

An Introduction to Islamic Finance

Theory and Practice

SECOND EDITION

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ZAMIR IQBAL
AND ABBAS MIRAKHOR



WILEY

John Wiley & Sons (Asia) Pte. Ltd.

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Published in 2011 by John Wiley & Sons (Asia) Pte. Ltd.
1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

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John Wiley & Sons, The Atrium, Southern Gate, Chichester, West Sussex,
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John Wiley & Sons (Canada) Ltd., 5353 Dundas Street West, Suite 400, Toronto,
Ontario, M9B 6HB, Canada
John Wiley & Sons Australia Ltd., 42 McDougall Street, Milton, Queensland
4064, Australia
Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

Library of Congress Cataloging-in-Publication Data

ISBN 978-0-470-82808-3 (Hardback)
ISBN 978-0-470-82810-6 (ePDF)
ISBN 978-0-470-82809-0 (Mobi)
ISBN 978-0-470-82811-3 (ePub)

Typeset in 10/11.5pt Sabon Roman by MPS Limited, a Macmillan Company
Printed in Singapore by
10 9 8 7 6 5 4 3 2 1



In the Name of Allah, the All Merciful, the All Beneficent

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Glossary of Arabic terms

A

- ajar*: Reward for doing good
akhlaq: Personality disposition stemming from individual character
akl amwal alnas bi al-batil: Enrichment through non-permissible means
al-adl: Justice
al-amal: The concept of work
al-bay': Exchange
al-ihsan: Behaving with full consciousness of the Supreme Creator
al-khiyar/khiyar: Option
al-mal: Wealth or property
al-Mo'meneen: Active believers
amanah: Trust
aqidah: Binding principles of faith
awqaf (sing. *waqf*): Endowments

B

- bai' bithamin ajil (BBA)*: Sales contract where payment is made in installments after delivery of goods. Sale could be for long term and there is no obligation to disclose profit margins
barakah: An invisible but “material” blessing whose results can be observed by any believer who engages in righteous conduct
bashar: Man. This concept refers to the physical/outward attributes, rather than the inner character
bay': Contracts of exchange
bay' al-arabun: A portion of the full sale price paid in good faith as earnest money (could be considered as non-refundable down payment)
bay' al-dayn: Sale of debt or liability
bay' al-istisna': Sale on order (usually manufactured goods)
bay' al-muajjal: Deferred-payment sale, either by installments or a lump sum
bay' al-salam (also *salaf*): Sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller

D

- dayn*: Debt
dharoorah: Necessity

F

fadl: Addition

faqih (pl. *fuqaha'*): Jurist who gives rulings on various issues in the light of the *Qur'an* and the *sunnah*

fatwa: Religious verdict by *fuqaha'*

fiqh: Corpus of Islamic jurisprudence. In contrast to conventional law, *fiqh* covers all aspects of life—religious, political, social, commercial, and economic. *Fiqh* is based primarily on interpretations of the *Qur'an* and the *sunnah* and secondarily on *ijma'* and *ijtihad* by the *fuqaha'*. While the *Qur'an* and the *sunnah* are immutable, *fiqhi* verdicts may change in line with changing circumstances

fiqhi: Relating to *fiqh*

G

ghabun: The difference between the price at which a transaction is executed and the fair price (unjustified exploitation, loss)

gharar: Literally, “deception, danger, risk, and excessive, unnecessary uncertainty (ambiguity).” Technically, it means exposing oneself to excessive risk and danger in a business transaction as a result of either having too little information or asymmetric information about price, quality and quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfill their commitment, or ambiguity in the terms of the deal—thereby, exposing either of the two parties to unnecessary risks

H

hadial/hibah: Gifts

hadith (pl. *ahadith*): Oral tradition of the Prophet Muhammad (pbuh) as narrated by his companions

hajj/umra: The pilgrimage to Mecca

hajr: Blocking the use of a resource

haram: Prohibited

hawala: Bills of transfer

hifz al-mal: Protection of wealth or property

hila (pl. *hiyal*): Refers to strategies in applying juristic rules to ease constraints on a particular transaction that would have been non-permissible otherwise

