Funds	Roll & Ross Asset Mgmt.	22	56.10%
Oasis International Equity	Robert Flemings	Fleming Investment Mgmt	5.7	37.30%
Global Trading Equity	National Commercial Bank	Wellington Management	–	–
Al-Bukhari Global Equity	The Int'l Investor	Wafra Invest. Advisory Grp./TII	9.5	19.03%
Al-Dar World Equities	The Int'l Investor & Pictet	Pictet & Cie	61.1	45.54

* General Manager, Al-Tawfeek, Dallah Albaraka Group, Jeddah, Saudi Arabia.

Riyad Equity Fund 2	Riyad Bank	Riyad Bank	–	28.60%
Global Equity Fund	Al Baraka Islamic Bank BSC (EC)	Mercury Asset Management	–	–
GAM Al-Kawthar	Al Baraka Islamic Bank BSC (EC)	Global Asset Management Ltd.	12.4	55.30%
Arab Investor Crescent Fund	Arab National Bank	Schroeder Invest. Mgmt. Int'l.	5.587	–
Miraj Global Equity Fund	Miraj Int'l Investment Ltd.	Royal Bank Invest. Mgmt.	–	18.76%
Barclays Islamic Portfolio	Barclays Private Bank		3.0	51.33%
Asia Equity Funds:				
Al-Nukhba Asia Equity	Al-Tawfeek Co. Investment Funds	Nomura Invest. Banking (ME)	–	3.63%
Middle East Equity Funds:				
Al-Rajhi Middle East Equity	Al-Rajhi Banking/Invest. Corp.	Bakheet Financial Advisors KSA	19	–33.36%
East European Equity Funds:				
Al-Dar East European Equities	The Int'l Investor & Pictet	Pictet & Cie	13	22.83%
European Equity Funds:				
Al-Sukoor European Equity Fund	Commerz Bank/ Al-Tawfeek Co.	Commerze Int'l Capital Mgmt.	18	38.4%
Al-Dar East European Equities	The Int'l Investor & Pictet	Pictet & Cie	21.5	–
Europe Trading Equity Fund	National Commercial Bank		–	4.70%
AlFanar Europe Ltd.	Worms & Cie/SEDCO	Permal Asset Management	19	–
Capital Protected Equity Funds:				
Al-Ahli US Secured Fund Index	Faysal Islamic Bank of (BH)	Banque National de Paris (Bahrain)	–	
Faysal Shield Fund	National Commercial Bank	Deutsche Bank	252	–
Al-Ahli US-Secured Fund				
Small Cap Equity Funds:				
TII Small Cap	The Int'l Investor	Pictet Asset Management UK Ltd.	23.1	41.00%
Small-Cap Trading Equity	National Commercial Bank		–	–
Small-Cap Fund	Al-Rajhi Banking & Inv. Corp.	Merrill Lynch	–	8.69%
ZAD Growth Fund	ZAD Assset Management LLC.	Awad & Associates/Roanoke A.M.	–	29.24%
Emerging Markets Equity Funds:				
Ibn Majid Emerging Markets	The Int'l Investor	UBS Brinson	19.8	19.20%
Country Equity Funds:				
Saudi Arabia Equity Funds:				
Al-Arabi Saudi Co. Shares	Arab National Bank		–	–
Al-Rajhi Local Share	Al-Rajhi Bank. & Invest. Corp.	Al-Rajhi Banking & Invest. Corp.	–	–
Saudi Trading Equity	National Commercial Bank	Bakheet Financial Advisors	–	35.48%
Egypt Equity Funds:				
Al-Rajhi Egypt Equity	Al-Rajhi Bank. & Invest. Corp.	EFG Hermes (Egypt)	–	24.68%
U.S. Equity Funds:				
Alkhawarizmi	The International Investor	Axa Rosenberg Invest. Mgmt. Ltd.	16.9	5.80%
US Trading Equity Fund	National Commercial Bank		–	–
AlFanar U.S. Capital Value	Worms & Cie/SEDCO	Permal Asset Management	30	2.80%
AlFanar U.S. Capital Growth	Worms & Cie/SEDCO	Permal Asset Management	27	7.80%

South Africa Equity Funds:				
Oasis Crescent Fund	Oasis Asset Management	Oasis Asset Management	–	–

The growth of the sector has been explosive. Without taking capital appreciation into account, Islamic mutual funds are growing at a rate of between 20–25% a year, making these investment funds one of the fastest growing sectors of the industry. The total value of equity funds under Islamic management has grown to $1–3 billion within a relatively short time.

What explains this growth? These funds have been noticeably popular among both Muslim and non-Muslim investors. Certainly, the simplicity and profitability of these funds deserve mention. Furthermore, *sharī'a* boards have demonstrated greater understanding of the mechanisms of these funds, so much so that even the conventional banking industry is emulating the Islamic finance sector and is appointing *sharī'a* boards in an effort to enter the Islamic investment fund market.

Recent growth of Islamic investment funds also owes much to the availability of Islamic indices that track the movements of *sharī'a*-compliant stocks in the global equity markets. These indices—such as the Dow Jones Islamic Market Index (DJIM), the FTSE Global Index and the four FTSE sub-indexes covering North America, Europe, the Pacific Rim and South Africa, and the MSCI Eastern European Index—serve as suitable benchmarks for Islamic investment funds. The presence of these equity indexes may further encourage growth of the sector.

II. ASSET CLASSES

Islamic mutual funds concentrate on various asset classes, most importantly trade finance and commodities, leasing, equities, real estate and venture capital. Each of these classes carries its own advantages and features.

A. Trade Finance and Commodities

Trade finance transactions are generally short-term with a fixed profit margin and are secured by tangible assets. Funds investing in such transactions provide a relatively safe and predictable return with little or no change in the fund's paid-up value. Commodity funds earn returns by trading of commodities, generally base metals. Such funds can have a relatively simple structure without the necessity for any offshore incorporation, custodian, or administrator.

B. Leasing

Leasing or *ijāra* funds securitize periodic, predetermined cash flows from leasing transactions. Like trade finance and commodities transactions, leasing transactions and fund structure are relatively simple and do not require extensive fund management input.

C. Equities

Islamic equity funds may be global or regional in scope. While most sponsors are located in Islamic countries, such funds' extensive investment focus necessitates professional investment management, both custodial and administrative. These are often located in the major financial centers. Many of these firms are incorporated offshore. Hence, unlike trade financing and leasing, these funds naturally have more complex structures.

D. Real Estate/Venture Capital

While the previous three asset classes are more common, other asset classes such as real estate and venture capital are being increasingly targeted and structured in a *sharī'a*-compliant manner. Al-Tawfeek, for example, has structured and marketed a real estate fund with paid-up capital of $52 million and a development fund with paid-up capital of $108 million.

III. *SHARĪ'A* "SCREENING" FOR EQUITY FUNDS

Perhaps the defining characteristic of Islamic investment portfolios is the presence of *sharī'a* screening. All companies violating a certain set of conditions defined under the *sharī'a* are eliminated from the Islamic

investment portfolio. The process is continuous in the case of Al-Tawfeek, where funds not meeting the criteria described below are removed from the investment portfolio.

A. Economic Activity

Securities that are issued by business entities that operate in any of the business lines prohibited by the *sharīʿa* cannot be included in an Islamic investment portfolio. Many scholars cite industries that are environmentally damaging or socially undesirable as prohibited business lines as well.

Thus companies that deal in impermissible products or services (including alcohol, pork, gambling, interest-based financial institutions) are excluded from the portfolio. The liquidity of Islamic funds cannot be invested in interest-based or conventional money market securities. Most Islamic funds therefore endeavor to be fully invested in their target markets, with cash reserves maintained to meet redemption requirements only.

B. Debt/Asset Ratio

Generally, a firm cannot exceed a maximum debt-equity ratio (normally 30% or lower) in order to remain *sharīʿa*-compliant. However, the definition of debt (whether it entails all financial debt) and equity (book value or market value) can significantly impact the number of qualified companies that can be invested in. As of today, there are no uniform ratios or definitions in the industry.

C. Interest Income Received

Companies in which funds are invested should conform to certain financial criteria, designed to ensure that their operations and assets are not predominantly financed by debt, and that their incomes, which ultimately accrue to the shareholder, do not include a significant amount of interest. The ratio of interest income to total income is usually restricted to 10% or lower; the total income is defined either as net income or as earnings before interest and tax.

D. Cleansing of Returns

Since it is not possible to have only debt-free companies in the portfolio, the proportion of the portfolio's return that can be ascribed to interest income is "cleansed" by its donation to charity.

E. Effects of *Sharīʿa* "Screening": The Problem of Benchmarking

The *sharīʿa* criteria usually result in a portfolio comprising of mature companies with conservative capital structures. This can be an advantage. But it can also be a disadvantage in that many rapidly growing companies that can generate higher returns due to higher earnings growth are excluded, as such companies usually require substantial debt funding.

The business line and financing criteria result in the exclusion of a large number of companies from the investment universe. In researching international equity funds, more than 10,000 companies were analyzed, and a *sharīʿa*-compliant universe of only 5% of that number—or only about 500 firms—was identified. 22% of the excluded firms dealt in prohibited business lines. 62% of the firms borrowed excessively. 8% of the firms had excessive interest income. 3% of the firms were excluded for other reasons.

The objective of diversification is to have securities that do not move together, so that the adverse performance of some securities is cushioned by the better performance of others. The degree of diversification increases with the number of securities in a portfolio. In an expanded portfolio universe, diversification is achieved simply by investing in a large enough number of firms.

Sharīʿa compliance significantly reduces the investment universe, and so diversification cannot be achieved simply by having a large number of firms in the portfolio. Instead, diversification must be achieved through the extended analysis by managers of the correlation among the performance of various securities, and the effect on portfolio diversification of each security.

The *sharīʿa* parameters result in a portfolio that is not representative of the overall conventional universe. A *sharīʿa*-compliant fund cannot therefore be expected to track a conventional index. In this situation, one option is to go on using a conventional index that mirrors the fund's composition as closely as possible. Alternatively, an Islamic fund may have an investment policy that aims to mirror the broad parameters (allocation by region, country and/or industry) of an index. At the individual firm's level, however, the Islamic "bias" will show. For example, an Islamic equity fund comprising mainly of mature conservative companies may underperform a rapidly increasing index driven by growth companies, but would also have lower downside risk. The main advantage to the options mentioned here is that the conventional index will be familiar to most investors.

An alternative option is to take the Islamic investment universe as the relevant universe and develop a synthetic Islamic index based upon it. The fund manager's investment-selection skill can thus be reasonably assessed, against this synthetic benchmark. The disadvantage of this option is that many investors will find it difficult to conceptualize such an index.

Obviously, trade-offs are involved in either approach, and it is useful to keep these trade-offs in mind when analyzing the recent development of Islamic indices, a development that has been spurred by the growing popularity of Islamic funds.

IV. DOES ADHERENCE TO THE *SHARĪ'A* LOWER RETURN ON INVESTMENTS?

The reduction in the investment universe due to the application of Islamic principles does not necessarily imply a lower return on investment. Empirical evidence, at least at the time of writing this paper indicates that the fears of lower performance are unfounded. The Dow Jones Islamic Market USA Index has outperformed both large and small capitalization stocks in the last four calendar years. The following sections will attempt to address the effect of *sharī'a* principles on stock performance by analyzing the funds of Al-Tawfeek.

Al-Tawfeek Company for Investment Funds Ltd., a major subsidiary of the Dallah Albaraka group is one of the first companies to recognize that *sharī'a*-compliant investments can potentially match or even outperform conventional investments at any given level of risk. It particularly specializes in structuring and managing funds with medium- to long-term horizons. This involves financing of venture capital, infrastructure projects, and equity participation in listed and unlisted businesses in diverse economic sectors.

All investments made by Al-Tawfeek are governed by the *sharī'a*. Al-Tawfeek's *sharī'a* board is constituted of five eminent *sharī'a* scholars. Investments are in five risk categories:

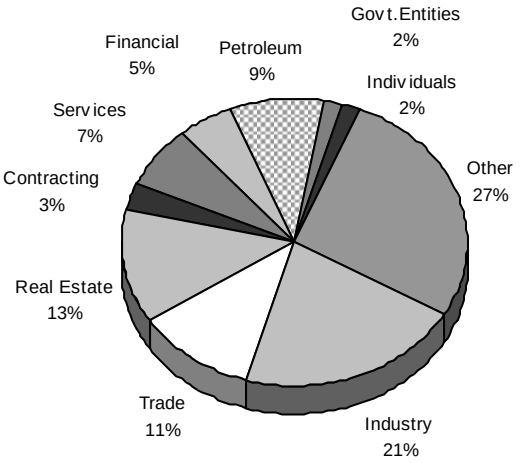
1. No Risk, such as the Al-Amin Company issues that are specifically structured to be riskless asset-backed instruments. It is useful to note here that the realized returns of this company's investments are consistently above expectations, and consistently above normal bank rates.
2. Low Risk, such as the Al-Baraka General fund that was launched by Al-Tawfeek.
3. Medium Risk, such as the GCC Leasing Fund and the International Leasing funds launched by Al-Tawfeek.
4. Moderate Risk, such as equity funds like the Al-Safwa International Equity Fund, the Al-Nukhba Fund, and the recently launched Al-Sukoor Equity Fund.
5. High Risk, such as the private equity funds that are based on the acquisition of small and medium-size companies that comply with the *sharī'a*. These funds have potentially high long-term returns. Al-Tawfeek is in the process of developing private equity funds.

Since its incorporation in 1992, Al-Tawfeek has structured and launched 10 investment funds with aggregate issued-capital of more than $900 million. These funds cover almost all asset classes that comply with the *sharī'a*. Al-Tawfeek provides asset management and investment banking services to both institutions and individuals. Its open and closed-end funds and private placements are designed to fit the needs of various market sectors and different investors' categories.

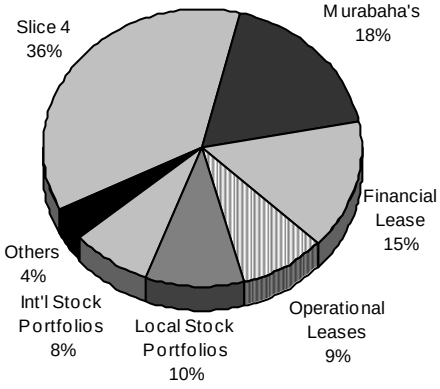
The sector profile of Al-Tawfeek's investment portfolio clearly reveals a dominant weight on industrial, real estate and trade sectors (21.20%, 12.77%, and 11.38%, respectively). Petroleum ranks next at 9.01%, followed by services at 6.9%. The greatest concentration of investment activity is in equity participation, 36% of the total. This is followed by *murāba®a* and financial leasing, at 18% and 15%, respectively. The remaining 31% is represented by *mu∞āraba*, local and international stock portfolios, and other Islamic financing modes. Half of Al-Tawfeek's investment activity is in two main regions, namely Saudi Arabia (29.41%) and Turkey (20.86%). Overall, Al-Tawfeek's investments are spread-out well over the Muslim countries, reflecting Al-Tawfeek's moral commitment toward effective participation in Muslim world development (see Figure 1).

FIGURE 1. INVESTMENT PORTFOLIO ANALYSIS AS OF FEBRUARY 29, 2000

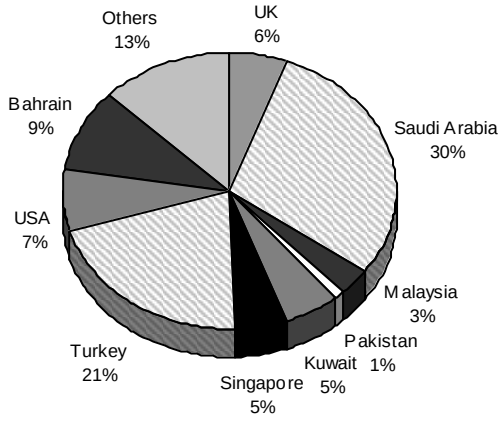
Sectoral Distribution



Distribution by Mode of Finance



Geographical Distribution



V. PERFORMANCE REVIEW OF AL-TAWFEEK'S FUNDS

The Al-Baraka General Fund invests in trade, leasing, and commodity transactions, and offers three share classes with different holding periods and returns. Unit A can be liquidated at any time. The average rate of return (ROR) over the referenced period for Unit A was 3.4%. Unit B can be redeemed every three months, and had an average ROR of 5.6%. Unit C, redeemable yearly, had an average return of 7.5% (see Figure 2).

The GCC and International Leasing Funds invest exclusively in lease transactions. Each has a different geographical focus. The GCC Leasing Fund shows an average ROR of 7.34% over the referenced period (see Figure 3). The International Leasing Fund showed an average ROR of 6.51% in the referenced period (see Figure 4).

FIGURE 2. PERFORMANCE OF AL-BARAKA GENERAL FUND

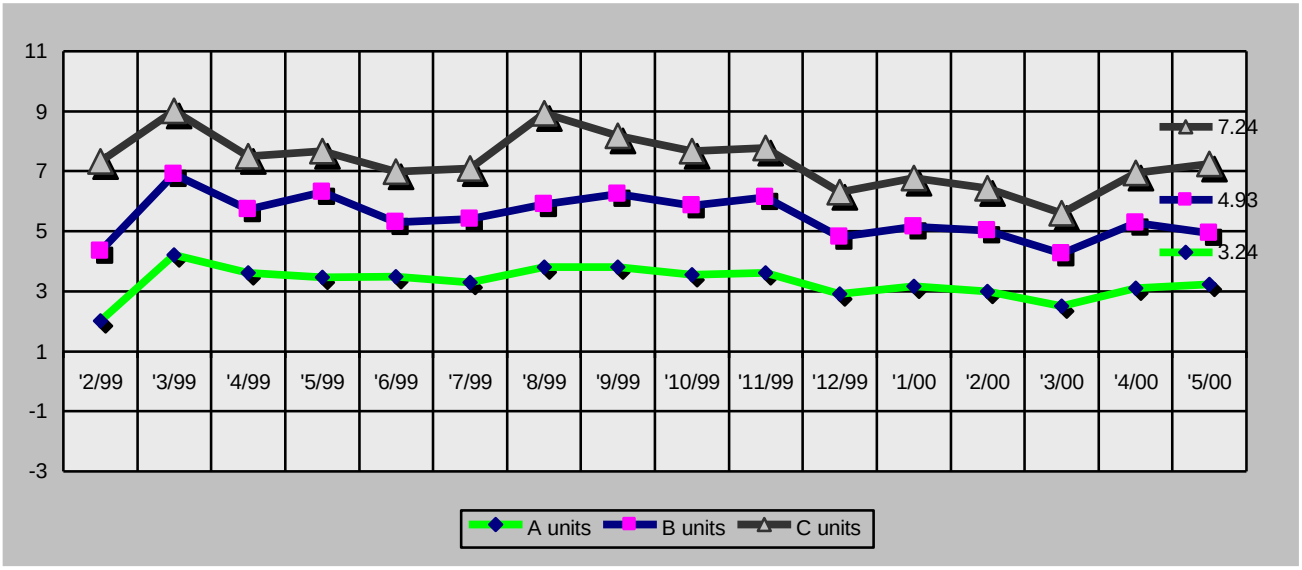


FIGURE 3. PERFORMANCE OF GCC LEASING FUND

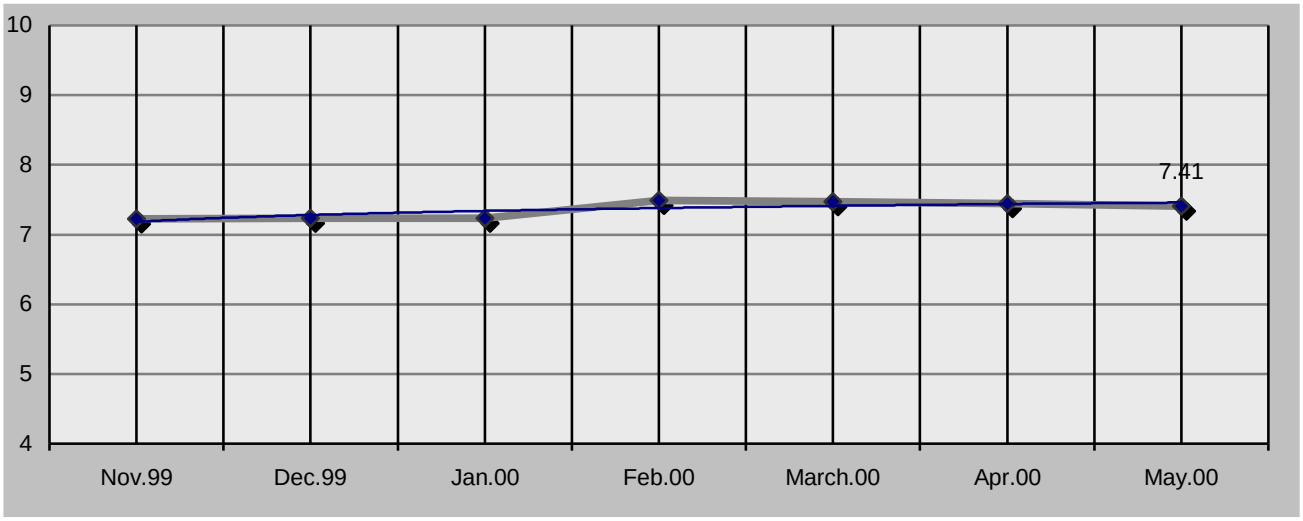
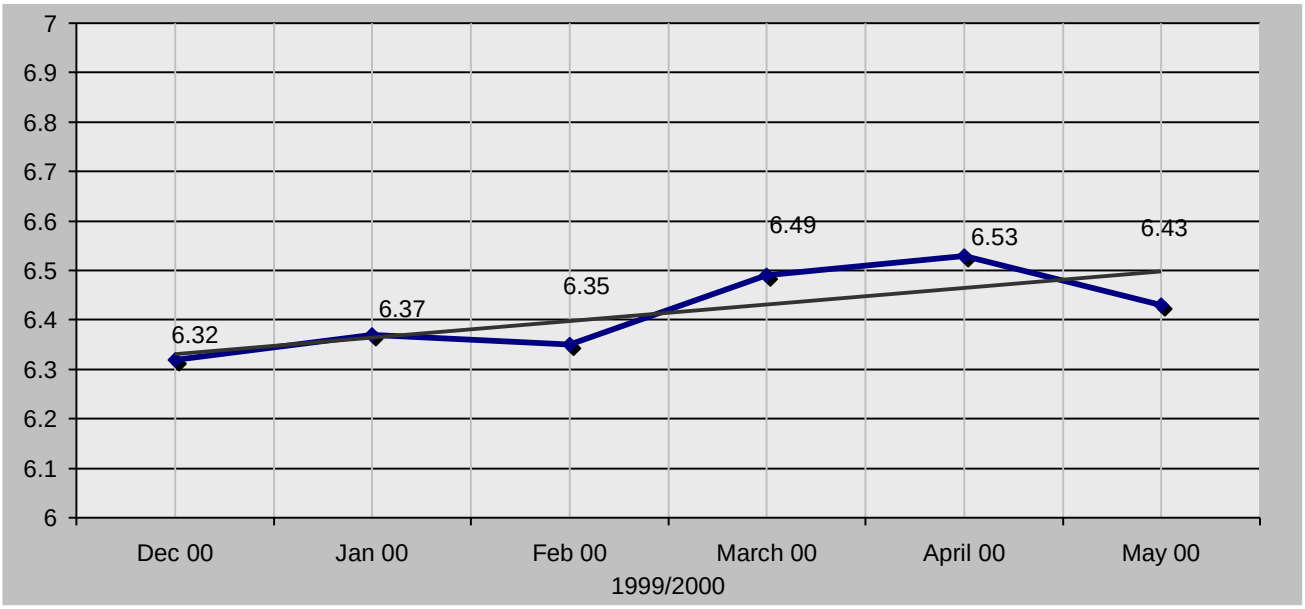
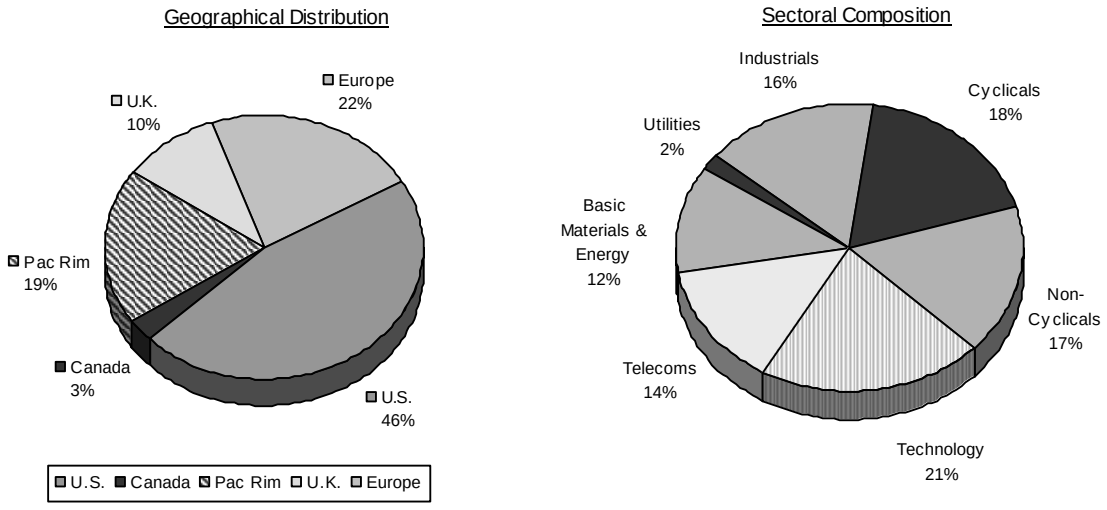