I

'ibada (pl. *ibadat*): Adoration of Allah (*swt*) through rule compliance

ijarah: Leasing. The sale of the usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership

ijarah sukuk: Instrument issued on the basis of an asset to be leased. The investors provide funds to a lessor (say, an Islamic bank). The lessor acquires an asset (either existing or to be created in future) and leases it out if it is not already leased out. They are issued by the lessor in favor of the investors, who become owners of the leased asset in proportion to their investment. These entitle the

holders to collect rental payments from the lessee directly. Can also be made tradable in the stock exchange

ijarah wa "qtinah": Hire-purchase agreement

ijma: The consensus of jurists

ijtihad: Exertion of personal effort to understand the wisdom behind the prescribed rules and/or efforts to extend juristic rulings to new situations based on study of the *Qur'an* and *hadith*

ikrah: Coercion

iman: Active belief

insan: This concept refers to a "human being" who is fully conscious of the human state in relation to the Supreme Creator. cf. *bashar*

israf: Overspending

istihsan: Judicial preference

istisna' (short form for *bay' al-istisna'*): A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver well-described products (or premises) at a given price on a given date in the future. The price need not be paid in advance and may be paid in installments in step with the preferences of the parties, or partly at the front end and the balance later on, as agreed

itlaf: Waste

itraf: Opulent and extravagant spending

J

jo'alab: Performing a given task for a prescribed fee in a given period

K

kanz (pl. *konooz*): Treasure(s). Refers to wealth held in the form of gold, silver, and other precious metals

khalifa: Vicegerent, trustee

khawf: Fear of the consequences of thoughts and actions

khilafah: Trusteeship, stewardship

khisarab: Loss

khums: One-fifth of income payable for the purpose of redeeming the rights of others

kifala: Taking responsibility for someone else (see also *takaful*, which is derived from this)

M

ma'aad: The ultimate return of everything to the Creator for the final accountability and judgment

madhabib: School of thought

manafaah al-ikhtiyarat: Gains from taking options

manfaa maal/ manfa' ah: Usufruct. Benefit flowing from a durable commodity or asset. Also, gains from transaction

maqasid al-Shari'ah: Basic objectives of the *Shari'ah*: the protection of faith, life, progeny, property, and reason

- maslahah:** Literally, “benefit.” Technically, it refers to any action taken to protect any one of the five basic objectives of the *Shari’ah*
- mithaq:** A covenant
- muamalat:** Interpersonal transactions
- mubaya’a:** Contract between the ruler and the community that he will be faithful in discharging his duties in compliance with the rules prescribed by Allah (*swt*)
- mudarabah:** Contract between two parties—a capital owner or financier (*rabb al-mal*) and an investment manager (*mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier. The investment manager’s loss lies in not getting any reward for his labor services
- mudarib:** Investment manager
- muhtasib:** A market supervisor
- murabahah:** Sale at a specified profit margin. This term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or as a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. Also referred to as *bay’ mu’ajjal*
- musharakah:** Partnership. Similar to a *mudarabah* contract, the difference being that here both partners participate in the management and the provision of capital and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one’s share in the capital. Also, this contract is more suitable for longer-term partnership contracts and long-gestating projects
- musharakah ‘aqd:** The contract of *musharakah*
- musharakah mulk:** Specification of property rights of partnership
- musharakah mutanaqisah:** “Diminishing partnership”
- mysir:** Gambling or any game of chance

N

- nafaqa:** Expenditure
- nafs:** The psyche (sometimes translated as “soul”)
- nisab:** A level of wealth beyond which levies are due
- niyyah:** Intention

Q

- qard:** A loan
- qard-ul-hassan:** Loan extended without interest or any other compensation from the borrower. The lender expects a reward only from Allah (*swt*)
- qimar:** Gambling
- qist:** Social (inter-relational) justice
- qiyas:** Analogy
- Qur’an** (also written as *al-Qur’an*): The Holy Book of Muslims, consisting of the revelations made by Allah (*swt*) to the Prophet Muhammad (pbuh). Prescribes the rules of social and personal behavior, compliance with which guarantees social solidarity, economic growth and development