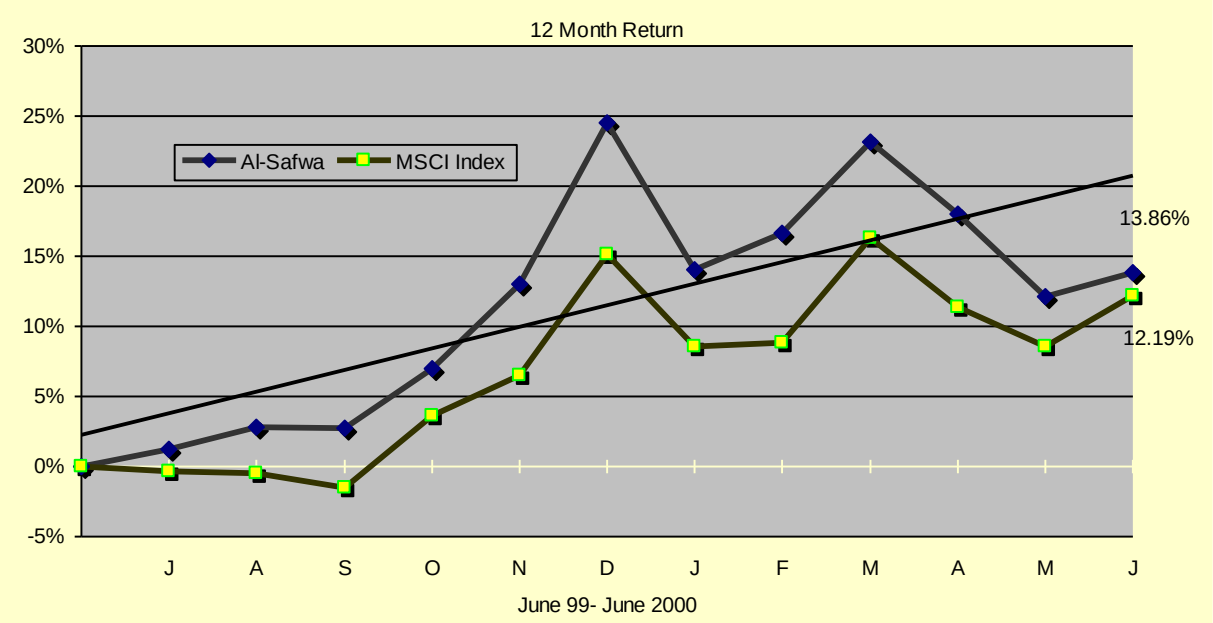
FIGURE 4. PERFORMANCE OF INT'L LEASING FUND



The Al-Safwa International Equity Fund is a global equity fund with relatively strict *sharīʿa* screens (5% leverage and 10% interest income). Geographically, the fund is invested in three major regions, based on the availability of ethical securities in those regions. About 50% of the fund is invested in U.S. and Canada, and the rest is split almost equally between the Pacific Rim and Europe. With over 100 securities, the fund is heavily exposed to technology, consumer cyclicals, and non-cyclicals. It has no exposure to finance, insurance and other activities deemed unethical by the *sharīʿa*. The fund has outperformed MSCI during the last 12 months (refer to Figure 5).

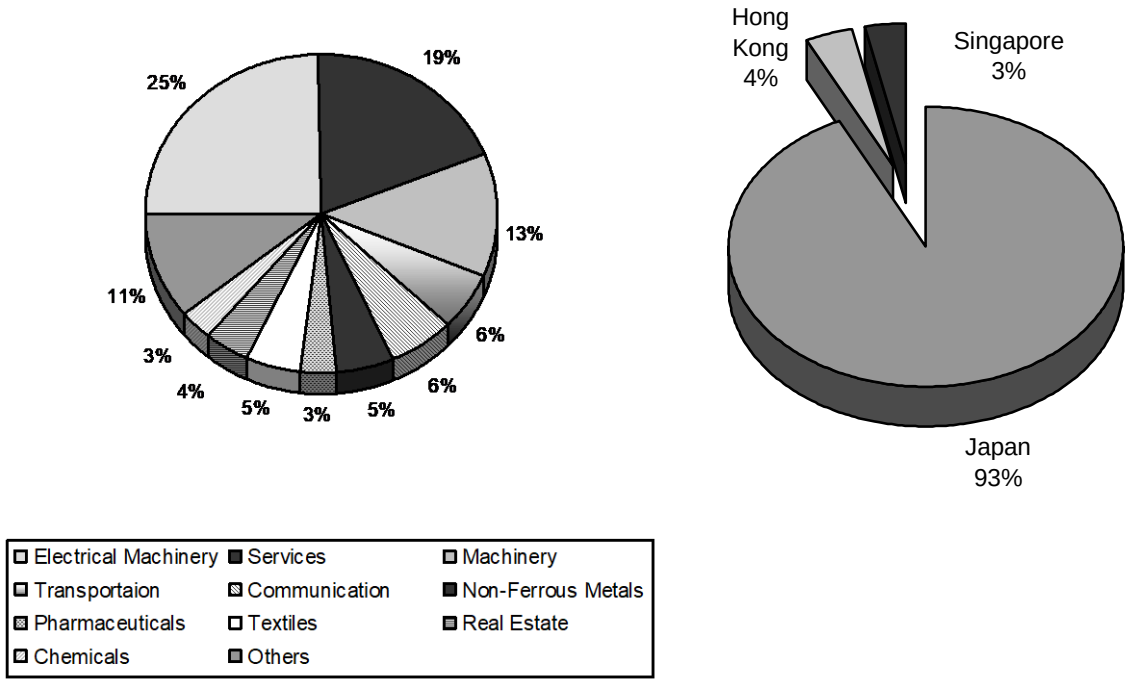
FIGURE 5. AL-SAFWA INT'L EQUITY FUND, JUNE 30, 2000

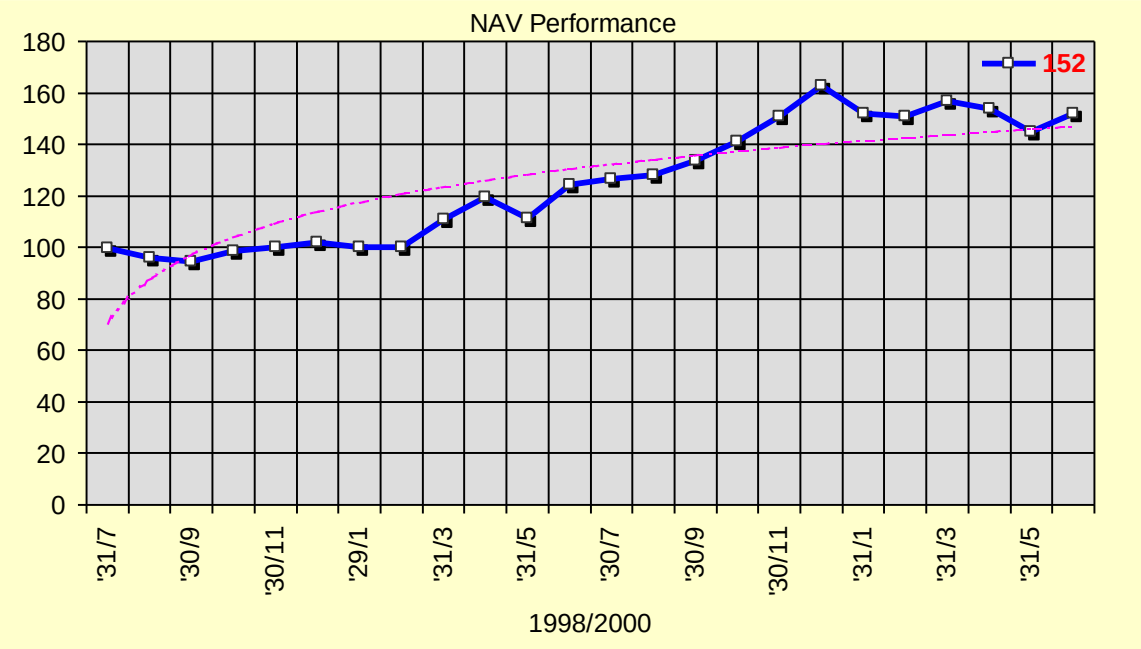




The Al-Nukhba Fund is focused on listed shares in seven Far East/Southeast Asian markets, and has been developed to capitalize on low valuations currently available. In terms of sector, it shows greatest concentration in corporate shares of machinery, electric machinery, communication, telecommunications, and transportation (62.3%). The remainder is distributed among real estate, services, and various miscellaneous classes. Geographically, Japan commands the greatest share of corporate equities with 86.88%. There has been a general upward trend in the value of Al-Nukhba's net assets, from an initial $100m to the $152m at around September 2000 (see Figure 6).

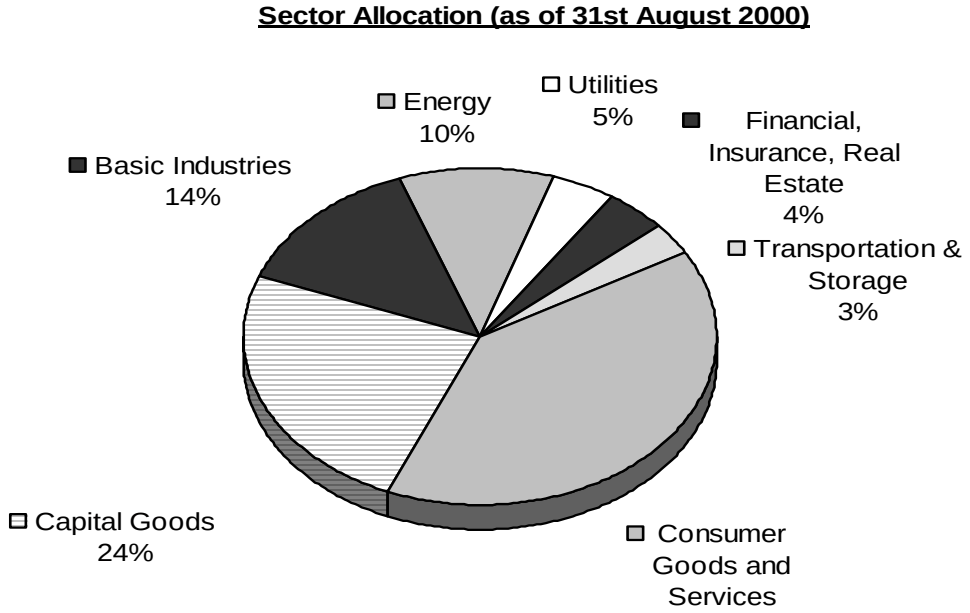
FIGURE 6. AL-NUKHBA ASIA EQUITY FUND



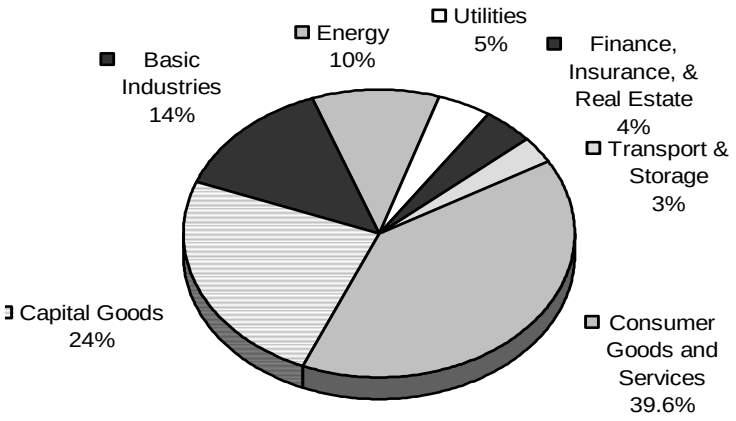


The Al-Sukoor European Equity Fund is a closed-end fund that is incorporated in Ireland and aims at investing in a diversified portfolio of European equities. The fund is benchmarked to MSCI Europe and has outperformed this index in the eight months prior to September 2000. It shows the greatest concentration of corporate shares in consumer goods and services, capital goods, communications, basic industries, and energy (88.20%). The remainder is distributed among utilities, transportation, and various miscellaneous classes. Almost 75% of investments are in Germany, UK, France, and the Netherlands, and the remaining 25% in Finland, Italy, Spain, Sweden, Switzerland, and Portugal (see Figure 7).

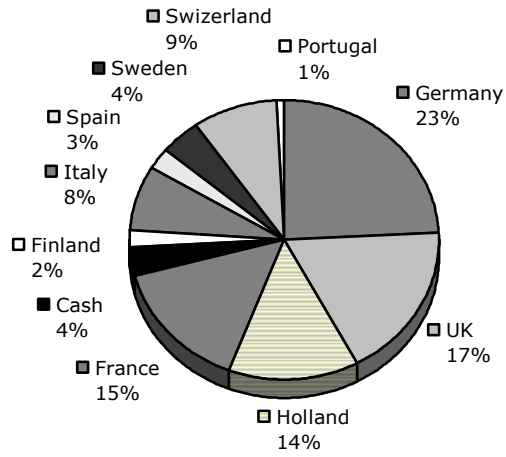
FIGURE 7. AL-SUKOOR EUROPEAN EQUITY FUND, AUGUST 31, 2000



Sector Allocation (as of 31st August 2000)



Country Allocation (as of 31st August 00)



The following table shows the recent performance of the Fund:

Performance	Fund	Benchmark
August 2000	5.63%	3.01%
2000	11.33%	-0.28%
3 months	6.79%	1.73%

VI. CONCLUSION

The operation of Islamic investment funds is not very difficult to understand. The *sharīʿa* screening process is easily summarized. Though there are still issues to be ironed out, the general principles and methods are well defined. The *sharīʿa* screening process does raise the interesting issue of how to check the performance of funds, since the funds cannot be expected to match the normal benchmarks. The development of Islamic indices has made this task easier. This development promises to augment the rapid growth of this sector. However, important caveats must be kept in mind when using these indices.

Investors in Islamic funds do not necessarily have to receive lower rates of return. This is clear from a perfunctory look at the DJIM figures. The case study of Al-Tawfeek further confirms this belief. While Al-Tawfeek targeted all types of investment funds, its equity-based funds are particularly attractive for investors with long- to medium-term horizons and who are ready to bear risk to a reasonable extent. Islamic investment funds then can match and even outperform the market. Like all investment funds, what matters at the end of the day is the ability of management to diversify risk optimally, given the needs of the clients.

Structuring Islamic Equity Funds

Sharīʿa *Board, Purification, Portfolio Management, and Performance Issues*

F. Scott Valpey*

ABSTRACT

In today's ever-evolving world of banking and financial services, one thing remains constant: the need to develop and deliver top-quality financial products and services in order to satisfy the demands of investors and develop a loyal and satisfied client base. The need for increased client service levels is at an all-time high. But keeping clients happy is only one part of the equation. Banking and financial services companies face constantly changing market, regulatory, and investor conditions, as well as the daily challenge of running a smooth business practice. There are strict advertising and disclosure limitations. Licensing, registration, and regulatory compliance issues must be constantly reviewed and kept current. Increased competition arises from within the industry, including many new and low-cost Internet banks, stock trading and online brokerages. Companies serving the Islamic community must be prepared to structure and deliver top-quality products and provide increased levels of client service in order to compete effectively in today's financial product and services industry.

I. INTRODUCTION

Investment management companies have been structuring and managing public equity funds in the United States for 76 years, but only recently have begun to seriously integrate compliance with generally accepted *sharīʿa* precepts. The founders of MFS Investment Management of Boston, Massachusetts, formed the first mutual fund, Massachusetts Investors Trust, in 1924. Members of the North American Islamic Trust (NAIT) established the first Islamic equity fund, the Amana Income Fund, in 1986. A small asset-management company, Saterna Capital Corporation of Bellingham, Washington, manages this fund. Currently there are 97 known Islamic equity funds in the world.[1] There are 7,791 mutual funds in the U.S., of which 3,952 are equity funds.[2] Presently there are only 3 Islamic equity mutual funds in the United States.

Islamic banks and other types of Islamic financial institutions, in general, have enjoyed impressive growth rates in terms of capital, total deposits, and assets under management. Total assets are growing at approximately 15% per year. At the beginning of 1998, there were over 190 Islamic financial institutions worldwide. It is estimated that $150 billion to $200 billion in Islamic funds is presently available for investment in equity and venture capital funds, and as much as $500 billion may be seeking shorter-term, income-oriented investment vehicles. About $90 billion is currently in equity-based Islamic funds and accounts. In the Arab Gulf countries, there are more than 200 local and foreign banks, only 20-25 of which are Islamic banks. These Islamic banks had deposits in 1998 of approximately $150 billion, which would represent about a 32% share of the Gulf's regional banking deposits. The rate of growth in terms of funds and companies serving this developing market has been accelerating globally over the last three years, and new "Islamic" financial products, services, and companies are burgeoning.

The United States contains an estimated 8 million to 12 million Muslims. The median income of Muslims nationally is about $40,000.[3] Islam, with about 1.2 billion followers around the world, is the fastest-growing religion in the United States, with an estimated 2.5% annual growth rate.[4] In 1999 alone, as many as 10,000 Muslims from Kosovo moved to the United States.[5] With only three Islamic equity funds in the U.S., it is safe to say that this growing financial and consumer market is underserved. For this reason, Bashar Qasem, a group of Gulf business leaders, and the author founded Azzad Asset Management, Inc., in 1997 and created two Islamic equity funds: the Azzad Growth Fund, L.P., a private small-cap equity fund; and the Azzad/Dow Jones Islamic Index Fund, an enhanced index mutual fund based on the extra-liquid version of the U.S. components of the Dow Jones Islamic Market Index (DJIM).

The Azzad Growth Fund was structured as a private equity fund under Regulations D and S of the United States Securities Act of 1933. The Azzad/Dow Jones Islamic Index Fund was structured as an open-ended mutual

* Co-founder and Executive Vice President, Azzad Asset Management, McLean, Va.

fund and filed with the U.S. Securities and Exchange Commission in the summer of 2000. In addition to utilizing a traditional investment and portfolio management process, Azzad employs a *sharīʿa*-based process that involves several areas of responsibility—the seven pillars of *sharīʿa*-based investing.

II. The Seven Pillars of *Sharīʿa*-Based Investing

Sharīʿa-based investing incorporates seven main pillars that work together to deliver competitive performance and to promote socially and ethically responsible business practices, which in turn, contribute to improvements in the quality of life throughout society.

A. *Sharīʿa* Supervision

Sharīʿa supervision by a qualified *sharīʿa* supervisory board is an integral component of any serious Islamic equity fund structure. The board is typically made up of prominent scholars well versed and disciplined in the *sharīʿa*, particularly in areas of transactions and business dealings. The board should be independent, should act in an advisory and supervisory role with the fund's management, and should assist in the development of fund management policy, *sharīʿa* screens, investment strategy, implementation, monitoring, and reporting.

B. Screening

Screening is the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on the religious and ethical precepts of Islamic law. Generally, Muslim investors seek to own profitable companies that make positive contributions to society. Certain businesses are incompatible with the *sharīʿa*. Therefore, stocks of companies whose primary business is not permissible according to the *sharīʿa* are excluded, including: companies that receive a major portion of their revenues from alcohol, tobacco, and pork-related products; interest-based financial institutions, such as banks, brokerages, and insurance companies; and entertainment companies, including most hotel, gaming, pornography, and music concerns. In addition, most *sharīʿa* screens currently in use by fund managers include three financial-ratio filters:

1. Excluding companies if total debt divided by total assets is equal to or greater than 33%.
2. Excluding companies if accounts receivable divided by total assets is equal to or greater than 45%.
3. Excluding companies if non-operating interest income is equal to or greater than 5%.

C. Purification

Purification is the process of eliminating or cleansing the portfolio from income or gain resulting from interest (*ribā)* or other impure revenue sources. The fund should have a strict, quantifiable formula and methodology of separating interest-related income and impure income, including dividends and capital gains, from the portfolio.

D. Shareholder Advocacy

Shareholder advocacy describes the actions that many socially aware investors take in their roles as owners of public corporations. These efforts include dialogue with corporate management on issues of concern and submitting and voting proxy resolutions. Socially responsible proxy resolutions are generally aimed at influencing corporate behavior and practices toward a more responsible level of corporate citizenship.

E. Monitoring and Reporting

Monitoring and reporting involves a process of vigilance over the fund's holdings to ensure compliance with *sharīʿa* filters, fund strategies, and policies. A screened portfolio is only the first step toward *sharīʿa* compliance. *Sharīʿa* compliance is an ongoing process and requires diligent analysis of company financial statements, practices, and revenue sources. Ongoing management and shareholder reports are necessary to provide fund principals and investors with timely information related to *sharīʿa* issues, the fund, its practices, and performance.

F. Charity and Community-Based Investment

Charity and community-based investment programs provide capital to people and organizations that have difficulty attaining it through conventional channels or that are underserved by conventional financial or lending institutions. Impure portfolio income can be donated to many different non-profit organizations as long as the monies are not used to build a mosque or print the Qur'an. Venture capital funds for low-income housing and small-

business development in the United States and abroad may also be established. Community-based investments enable people to improve their standard of living, develop their own small businesses, and create jobs for themselves and their neighbors.

G. *Zakāt* Calculations

Zakāt calculations may be provided through the accounting process of the fund for investors. The matter of calculating *zakāt* is complicated in equity portfolios due to the timing of portfolio income and capital gains. Tax-deferred and tax-exempt arrangements, as well as trusts, can further complicate this. Nonetheless, *sharīʿa* supervisory boards may be asked to suggest guidelines that may then be incorporated into specialized software. Many Muslim shareholders would undoubtedly appreciate a *sharīʿa*-supervised service for the timely and accurate payment of *zakāt*.

III. Portfolio Management (The Azzad Growth Fund)

The investments of the Azzad Growth Fund consist predominantly of the equity securities of small- to mid-capitalization companies selected in accordance with the investment methodology of Azzad and the portfolio managers selected by it, consistent with applicable *sharīʿa* principles and restrictions. Azzad's basic investment approach is to diversify the fund's assets between the two predominant styles of fundamental-based investing, namely value and growth, and allocate fund capital equally between value- and growth-oriented portfolios. The portfolios are entrusted to experienced portfolio managers with demonstrated superior historical investment performance. At present, the master fund utilizes a single portfolio manager in each of the two basic investment styles.

A. Investment Methodology

Azzad has established basic investment methodologies for both the growth portfolio and the value portfolio of the Partnership. These methodologies are reviewed with the relevant portfolio managers and are further refined and developed as appropriate.

The fund's growth style strategy begins with research using fundamental analysis, including the application of Azzad's Islamic filter process. Stocks are selected according to the following quantitative measures: sales growth of greater than 20%; earnings growth of greater than 20%; analysis of income statements as to, among other factors, operating margins and above-average profitability ratios; and analysis of balance sheets for *sharīʿa* compliance as well as for financial ratios and overall strength. The portfolio manager analyzes a variety of qualitative considerations, including, among others, entrepreneurial management, dominant market position, pricing flexibility, and new product flow. The sell discipline is utilized when the *sharīʿa* is violated, price objectives are achieved, a position becomes too large, fundamentals deteriorate, a sector's outlook changes, or there is unfavorable relative price performance.

Similar to the growth style, the fund's value style strategy also begins with fundamental analysis, including the application of Azzad's Islamic filter process. Value stocks are selected according to the following characteristics: steady earnings and cash flow growth; dominant market position or strong niche franchises; good (or improved) balance sheets; excess cash flow from operations; and a high degree of management stock ownership. Companies that meet many of these criteria are further reviewed to identify those with low absolute and comparative price-to-earnings ratios; low price-to-book value; and low price relative to the company's industrial value, as a strategic acquirer may view the same. As with the growth portfolio, a strict sell discipline is employed when: the *sharīʿa* is violated; a stock achieves a target price or moves to "market level" valuations; or is sold and replaced by other undervalued securities.

B. Limitations on Investment Techniques

By reason of *sharīʿa* principles and restrictions, as well the Azzad's own investment approach, the fund does not engage in a variety of investment practices and techniques typically employed by private investment partnerships or "hedge funds." The fund does not employ leverage, or the use of borrowed funds, to increase investment exposure. The fund does not engage in short selling, in options strategies, or the use of other derivative securities. As a result, the fund's portfolios are exclusively "long" and therefore unhedged. Interest-based securities such as bonds, convertible bonds, and preferred stocks are avoided.

C. Holding Periods and Turnover

On account of Azzad's investment strategy, most positions in both the fund's growth portfolio and value portfolio are acquired with a view to holding them on a long-term basis, with some holding periods in excess of one year or more. Portfolio managers may at times trade around core positions on a short-term basis. On account of the foregoing, the rate of portfolio turnover for the fund is low to moderate.

IV. PERFORMANCE (AZZAD GROWTH FUND, LP)[6]

Period		The Fund			Benchmarks [(a)] S & P 500			Russell 2000		
From	To	Quarter-to-Date	Year-to-Date	Inception-to-Date	Quarter-to-Date	Year-to-Date	Inception-to-Date	Quarter-to-Date	Year-to-Date	Inception-to-Date
February 12, 1998	December 31, 1998			3.67%			20.51%			-6.73%
January 1, 1999	March 31, 1999	-2.59%	-2.59%	0.99%	4.65%	4.65%	26.11%	-5.77%	-5.77%	-12.11%
April 1, 1999	June 30, 1999	20.00%	16.89%	21.18%	6.71%	11.67%	36.38%	15.10%	8.47%	0.49%
July 1, 1999	September 30, 1999	6.65%	24.66%	29.24%	-6.56%	4.35%	25.76%	-6.64%	1.27%	-6.77%
October 1, 1999	December 31, 1999	30.12%	62.20%	68.16%	14.54%	19.53%	44.03%	18.13%	19.62%	11.11%
January 1, 2000	March 31, 2000	17.18%	17.18%	97.07%	2.00%	2.00%	46.91%	6.80%	6.80%	18.67%
April 1, 2000	June 30, 2000	-11.40%	3.82%	74.58%	-2.93%	-0.99%	42.60%	-4.05%	2.47%	13.85%

V. CONCLUSION

Sharīʿa-based investment companies, funds, and portfolios are beginning to grow significantly in terms of number of funds, assets under management, and performance gain. The demand for these niche financial products and services stems from one-fifth of the world's population. Muslim investors, as well as most ethical and social investors, desire to own profitable companies that make positive contributions to society. They are knowledgeable and informed consumers with a high level of discretionary income. They strive for self-improvement and perfection and demand quality and service. Financial companies that desire to serve these devout consumers need to customize their operations, products, and services to conform to generally accepted and supervised *sharīʿa* precepts in order to prosper. Their funds and portfolios must produce competitive performance. The recent returns of Azzad's investment portfolios using *sharīʿa*-based principles and processes suggest that investors do not sacrifice performance when investing according to their religious principles and beliefs.

[1] Failaka International, Inc.
[2] Investment Company Institute 1999 Fact Book.
[3] Center for Muslim Research and Information, New York, N.Y.
[4] Ibid.
[5] Abdurahman Almoudi, President of the American Muslim Foundation, Alexandria, Va.
[6] Without dividends reinvested.

APPENDICES

Appendix A

Fourth Forum Program of Events

Saturday, September 30

8:00 a.m. **Registration (Science Center Lobby)**

9:00 a.m. **Opening Session (Science Center C)**

Introduction
Zayed M. Yasin (President, Harvard Islamic Society)

Welcome
Thomas D. Mullins (Harvard Islamic Finance Information Program)

Forum Chairman's Address
Samuel L. Hayes, III (Harvard Business School)

Keynote Speaker: Islamic Economics
Mahmoud A. El-Gamal (Rice University)
The Economics of 21st-Century Islamic Jurisprudence

Keynote Speaker: Islamic Finance
Stephen Green (HSBC Investment Bank)
Challenges Facing the Islamic Financial Industry

Keynote Speaker: The *Sharīʿa*
Yusuf Talal DeLorenzo (Independent *Sharīʿa* Consultant)
Changing Perspectives in Sharīʿa *Supervision*

10:30 a.m. **Break**

11:00 a.m. **Critical Issues in Islamic Finance (Science Center C)**

Chairman: Samuel L. Hayes, III (Harvard Business School)

Jassar Al Jassar (Kuwait Finance House)
Islamic Finance: Successes, Prospects, and Neglected Areas
Fred Crawford (The National Commercial Bank)
Developing Financial Products in Islamic Finance
Mabid Ali Al Jarhi (Islamic Research and Training Institute, Islamic Development Bank)
A Comparison of Transactions in Conventional and Islamic Economies
Omer Ahmed (Crescent Capital Management)
Islamic Investing: An Institutional Investor's Perspective

12:45 p.m. **Lunch (Greenhouse Restaurant)**

2:30 p.m. Islamic Finance: *Sharīʿa* Perspectives (Science Center C)

Chairman: Yahia Abdul-Rahman (American Finance House – LARIBA)

Mohamed Ali Elgari (Independent *Sharīʿa* Consultant)
Purification of Islamic Equity Funds: Methodology and Sharīʿa *Foundation*
Nizam Yaquby (Independent *Sharīʿa* Consultant)
Trading in Equities: A Sharīʿa *Perspective*
Yusuf Talal DeLorenzo (Independent *Sharīʿa* Consultant)
Sharīʿa *Supervision of Islamic Mutual Funds*
Mohd. Daud Bakar (International Islamic University, Malaysia) &
Zainudin Jaffar (Darul Ehsan Islamic College, Malaysia)
Sharīʿa *and Legal Issues of Online Islamic Banking and Finance*

4:15 p.m. Break

4:45 p.m. Parallel Session 1 – Workshop for Newcomers to Islamic Economics and Finance (Science Center C)

Chairman: Mahmoud A. El-Gamal (Rice University)

Mahmoud A. El-Gamal (Rice University)
An Introduction to Modern Islamic Economics and Finance
Mohammad Fadel (U.S. Court of Appeals for the 4th Circuit)
The Regulation of Risk in Islamic Law, the Common Law, and Federal Regulatory Law
Iqbal Ahmad Khan (HSBC Amanah Finance)
Islamic Banking and Finance in Action: Achievements, Prospects, and Challenges

El-Gamal will orient workshop participants to the economic, financial, and regulatory content of Islamic law. He will then review common Islamic alternatives to conventional financial tools, with a view to highlighting their similarities and differences.

Fadel will compare and contrast the approaches of Islamic law, the common law, and modern law to the regulation of risk in financial markets. He will discuss the three legal frameworks with reference to the regulation of derivatives trading (options, futures, etc.).

Khan will survey the achievements of the Islamic financial movement to date, as well as consider the prospects and challenges it now faces as it tries to harness the intellectual and entrepreneurial talents of those interested in ethical investment and savings mobilization.

4:45 p.m. Parallel Session 2 – Current Research in Islamic Banking and Finance (Science Center D)

Chairman: Yusuf Talal DeLorenzo (Independent *Sharīʿa* Consultant)

Sudin Haron & Norafifah Ahmad (Northern University of Malaysia)
The Islamic Banking System in Malaysia: Some Issues
Zamir Iqbal (World Bank)
The Scope of Off-Balance-Sheet Transactions in Islamic Finance
Shaikh Abdul Hamid (New Hampshire College)
Corporate Debt and Islam
Aamir Khan (ABN AMRO) & Tariq Al-Rifai (The International Investor)
The Role of Venture Capital in Contemporary Islamic Finance

6:30 p.m.	**Day 1 of Forum Ends**

8:00 p.m.	**Reception and Banquet (Lowell House)**

Welcome

David Gordon Mitten (Faculty Advisor, Harvard Islamic Society)

Banquet Speaker

Nizam Yaquby (Independent *Sharīʿa* Consultant)

Sunday, October 1

9:00 a.m. Islamic Finance: Business Perspectives (Science Center C)

Chairman: Jassar Al Jassar (Kuwait Finance House)

Yahia Abdul-Rahman & Mike Abdelaaty (American Finance House – LARIBA)
The Capitalization of Islamic Financial Institutions in the United States
Iqbal Ahmad Khan (HSBC Amanah Finance)
The Challenge of Reach and Richness in Islamic Finance
John Bauer and Richard P. Keigher (SAMBA Capital Management International)
Islamic Equity Funds: Opportunities and Challenges for Fund Managers
Essam Mahmoud (King Fahd University of Petroleum and Minerals) &
Gillian Rice (American Graduate School of International Management)
Meeting the Competitive Challenge: Marketing Leadership in Islamic Financial Institutions

10:45 a.m. HIFIP *DataBank* Presentation

Taha bin Hasan Abdul-Basser (Harvard Islamic Finance Information Program)

11:00 a.m. Break

11:30 a.m. Parallel Session 1 – Islamic Finance: Legal and Regulatory Perspectives (Science Center C)

Chairman: Isam Salah (King & Spalding)

W. Donald Knight, Jr. (King & Spalding) &
Henry Thompson (First Islamic Investment Bank)
Structuring Islamic Investment Funds: The Legal, Tax, and Regulatory Aspects
Jameel W. Aalim-Johnson (Office of Representative Gregory Meeks)
The Relationship between Legislation, Regulation, and the Influence of the Private Sector: A Congressional Perspective
Andrew Cunningham (Moody's Investors Service)
Culture or Accounting: What Are the Real Constraints for Islamic Finance in a Ribā*-based Global Economy?*

11:30 a.m. Parallel Session 2: Contemporary and Historical Views on Islamic Economics and Finance (Science Center D)

Chairman: Mabid Ali Al Jarhi (Islamic Research and Training Institute, Islamic Development Bank)

Danial Mah Abdullah (Labuan Offshore Financial Services Authority)
Toward Developing a Global Islamic Capital and Money Market
M. Kabir Hassan & M. Imtiaz Ahmed Mazumder (University of New Orleans)
Islamic Finance and Economic Stability: An Econometric Analysis
Ibrahim Warde (University of California, Berkeley)
Islamic Finance: A Quarter-Century Assessment
M.A. Muqtedar Khan (Adrian College)
The Mythology of Islamic Economics and the Theology of the East Asian Economic Miracle

1:00 p.m. Lunch

2:30 p.m. Islamic Funds and Indices (Science Center C)

Chair: Nizam Yaquby (Independent *Sharīʿa* Consultant)

Naseeruddin Khan (Albaraka Investment and Development Company)
Do Islamic Equity Funds Measure Up?: The View from Al-Tawfeek

Tom Gainor (The International Investor)
A Practical Approach to Product Development

Scott Valpey (Azzad Asset Management)
Structuring Islamic Equity Funds: Sharīʿa *Board, Purification, Portfolio Management, and Performance Issues*

Laurent Chappuis (Pictet & Cie, Banquiers)
Sharīʿa *Guidelines: A Look at the Differences and Their Impact on Performance*

4:30 p.m. Conference Closing (Science Center C)

Thomas D. Mullins (Harvard Islamic Finance Information Program)

Appendix B

Profiles of Speakers and Chairs

AALIM-JOHNSON, JAMEEL W.
Washington Chief of Staff, Office of Representative Gregory W. Meeks; Washington, D.C.
Jameel W. Aalim-Johnson has been Washington Chief of Staff for Representative Gregory W. Meeks (6th District, New York) since May 1998. As Washington Chief of Staff, Aalim-Johnson manages the Washington office and advises Meeks on economic development issues and opportunities as they relate to the district. He provides staff support to Meeks on the banking and international relations committees and is also responsible for legislative issues related to international trade and small business. Prior to joining Meeks' staff, Aalim-Johnson was Executive Director of the Rockaway Development and Revitalization Corporation, a non-profit community development organization. From 1988 to 1993, he was employed by the Greater Jamaica Development Corporation to be the first administrator of the Jamaica Economic Development Zone. Aalim-Johnson holds a B.A. in economics from the University of Virginia and an MBA in international finance from St. John's University in New York. Aalim-Johnson is active in a number of civic organizations.

ABDELAATY, MIKE
President, American Finance House – LARIBA; Pasadena, Calif.
Mike Abdelaaty is President of American Finance House – LARIBA, a California finance company specializing in LARIBA-type transactions to meet the needs of individuals, professionals, and businesses. He possesses over twenty years of traditional banking experience, both locally and in the Middle East. Abdelaaty has held positions with Bank of America, The Sanwa Bank Limited and its subsidiary, Sanwa Bank California, and The Saudi Investment Bank. Abdelaaty received a B.S. and an MBA from California Polytechnic University and has completed a three-year executive education program at the University of Washington's Pacific Coast Banking School. Abdelaaty has participated in the formation of two entities that offer the LARIBA style of banking and finance in the United States.

ABDUL-BASSER, TAHA BIN HASAN
Chief Technology Officer, Harvard Islamic Finance Information Program; Cambridge, Mass.
Taha bin Hasan Abdul-Basser is Coordinator of Software Development and *Sharīʿa* Database Consultant at HIFIP. He holds an A.B. from Harvard College in the Comparative Study of Religion and is currently working on a Ph.D. in Arabic and Islamic Studies in the Department of Near Eastern Languages and Civilizations at Harvard University. His areas of research include *ʿilm al-balāgha*, *usūl al-fiqh*, and *fiqh al-muʿāmalāt*.

ABDUL-RAHMAN, YAHIA
Founder, American Finance House – LARIBA; Pasadena, Calif.
Yahia Abdul-Rahman is Founder of American Finance House – LARIBA, which has been offering LARIBA (Islamic) financing and financial services since 1987. He has over 30 years of experience in international banking, project financing, and the oil and gas industry, and has held positions with Salomon Smith Barney, Atlantic Richfield, and the Industrial Bank of Kuwait. Abdul-Rahman has a B.S. from Cairo University and an M.S. and Ph.D. from the University of Wisconsin, Madison, all in Chemical Engineering, and an M.A. in International Management and Finance from the University of Texas, Dallas. He is the author of *LARIBA Bank – Islamic Banking, Foundation for a United and Prosperous Community*.

ABDULLAH, DANIAL MAH
Director of Banking, Labuan Offshore Financial Services Authority; Federal Territory Labuan, Malaysia
Danial Mah Abdullah is the Director of Banking for the Labuan Offshore Financial Services Authority (LOFSA). He has been with LOFSA since its inception in 1997. Abdullah is responsible for policymaking and developing new business for the offshore banking industry in Labuan, including the international Islamic money market project. He has spoken at various conferences, including the World Islamic Banking Conference held in Bahrain. Prior to joining LOFSA, Abdullah was with the Central Bank of Malaysia in various positions. Abdullah has a degree in accountancy from the University of Malaya and an MBA from the Manchester Business School.

AHMAD, NORAFIFAH
Senior Lecturer, Northern University of Malaysia; Sintok, Malaysia
Norafifah Ahmad is a senior lecturer in the School of Banking and Finance, Northern University of Malaysia. Her works have appeared in journals such as *International Journal of Bank Marketing*, *Malaysian Management Journal*, and *Bankers' Journal of Malaysia*. She has also presented papers at local and international conferences.

AHMED, OMER
President, Crescent Capital Management; Chicago, Ill.
Omer Ahmed is President of Crescent Capital Management, a Chicago-based investment firm that specializes in alternative asset management for family offices representing wealthy individuals and global financial institutions. Prior to establishing Crescent Capital, Ahmed was Senior Vice President at Crédit Agricole Indosuez Bank and advised on managed, alternative asset portfolios. He has also held senior management positions at Merrill Lynch International and ABN AMRO Private Banking. He has managed/advised on over $880 million of private and institutionally held assets ranging across real estate, fixed income, equities, OTC and exchange-traded derivatives, privately-placed hybrid securities, structured notes, and strategic venture capital. Ahmed is a graduate of Washington University in St. Louis. He is a member of the New York Mercantile Exchange's Institutional Money Management Advisory Committee, chair of the Middle East effort for the Alternative Investment Management Association, and Vice Chairman of Arabianbiz Holdings, a Middle East focused Internet services holding company.

BAKAR, MOHD. DAUD
Associate Professor, International Islamic University; Kuala Lumpur, Malaysia
Mohd. Daud Bakar is Associate Professor of Islamic Law at the International Islamic University in Kuala Lumpur, a post he has held since 1993. He is also Dean of the Center of Postgraduate Studies at the same institution. He was Assistant Lecturer in the same department from 1989 to 1993 and Officer at the Ministry of *Awqāf* in Kuwait in 1998. Bakar holds a bachelors' degree in *Sharīʿa* from Kuwait University and earned his Ph.D. from the University of St. Andrews, Scotland. He has presented over 50 papers and talks at various seminars and conferences in Malaysia and around the world and has published more than 25 articles in various journals. He is presently working on a number of books on comparative law and *sharīʿa* issues. He is also a *sharīʿa* consultant and advisor for a number of institutions, including the Securities Commission of Malaysia, the Central Bank of Malaysia, and IslamiQ.com.

BAUER, JOHN
Marketing Director, SAMBA Capital Management International; London, United Kingdom
John Bauer is Marketing Director for SAMBA Capital Management International, which he joined in April 1998, and has managed the establishment of SAMBA Asset Management S.A. in Luxembourg, an Islamic investment company. Bauer has been a senior executive for nearly 30 years in major financial institutions around the world, including Merrill Lynch, American Express Bank, NationsBank, The Gulf Bank (Kuwait), and the National Bank of Bahrain. He has been instrumental in successfully developing and integrating modern investment and commercial banking products, delivery systems, and marketing techniques for distribution to clients with a diverse range of cultural backgrounds. He has been a Director on the Board of two funds. In 1996-97, he worked closely with the *Sharīʿa* Advisory Panel for the Al Watani Fund for Islamic Investment EC in structuring and marketing a diversified Islamic portfolio. Bauer has a BBA and MBA from the University of Michigan and has taught business courses for the University of Maryland's European Division.

BILAL, GOHAR
Consultant, United Bank of Kuwait; London, United Kingdom
Gohar Bilal is currently a consultant with the United Bank of Kuwait, focusing on neutral transactions that can be offered to both Islamic and conventional investors. An investment banker by profession, she was previously a Visiting Scholar at the Islamic Legal Studies Program, where she did research on Islamic asset-backed securities. Before coming to Harvard, Bilal headed the Corporate Finance and Investment Banking Division at Faysal Bank Limited in Karachi, Pakistan. She has also worked at Citibank N.A., Karachi (investment banking division) and Imperial Bank, Los Angeles (real estate finance). Bilal holds an M.S. in Construction Engineering and Management from Stanford University. In April 1997, Euromoney magazine named Bilal among the "Top 50 Women in the Finance World." Bilal is presently writing a book on Islamic asset-backed securities and works closely with the Harvard Islamic Finance Information Program.

CHAPPUIS, LAURENT
Vice President and Head of Islamic Equities, Pictet & Cie, Banquiers; Geneva, Switzerland
Laurent Chappuis is currently Vice President & Head of Islamic Equities for Pictet & Cie, where he is responsible for the management of the World Equities compartment of the fund as well as for all the individual Islamic accounts of Pictet & Cie. Chappuis started his investment career with Pictet & Cie in Geneva in 1990. He returned to Geneva in 1995 after an 18-month assignment in Bahrain to manage the portfolios of major Middle Eastern clients. In this capacity, he spearheaded the entry of Pictet & Cie into the Islamic asset management market, which led to the creation of the Luxembourg-registered Al Dar Islamic Fund in 1998. Since the start of this year, Chappuis has been a member of Pictet & Cie's Private Banking Investment Committee, a three-man team in charge of defining asset allocation for all discretionary managed portfolios of the bank's private clients. Chappuis graduated from the University of Geneva with a degree in finance.

CRAWFORD, FRED
Advisor, The National Commercial Bank; London, United Kingdom
Fred Crawford is presently Advisor and was previously Division Head of the National Bank of Saudi Arabia's Investment Services, with which he has been associated since 1984. From 1970 and 1979, Crawford worked for Citicorp as Vice President and Market Manager, a position in which he organized a large number of major transactions. In 1979, he joined Blyth Eastman Dillon to run its Athens-based corporate finance office and merged with Paine Webber International in 1980 after its acquisition of Blyth. He remained until 1984 as Executive Director at Paine Webber. Crawford received his bachelors' degree from Princeton University and later earned a bachelor's in Foreign Trade from the American Graduate School of International Management (Thunderbird) in Arizona. Crawford has published articles in Euromoney and is a frequent speaker at Middle East conferences. He served in the United States Army Signal Corps in South Vietnam and as an instructor in the International College in Beirut.

CUNNINGHAM, ANDREW
Vice President and Senior Credit Officer, Moody's Investors Service; London, United Kingdom
Andrew Cunningham is a Vice President and Senior Credit Officer with Moody's Investors Service, the global credit ratings agency. While he is now primarily concerned with European banks, he formerly analyzed Middle Eastern banks and was based in Moody's office in Cyprus. He was formerly a journalist writing about banking and finance in the Middle East, first for Middle East Economic Digest (MEED) in London and then for Middle East Economic Survey in Cyprus. Cunningham has a B.A. in Arabic and Islamic Studies from the University of Exeter. His publications include Banking and Finance in the Middle East (London: FT Financial Publishing, 1996); Islamic Banking and Finance (London: MEED, 1990); and Gulf Banking and Finance (London: MEED, 1989). His most recent publication is Bank Credit Risk in Emerging Markets, a special report published by Moody's in 1999.

DELORENZO, YUSUF TALAL
Independent Sharīʿa *Consultant*; Ashburn, Va.
Yusuf Talal DeLorenzo is an independent *sharīʿa* consultant associated with the Dow Jones Islamic Market Index, the Wafra Investment Advisory Group, the NovaBancorp SAMI fund, the Institute of Islamic Banking and Insurance, Azzad Asset Management, the Brown Brothers Harriman Global Islamic Equity Fund, Barclays Global Investors, and others. DeLorenzo studied the classical Islamic disciplines in the traditional manner at Jamiʿat al-ʿUlum al-Islamiyah in Karachi, where he received an M.A. in Islamic Studies, and is a Ph.D. candidate at the Hartford Seminary. He has researched, translated, and published from Arabic, classical Persian, and Urdu and has taught *sharīʿa* subjects at institutions in Pakistan, Sri Lanka, and the United States. He was Advisor on Islamic Affairs to the Government of Pakistan from 1981-84. DeLorenzo is presently working on the third volume of his compilation and English translation of *A Compendium of Legal Rulings on the Operations of Islamic Banks* (London: Institute of Islamic Banking and Insurance, vol. I, 1997, vol. II, 2000).

EBRAHIM, MUHAMMED-SHAHID
Assistant Professor, Department of Real Estate, National University of Singapore; Singapore
Muhammed-Shahid Ebrahim is an Assistant Professor in the Department of Real Estate at the National University of Singapore. He was previously a Visiting Fellow at the Oxford Center for Islamic Studies and has been affiliated with such institutions as the University of Brunei Darussalam, the University of Illinois at Urbana-Champaign, and Southern Illinois University. Ebrahim has a B.Tech. from the Indian Institute of Technology, an M.S. from the University of Pennsylvania, an MBA from the University of Wisconsin, Madison, and a D.B.A. from Southern

Illinois University, Carbondale. He has worked at the United Bank of Kuwait, First Path Securities, and IDS Financial Services. Ebrahim's research interests include asset pricing, capital structure and security design, investments, international finance, Islamic banking, and real estate. He publishes frequently in international refereed journals. Ebrahim was a visiting scholar at HIFIP in 1997.

ELGARI, MOHAMED ALI
Associate Professor, King Abdulaziz University; Jeddah, Saudi Arabia
Mohamed Ali Elgari is Associate Professor of Islamic Economics at King Abdulaziz University in Jeddah. He was formerly the director for the Center for Research in Islamic Economics at King Abdulaziz University. He serves as a consultant to Islamic banks and sits on the *sharī*ʿ*a* boards of over 15 financial institutions worldwide. Elgari has served on the consulting committee that counseled the Government of Pakistan on the Islamization of its banking system. Elgari holds a Ph.D. in Economics from the University of California and studied the *sharī*ʿ*a* in the traditional manner through tutelage under learned scholars. Elgari is a member of the OIC *Fiqh* Council and the author of several books (including a widely used textbook on Islamic economics) and dozens of research papers, in English as well as Arabic, on the subject of Islamic finance.

FADEL, MOHAMMAD
Clerk, U.S. Court of Appeals for the Fourth Circuit; Baltimore, Md.
Mohammad Fadel is currently a clerk at the U.S. Court of Appeals for the Fourth Circuit in Baltimore, Md. He was previously a clerk at the U.S. District Court for the Southern District of Georgia. Fadel earned both his B.A. in Government and Foreign Affairs and his J.D. from the University of Virginia. He obtained a Ph.D. in Near Eastern Languages and Civilizations from the University of Chicago, where he specialized in medieval Islamic law. Fadel has published several papers on topics within Islamic law in academic journals. He taught at several American universities prior to entering law school, has worked at several private law firms in Atlanta, Washington, D.C., and New York, and had a stint in the United States Department of Justice.

GAINOR, THOMAS R.
Managing Partner, The International Investor; London, United Kingdom
Thomas R. Gainor is presently Managing Partner at The International Investor, London, UK. From 1995-1998, he served as Partner with The International Investor, Safat, Kuwait. At TII, he founded the company's fund administration unit, which is responsible for all legal and operational matters for 14 investment companies, and chaired the company's Product Development Committee with primary responsibility in launching and maintaining eight investment products and three specialty indices. He helped develop and manage the specialized Islamic Index Series with FTSE International Limited. Gainor worked as Tax Strategy Advisor for the FPL Group in Florida from 1990-95 and as Tax Manager and Auditor-Tax Manager, respectively, at KPMG Peat Marwick in Providence, R.I., and Touche Ross & Co. in Miami. Gainor has a B.S. in Accounting, in addition to a J.D. and an LL.M. in Taxation from the University of Miami School of Law. Gainor is a Certified Public Accountant and a Certified Management Accountant in the United States.

EL-GAMAL, MAHMOUD A.
Professor of Islamic Economics, Finance, and Management, Rice University; Houston, Tex.
Mahmoud A. El-Gamal is the Chair of Islamic Economics, Finance, and Management and a Professor of Economics and Statistics at Rice University. He has held professorial positions at the University of Wisconsin, California Institute of Technology, and University of Rochester, in addition to working as an Economist at the International Monetary Fund. El-Gamal has a B.A. in Economics and Computer Science and an M.A. in Economics from the American University of Cairo, an M.S. in Statistics from Stanford University, and a Ph.D. in Economics from Northwestern University for a dissertation entitled "Estimation in Economic Systems Characterized by Deterministic Chaos." El-Gamal has research grants to study Islamic jurisprudence and its proofs, game theory, and the data of experimental economics. He has published extensively.

GREEN, STEPHEN K.
Executive Director, HSBC Investment Bank; London, United Kingdom
Stephen K. Green has been Executive Director of Investment Banking and Markets with HSBC Holdings plc since March 1998. Green began his career with the British Government's Ministry of Overseas Development. In 1977 he joined McKinsey & Co., moving to The Hongkong and Shanghai Banking Corporation Limited in 1982 to oversee corporate planning activities. Since 1985, he has been in charge of the development of the Bank's global treasury

operations. In 1992, he became Group Treasurer of HSBC Holdings plc. He was made a Director of HSBC Bank (formerly Midland Bank) in 1995. Green is a director of HSBC USA Inc., HSBC Guyerzeller Bank AG, and HSBC Republic Holdings (Luxembourg) S.A.; a member of the Supervisory Board of HSBC Trinkaus & Burkhardt KGaA; and Chairman of HSBC Holdings' subsidiary HSBC Investment Bank Holdings, responsible for the Investment and Private Banking activities of the Group. Green received his bachelor's degree at Oxford University and a master's degree from the Massachusetts Institute of Technology.

HAMID, SHAIKH ABDUL
Assistant Professor, New Hampshire College; Manchester, N.H.
Shaikh Abdul Hamid is an Assistant Professor of Finance at New Hampshire College Graduate School of Business and Visiting Assistant Professor at Northeastern University. He was formerly Assistant Professor at Boston University and Lecturer at Boston University and Dhaka University. He consulted for a number of projects in Bangladesh in the 1980s. Hamid obtained his B.A. and MBA at the University of Dhaka and his D.B.A. in Financial Economics from Boston University. His research interests include the volatility of markets, market behavior, the interrelationship between international financial markets, and the use of neural networks in finance. He has presented papers at various international, national, and regional finance meetings. He has a number of published articles to his credit in such journals as the *Journal of Business Administration* and *Derivatives Quarterly*.

HARON, SUDIN
Dean, School of Banking and Finance, Northern University of Malaysia; Sintok, Malaysia
Sudin Haron is currently Dean of the School of Banking and Finance at the Northern University of Malaysia. He has served as Dean of the School of Management and Director of the Entrepreneurial Development Institute. He previously worked with a local bank in Malaysia. Haron has published extensively in the areas of Islamic banking and entrepreneurship in *Islamic Economic Studies*, *Journal of King Abdulaziz University – Islamic Economics*, *Asia-Pacific Journal of Management*, *Journal of Islamic Banking and Finance*, *New Horizon*, and many others. Haron has written several books, including *Islamic Banking System: Concepts & Applications*, and *Islamic Banking Rules & Regulations*. He has presented more than 30 papers in international seminars and conferences.

HASSAN, M. KABIR
Associate Chair, Department of Economics and Finance, University of New Orleans; New Orleans, La.
M. Kabir Hassan is currently Associate Professor of Finance and Associate Chair of the Department of Economics and Finance at the University of New Orleans, where he has been teaching since 1990. He also regularly runs executive development seminars on financial decision-making, international banking, and finance in the United States, Jamaica, and Bangladesh. He has worked as a consultant for the Government of Bangladesh, USAID, the World Bank, IDB, ICDT, USIA, and Nathan Associates, and as a Visiting Scholar at the IMF has written on both interest rate and monetary policies in developing countries. Hassan earned his B.A. in Mathematics and Economics from Gustavus Adolphus College, and his M.A. in Economics and Ph.D. in Finance from the University of Nebraska at Lincoln. He has published one book and over 40 articles in refereed journals, and has presented over 100 research papers at conferences all over the world.

HAYES III, SAMUEL L.
Jacob Schiff Professor Emeritus, Harvard Business School; Boston, Mass.
Samuel L. Hayes, III, is Jacob Schiff Professor Emeritus at the Harvard Business School. He joined Harvard's faculty in 1971, prior to which he was a tenured faculty member of the Columbia Business School. Hayes has a B.A. in Political Science from Swarthmore College and an MBA and D.B.A. from the Harvard Business School. Hayes has published in journals such as *Harvard Business Review*, *Accounting Review*, and *Financial Management*. Hayes was a principal contributor to the Harvard Islamic Investment Study. He is the author or co-author of seven books, including *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998), which he co-authored with Frank E. Vogel of Harvard Law School. Hayes has consulted for a number of corporations, financial institutions, and government agencies, and is a member of HIFIP's Advisory Board.

HENRY, CLEMENT M.
Professor of Government, University of Texas, Austin; Austin, Tex.
Clement M. Henry currently specializes in the Middle East and North Africa at the University of Texas, Austin, where he has researched political parties, the engineering profession, and financial institutions. He has lived over 12 years in the field and taught in Algiers, Beirut, Cairo, and Rabat. From 1973 to 1980, he taught at the University of

Michigan. Henry received his A.B., *summa cum laude*, and his Ph.D. in political science from Harvard University, and his MBA from the University of Michigan. His most recent work, co-authored with Robert Springborg, is *Globalization and the Politics of Development in the Middle East* (Cambridge University Press, 2001). He has written, co-authored, and co-edited ten books, and contributed over three dozen articles to other publications, including the American Political Science Review. In July 1999, Henry guest-edited a special double issue of the *Thunderbird International Business Review* on Islamic banking.

IQBAL, ZAMIR
Senior Information Officer, World Bank; Washington, D.C.
Zamir Iqbal is currently a Senior Information Officer in the Treasury Information Services Department of the World Bank. He is also associated with George Washington University, where he is a visiting professor in the International Business Department. Iqbal received his Ph.D. in Economics from the University of Chicago. He has a special research interest in Islamic finance and has published articles in several journals and magazines. His areas of research include Islamic securitization, financial engineering and capital markets.

JAFFAR, ZAINUDIN
President and CEO, Darul Ehsan Islamic College; Kuala Lumpur, Malaysia
Zainudin Jaffar is currently President and CEO of Darul Ehsan Islamic College, a post he has held since August 1996. He joined the International Islamic University Malaysia in 1985 as an Assistant Lecturer and was appointed Lecturer in 1988, Assistant Professor in 1994. In October 1994, he was appointed Deputy Dean (Academic) at the University's Matriculation Center. In 1995, he was also made head of the Law Department at the same center. Jaffar graduated from the University of Malaya in *Sharīʿa* and Malaysian Laws and has an LL.M. from Kings College, University of London and a Ph.D. from the University of Edinburgh. Jaffar is a *Sharīʿa* Advisor to Perwira Affin Bank, Amanah Saham Darul Iman (ASDI), Amanah Saham Wanita (ASNITA), Metrowangsa Asset Management Sdn Bhd (MAM), Pusat Zakat Selangor (PZS), and Corporate Eight Asset Management Sdn Bhd (CEAM).

AL JARHI, MABID ALI
Director, Islamic Research and Training Institute, Islamic Development Bank; Jeddah, Saudi Arabia
Mabid Ali Al Jarhi is presently Director of the Islamic Research and Training Institute at the Islamic Development Bank. He served from 1978-1983 as Division Chief and Senior Economist at the Economic Policy Institute at the Arab Monetary Fund (AMF), as well as Technical Editor for AMF's Joint Arab Economic Report. From 1984-1996 he served as Chief of a number of divisions at the AMF, and as Secretary General of the Council of Governors of Arab Central Banks and Monetary Authorities. He was also Director of the Research Project on Exchange Rate Management and Coordination. He has served on consulting missions to a number of member countries of the AMF, and has taught in California and in Cairo. Al Jarhi earned his B.A. in Economics from Cairo University, his M.A. in economics from the University of Illinois, and his Ph.D. in Economics from the University of Southern California. He has published extensively on both economics and Islamic economics.

AL JASSAR, JASSAR
General Manager, Kuwait Finance House; Safat, Kuwait
Jassar Al Jassar has been the General Manager of Kuwait Finance House (KFH) since January 2000. He was previously the Deputy General Manager at KFH, managing that institution's Investment Sector, Commercial Sector, Technology Sector, and Public Relations and Information Department. Prior to that, he was Assistant General Manager at KFH (Investment Sector); he held a senior management position at The International Investor from 1992-1995. Much of his career has been spent in KFH, where he joined the Treasury Dealing Room in 1980 and rose to Department Manager of the International Investment Department in 1990. Al Jassar earned his MBA in 1980 from the University of North Carolina and his Bachelor's of Commerce and Business Administration in Egypt. He has participated in numerous courses and seminars in the United States and around the world.

KEIGHER, RICHARD P.
Managing Director and Chief Investment Officer, SAMBA Capital Management International; London, U.K.
Richard P. Keigher is Managing Director and Chief Investment Officer of SAMBA Capital Management International (SCMI). His investment responsibilities are directed toward the U.S. equity market. He commenced his investment career 30 years ago, holding senior investment positions at United States Trust Company and Mellon

Bank. He formed SCMI in 1988. Keigher was educated at Syracuse University, University of Rochester Graduate School of Business, and Buffalo Law School.

KHAN, AAMIR
Controller and Vice President, ABN AMRO Venture Capital & Mezzanine Finance; Chicago, Ill.
Aamir Khan joined AAPE in May 2000 after spending two years with AA Wholesale Bank's finance division. In this position, he was responsible for providing senior management with financial analysis and profitability reporting for both domestic and global corporate clients. He worked extensively with several internal departments, such as Treasury, Investment Banking, and Structured Finance in order to improve business processes and reporting structures. Prior to joining AA, Khan worked as Finance Manager for a foreign affiliate of Siemens, where he was responsible for all accounting, treasury, and MIS functions, and at Enron, in the risk management planning and reporting group. Khan has a B.S. in Accounting from the University of Houston and is a Certified Public Accountant.

KHAN, IQBAL AHMAD
Managing Director, HSBC Amanah Finance; London, United Kingdom
Iqbal Ahmad Khan is Managing Director of HSBC Amanah Finance. He was formerly Managing Director of Citi Islamic Investment Bank and Global Head of Islamic Finance for Citicorp. Before that, Khan worked for the DMI Group's subsidiary Islamic Investment Company of the Gulf, Bahrain. He was also a member of the Management Committee of the DMI Group. Khan has a B.Sc. in Physics and Chemistry and an M.A. in Political Science and International Relations, both from Aligarh Muslim University. He serves on the Board of the International Association of Islamic Banks and is a member of the Consultative Committee for the Islamic Credit and Investment Export Corporation, a subsidiary of the Islamic Development Bank. Khan is a founding member of HIFIP's Operating Board.

KHAN, M.A. MUQTEDAR
Assistant Professor, Adrian College; Adrian, Mich.
M.A. Muqtedar Khan is Assistant Professor of International Politics at Adrian College. Khan held faculty positions at Washington College, Georgetown University, and Florida International University from 1991 to 2000. Khan has a B.E. in Electronics and Communication Engineering from Osmania University, India, an M.A. in International Studies from Florida International University, an MBA in Strategic Management and Marketing from Bombay University, and a Ph.D. in International Relations from Georgetown University. He is editor of *Ijtihad, A Return to Enlightenment*, a magazine on issues related to Islam, and is associated with institutions including the Center for Muslim-Christian Understanding at Georgetown University, the Association of Muslim Social Scientists, the International Institute of Islamic Thought, and the Center for the Study of Islam and Democracy. He has published numerous articles in various refereed journals including *Islamica*, *Middle East Policy*, *Security Dialogue*, *Middle East Affairs*, and *American Journal of Islamic Social Sciences*. He regularly writes policy articles and commentaries, and comments on issues related to Islam in the broadcast media.

KHAN, NASEERUDDIN
General Manager, Al-Tawfeek, Dallah Albaraka Group; Jeddah, Saudi Arabia
Naseeruddin Khan is General Manager of Specialized Funds and Public Relations at Al-Tawfeek Co. for Investment Funds Ltd. (Al-Tawfeek). Al-Tawfeek is one of the major subsidiaries within the Financial Services Sector of Dallah Albaraka Group of Saudi Arabia and has successfully developed and marketed Islamic investment funds in various asset classes. Mr. Khan's experience spans more than 38 years in various management positions internationally, including more than 15 years in senior management in Islamic financial institutions. Prior to joining Al-Tawfeek in 1993, he was Credit Controller at the Islamic Investment Co. of the Gulf, Bahrain, a subsidiary of Dar Al-Maal Al-Islami Group, for eight years. Khan has an MBA and is a Certified Management Accountant in Canada. He has presented papers on Islamic finance in global conferences.

KNIGHT, JR., W. DONALD
Senior Partner, King & Spalding; Atlanta, Ga.
W. Donald Knight, Jr., is a senior partner in King & Spalding's Corporate Practice Department and chairs its International Practice Group. He has authored several papers and articles on international law and taxation. He is the author of "Structuring Foreign Investment in U.S. Real Estate." He received his B.A. from Mississippi State

University, his M.A. from Emory University, and his LL.B. from the University of Virginia. He is a member of the Advisory Board of the North American Free Trade & Investment Report in Boston.

MAHMOUD, ESSAM
Professor, King Fahd University of Petroleum and Minerals; Dhahran, Saudi Arabia
Essam Mahmoud is Professor of Quantitative Analysis and Quality in the Management and Marketing Department at King Fahd University. He was previously Chair of Technology Management and Director of the Technology Management Program at Arabian Gulf University and has taught at Arizona State University, the American Graduate School of International Management (Thunderbird), the University of North Texas, the University of Michigan at Flint, and Concordia University. He has experience as a consultant in the Middle East and the U.S. Mahmoud received his MBA and Ph.D. in Management Science and Systems from SUNY Buffalo and another MBA from Ain Shams University in Cairo in Production Planning and Control. He is an editorial board member of 11 journals. He has published over 65 papers and lectured at seminars and executive training courses around the world.

MAZUMDER, M. IMTIAZ AHMED
Doctoral Student, University of New Orleans; New Orleans, La.
M. Imtiaz Ahmed Mazumder is currently a doctoral candidate in financial economics in the Department of Economics and Finance at the University of New Orleans. His interests lie in the areas of financial institutions, international finance, and monetary economics. He was formerly Assistant Professor of Economics at Shahjalal University of Science and Technology in Bangladesh. Mazumder earned his B.A. (Honors) and M.A. in Economics from the University of Dhaka, Bangladesh.

MULLINS, THOMAS D.
Executive Director, Harvard Islamic Finance Information Program; Cambridge, Mass.
Thomas D. Mullins is Executive Director of the Harvard Islamic Finance Information Program and Associate Director of Harvard University's Center for Middle Eastern Studies (CMES). He is also the Executive Director of Contemporary Arab Studies at the CMES and was Chair of the Harvard Islamic Investment Study. Mullins directs new program development and external affairs at the CMES. He has over thirty years of experience in the international oil industry in Europe and the Middle East. His interests include geo-political and strategic studies and Islamic finance. Mullins holds a B.A. from the University of Pennsylvania. His graduate studies were at the American University of Beirut and the Harvard Business School.

OBAIDULLAH, MOHAMMED
Associate Professor, International Islamic University; Kuala Lumpur, Malaysia
Mohammed Obaidullah is Associate Professor of Business Administration at the International Islamic University Malaysia. His areas of interest include Islamic finance, securities markets, and infrastructure finance. Obaidullah received his MBA from the University of Lucknow and Ph.D. in Finance from Utkal University, both in India. He also holds a Master of Education Technology from the University of Southern Queensland, Australia. Obaidullah is the author of *Indian Stock Markets: Theories and Evidence* (Hyderabad: Institute of Chartered Financial Analysts of India, n.d.). Obaidullah has published research in journals such as *Chartered Accountant*, *Islamic Economic Studies*, *Journal of Objective Studies*, and *Securities Industries Review*. He is the Project Director of the School of Islamic Business Education and Research, coordinates the activities of the online Islamic Banking and Finance Net, and edits the *International Journal of Islamic Financial Services*.

RICE, GILLIAN
Associate Professor, American Graduate School of International Management; Glendale, Ariz.
Gillian Rice has been Associate Professor of Marketing at the American Graduate School of International Management (Thunderbird) since 1990. Her research investigates international trade shows as export promotion tools, predictors of environmental consumer behavior, the transfer of environmental technology to developing countries, and the implications of Islamic ethics for advertisers. She was a Fulbright Scholar at the University of Bahrain during 1996-7. Prior to 1990, she served as Director of Rice Mahmoud Associates, a research and consulting firm. Rice has also been Associate Professor of Marketing at the University of Michigan-Flint, Assistant Professor of Marketing at West Virginia University, Concordia University, and Canisius College, and Visiting Professor at SUNY Buffalo. Rice received her B.S. in Business Studies and Ph.D. from the University of Bradford, U.K. She has published extensively, and has presented and chaired at numerous conferences and seminars.

AL-RIFAI, TARIQ
Partner, The International Investor; London, United Kingdom
Tariq Al-Rifai joined The International Investor in February 2000 and is the Partner in charge of information and research. Since joining TII, he has been working on enhancing the company's research capabilities. He has also been active in new product development and distribution with particular emphasis on using Internet technology for the benefit of Islamic banking. In 1996, Al-Rifai established Failaka International Inc., a Chicago-based Islamic financial research and consulting firm that monitors over half the nearly 100 Islamic equity funds worldwide and offers customized research, consulting, and Islamic product development services. Al-Rifai has a B.S. in International Finance from St. Cloud State University in Minnesota and an MBA in International Management from DePaul University in Chicago.

SALAH, ISAM
Partner, King & Spalding; New York, N.Y.
Isam Salah is a partner at King & Spalding in New York. He is a member of the Middle East and Latin America Practice Group and the Co-chairman of the Islamic Finance and Investment Practice Group at King & Spalding. His practice areas include international and domestic finance and commercial and investment matters. He received his B.A. from Case Western Reserve University, his J.D. from Cleveland State University, and his LL.M. from Georgetown University.

THOMPSON, HENRY A.
General Counsel, First Islamic Investment Bank; Manama, Bahrain
Henry A. Thompson is General Counsel for First Islamic Investment Bank, responsible for administering the Bank's legal affairs, investment administration, and developing the legal aspects of the Islamic financial instruments utilized by the Bank. He previously worked at the U.S. law firms Gibson, Dunn & Crutcher and Hogan & Hartson, specializing in cross-border investments as well as financing on both conventional and Islamic lines. He holds a B.S. in Foreign Services and a J.D. from Georgetown University. Thompson is a member of the bar in the District of Columbia.

VALPEY, F. SCOTT
Co-founder and Executive Vice President, Azzad Asset Management; McLean, Va.
F. Scott Valpey is a co-founder and Executive Vice President of Azzad Asset Management and the portfolio manager of the AZZAD/Dow Jones Islamic Index Fund. Valpey practiced as a professional pension and investment consultant from 1983 to 1999, and was registered as a general securities principal (NASD Series 24) with Raymond James Financial Services. Previously, Valpey was Director of Pension Services for Johnston, Lemon & Company, an investment banking firm in Washington, D.C. He has professionally managed assets for private individuals, corporations, pension funds, institutions, and foreign investors. Valpey has over 17 years of investment management and financial services experience.

WARDE, IBRAHIM
Lecturer, University of California, Berkeley; Berkeley, Calif.
Ibrahim Warde is a lecturer at the University of California, Berkeley, and an international consultant specializing in global financial issues. He was previously a research fellow at BRIE (The Berkeley Roundtable on the International Economy), where he did extensive research on the Silicon Valley economy and business practices. He has a B.A. from the Universite Saint-Joseph, an MBA from Ecole des Hautes Etudes Commerciales, and a Ph.D. in Political Science from U.C. Berkeley. Warde is the author of *Islamic Finance in the Global Economy* (Edinburgh University Press, 1999). Warde has written over 30 monographs and articles on international finance.

YAQUBY, NIZAM
Independent Sharīʿa *Consultant*; Manama, Bahrain
Nizam Yaquby is a renowned *sharīʿa* scholar and advisor to numerous Islamic banks and companies, including Abu Dhabi Islamic Bank, Islamic Investment Company of the Gulf, Arab Islamic Bank, and Dow Jones Indexes. He pursued traditional Islamic studies in Mecca, India, and Morocco under the guidance of scholars such as Abdullah Al-Farisi and Muhammad Saleh al-Abbasi. Yaquby has a B.A. in Economics and Comparative Religion from McGill University and is a Ph.D. candidate in Islamic Law at the University of Wales. Yaquby has published several books on Islamic law, is a frequent speaker at Islamic conferences, and has taught Islamic subjects in Bahrain since 1976.

Appendix C

About the Harvard Islamic Finance Information Program

Thomas D. Mullins
Executive Director

S. Nazim Ali
Director of Operations

INTRODUCTION

The Harvard Islamic Finance Information Program (HIFIP) is a unique academic research program in the field of Islamic finance and economics. Interdisciplinary in nature, it draws broadly from law, economics, business, and Islamic studies, making it the only program of its kind. As the information clearing house for this emerging discipline, HIFIP brings together academics and practitioners in the production, channeling, and application of the knowledge needed to promote greater understanding of Islamic finance.

The publication of Vogel and Hayes' *Islamic Law and Finance: Religion, Risk, and Return* in 1998 was very well received by scholars and students. It has drawn their attention to, and raised their interest in, the study of Islamic finance at Harvard. HIFIP is a natural magnet for this continued interest, attracting and centralizing resources that help give Harvard a leadership role in this dynamic aspect of Islamic studies.

In the few years since its establishment in 1995, HIFIP has reached a diverse audience through a wide array of activities—including the regular release of the HIFIP *DataBank*, the annual calling of the Harvard University Forum on Islamic Finance, and the publication of several volumes of Proceedings of the Forum.

OBJECTIVES

To Act as an Information Clearinghouse
The main goal of HIFIP is to act as a clearinghouse of information on Islamic banking and finance.

To Increase Awareness and Understanding
HIFIP seeks to foster an increased awareness and understanding of Islamic banking and finance within Islamic society as well as between the Islamic and non-Islamic worlds. To this end, the Program sponsors seminars, lectures, and forums on topics relevant to Islamic banking and finance. Most noteworthy is the Harvard University Forum on Islamic Finance, organized and hosted by HIFIP each year since 1997.

To Promote Research and Development
HIFIP sponsors research projects that investigate new trends, strategies, and methods, with particular emphasis on studies of how existing financing methods available in conventional banking and finance can be applied to their Islamic counterparts, and vice versa. A Visiting Research Scholars Program provides recognized experts the opportunity to visit HIFIP and conduct research, present papers, and participate in other academic activities.

To Identify and Access Resources
In response to requests from around the world to identify and obtain rare or obscure documents on Islamic banking and finance, HIFIP researches Harvard's vast information resources, which include dozens of libraries, hundreds of journals, and millions of books.

ACTIVITIES

The Harvard University Forum on Islamic Finance

Each year, the Program organizes the Harvard University Forum on Islamic Finance. HIFIP's purpose in planning the Forum is to bring a global assembly of participants under one roof to foster productive dialogue about the present status and future directions of Islamic banking and finance. The Forum holds the distinction of being the only conference of its kind that devotes at least one entire session to the *sharīʿa* (Islamic law). Every year, distinguished jurists in *fiqh al-muʿamalat* (the portion of the *sharīʿa* dealing with economic and financial matters) address the Forum and present papers. Other sessions cover Islamic economics, Islamic finance, and the practice of

Islamic finance by financial institutions. HIFIP has been able to attract leading thinkers and leaders of the industry, who have presented important papers at the Forums.

In May 1997, the First Forum, "Islamic Finance in the Global Market," gathered some 100 participants. Though a small, single-day event, the First Forum drew some of the luminaries in Islamic finance. The Second Forum, "Islamic Finance into the 21st Century," took the vision of the First Forum to a new level. This two-day event attracted more than 200 guests, including *sharīʿa* scholars, economists, banking practitioners, lawyers, and students. The Third Forum, "Islamic Finance: Local Challenges, Global Opportunities," welcomed even more participants anxious to tackle the kinds of vital issues emerging at previous Forums.

The Fourth Forum, "The Task Ahead," was held in Autumn 2000. Like previous Forums, it covered theoretical and practical, current and upcoming issues in Islamic finance and economics, in addition to the *sharīʿa*. The Forum focused on critical issues in Islamic economics and finance as well as opportunities for and constraints on their development. The Fourth Forum's base of over 300 participants, and its display of cutting-edge research and development, portends a strong future for the Harvard University Forum on Islamic Finance.

The Fifth Forum, entitled "Dynamics and Development," has been called for April 6 and 7, 2002, and is expected to bring together scholars, industry players, students, and the concerned public in the same manner as at past Forums.

The HIFIP *DataBank*

The main work of HIFIP for much of the year centers on the compilation and updating of the HIFIP *DataBank*. This original and unique collection is a helpful tool for both researchers and practitioners. The information in the *DataBank* is collected continuously by Harvard students from libraries, Internet sources, and, most importantly, the hundreds of institutions in the Islamic financial field.

The *DataBank* contains detailed information on the constitution and performance of Islamic financial institutions and funds. It also includes information on research programs and publications in Islamic economics and finance. A section of the *DataBank* is devoted to *sharīʿa* matters, with original essays on the different terms relevant to Islamic finance as well as translations of the rulings of the *sharīʿa* boards of a number of institutions. HIFIP's Who's Who Database contains biographical and contact information on thousands of scholars and practitioners in Islamic economics and finance. All of this information, and more, constitutes the HIFIP *DataBank*. The *DataBank*'s approach is encyclopedic in scope, yet remains very accessible. HIFIP is working hard to create a user-friendly interface in the layout of the *DataBank*.

HIFIP Online

In keeping with its goal of being the premier information clearinghouse for the Islamic finance and banking sector, HIFIP has laid out an aggressive Web strategy to focus its online efforts. This Web strategy calls for all of HIFIP's information systems and products, both internal and external, to be Web-enabled by the end of Summer 2001. This will allow HIFIP to collect, analyze, and disseminate information more rapidly and effectively.

In keeping with this plan, HIFIP has already begun to move its systems and products to the World Wide Web. Specifically, an alpha release of the Web version of the HIFIP *DataBank*, the i*DataBank*, has been online for several months (http://www.hifip.harvard.edu). Based on user feedback, a complete redesign is now in progress for a beta release. After the release of the i*DataBank*, all the latest information on the Islamic banking industry will be available online. Older information will be archived, however, and made available on CD. HIFIP is also currently transferring its internal Data Entry System (DES) to the Web so that staff can participate more effectively in internal workflow. A unified HIFIP portal will provide a single point of access for both systems.

As part of its overall Web strategy, HIFIP intends to intensify its relationships with various content providers, update its industry directories more frequently, and maintain a high level of navigability and overall usability, so that the sheer volume of information in the i*DataBank* does not overwhelm the user. HIFIP is encouraging the entire Islamic banking and finance community to send suggestions as it continues implementing this very exciting plan.

Publications

The Harvard Islamic Finance Information Program regularly publishes the proceedings of its forums, adding scholarly introductions, and an extensive index to the papers presented. Each volume highlights some of the most important developments in the field and is a valuable resource for industry leaders as well as scholars.

In September 1999, HIFIP published the Proceedings of the Second Harvard University Forum on Islamic Finance, a landmark publication with over thirty original works covering Islamic economics, the *sharīʿa*, Islamic finance, and business models. This volume holds the distinction of being the first complete proceedings of a

conference on Islamic finance. The next year, HIFIP released the Proceedings of the Third Forum. These and future Proceedings are expected to further HIFIP's position as the leader in collecting and disseminating original knowledge about Islamic banking and finance.

Research Assistance

That HIFIP, as an academic program, should give great importance to research is self-evident. HIFIP sees itself as an information clearinghouse for the Islamic financial community, channeling information between the research and practice of Islamic finance. Exhibit 1 illustrates HIFIP's role in this capacity. A significant exchange of information with the community and a range of research activities are commensurate with this ambition, and HIFIP is committed to both.

HIFIP allows researchers in Islamic finance and economics access to its vast store of information. Researchers throughout the world are encouraged to contact HIFIP to obtain information needed to facilitate their work. Financial professionals also request information from the Program on matters ranging from *sharīʿa* issues to the engineering of financial instruments.

Visiting Research Scholars Program

HIFIP also supports groundbreaking research in Islamic banking and finance by allowing scholars access to Harvard University's vast resources. The Visiting Research Scholars Program invites prominent researchers to Harvard under HIFIP's auspices and provides them with an opportunity to complete their research here. Recent fellows have studied Islamic tradable instruments and published the results. The Program further provides assistance and information for graduate and post-graduate students studying Islamic finance. It advises Ph.D. candidates around the world in their work.

Internships

HIFIP has organized internships and travel opportunities for its researchers at various companies, facilitating and furthering their education. Several institutions have contacted HIFIP in order to create internships for HIFIP researchers.

Information Sessions

HIFIP organizes information sessions throughout the year for members of the Harvard community interested in the Program and in Islamic banking and finance. At its offices, the Program has held informal discussions with students from Harvard College, the Graduate School of Arts and Sciences, the Harvard Business School, and Harvard Law School. As a service to beginners in Islamic finance, especially at Harvard, HIFIP organized a workshop within the Fourth Forum that introduced newcomers to the basic concepts of Islamic finance. The Program plans to continue this session in future forums.

Career Opportunities

HIFIP hopes to train future leaders of the Islamic financial community. In the years since its inception, the Program has helped create career opportunities for the students it has employed. Having graduated, many of the associates of the Program are now employed in prominent institutions, including several leading financial and consulting firms, both within and outside the Islamic financial industry.

Present Researchers

HIFIP employs about a dozen students, drawn mainly from Harvard College, but also from the Harvard graduate schools as well as neighboring colleges. HIFIP's student researchers have come from MIT, Tufts, and Boston University in addition to Harvard. It is these students who carry out the enormous task of compiling and updating the *DataBank* as well as organizing the Forum. HIFIP also utilizes volunteers from and graduates of the College, the Business School, and the Law School to compile and edit the Proceedings that issue from the Forum.

LOOKING AHEAD

In the six short years of its existence, HIFIP has indeed achieved much. However, the Program has the potential for much more. Islamic finance is a growing field, and so new areas of study and new opportunities for involvement spring up every day before a program such as HIFIP.

HIFIP's potential promise is to promote Islamic finance in several modes: studying and serving the Islamic finance industry, inducing collaboration among scholars within and outside the Muslim world, and increasing

cooperation and understanding among Muslim and non-Muslim countries. To these ends, HIFIP has matchless access to a combination of resources: the world's leading institution of higher learning and research, scholarly authorities, potential leaders among Harvard's students, and the active cooperation and goodwill of the Islamic finance industry.

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