R

rabb al-mal: Capital owner or financier

rahn: a pledge (also translated as “collateral”)

riba: Literally, “increase,” “addition” or “growth.” Technically, it refers to the “premium” that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest, as commonly understood today, is regarded by a predominant majority of *fuqaha*’ to be equivalent to *riba*

ribh: Profit

S

sadaqat: Payments to redeem others’ rights(also translated as “charity”)

safih: A person of weak understanding

sarf: An exchange contract

sarrafs: Exchange dealers

Shari’ah: The corpus of Islamic law based on Divine guidance, as given by the *Qur’an* and the *sunnah*, and embodies all aspects of the Islamic faith, including beliefs and practices

shirakah: Partnership.

suftaja: Bills of exchange

sukuk: Negotiable financial instruments

sunnah: The second-most important source of the Islamic faith after the *Qur’an* and refers to the Prophet’s (pbuh) operationalization and explication of the rules prescribed by Allah (*swt*) in the *Qur’an* in words and action

surah: A chapter of the *Qur’an*

T

tabdhir: Squandering

takaful: An alternative to the contemporary insurance contract. A group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. Any loss is met from the collected funds

taqwa: Awe/fear that comes with consciousness of the presence of Allah (*swt*)

tawarruq: Reverse *murabahah*. Buying an item on credit on a deferred-payment basis and then immediately reselling it for cash at discounted/prize to a third party

tawhid: The Unity and Oneness of the Creator

tijÉrah/tirajah: Contracts of trade

U

urf: Customs

W

wa’d: A time-bound promise to deliver on terms contracted

wadia: Trust or safe keeping

wakalah/wikala: Contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually for a fixed fee

wali: A protective, loving friend

waqf (pl. *awqaf*): Endowment

Z

zakah/zakat: Amount payable by a Muslim on his net worth as a part of his religious obligations to redeem the rights of others

CHAPTER 1

Introduction

Islam propounds the guiding principles, and prescribes a set of rules, for all aspects of human life, including the economic aspect. How, and to what degree, would an economic and financial system designed in conformity with the principles of Islam be different from a modern, conventional, non-Islamic system? How would such a system deal with the questions of the allocation, production, exchange, and distribution of economic resources? How can some of its fundamental principles be explained with due analytical rigor? Researchers interested in contemplating or devising a social, economic, and financial system based on the tenets of Islam are familiar with these and many other such questions.

It is only in the past few decades that efforts have been made to explain Islamic financial and economic principles and rules in modern analytical terms and, despite considerable published research, there is still some confusion in regard to applying a precise definition to various social sciences prefixed with the term “Islamic,” such as “Islamic economics” or “Islamic finance.” One of the main reasons for this confusion is the tendency to view different aspects of such a system in isolation, without looking at it in its totality. For example, the term “Islamic finance” is often deemed to denote a system that prohibits “interest.” However, this simple description is not only inaccurate but is itself a source of further confusion. Unfortunately, too, a number of writers have taken the liberty of expressing opinions on these issues without sufficient knowledge of Islam, its primary sources, its history and often without even a working knowledge of Arabic—the language of Islam.¹ Against the backdrop of a politicized atmosphere, such attempts render an understanding of these issues even more difficult.

Systematic thinking by professional economists about Islam and economics has had a short history compared to both the remarkable earlier period of vibrant scholarship in the sciences and humanities in the Muslim world and to the long “hibernation”² that followed it. This earlier period witnessed major achievements in all areas of Muslim scholarship and gave rise to dynamic economic growth in Muslim societies. History has recorded how these contributions, discoveries and intermediation by Islamic sciences

actually helped facilitate the development and growth of Western societies and economies. When measured against the last three decades of research and development in other disciplines, it is clear that this hibernation is now over and the published writings on Islamic economics in various languages are testimony to a return of vibrancy and energy in the discipline. These efforts are directed toward the development of a coherent and rigorous explanation of how Islam proposes to organize an economic system by answering the fundamental questions of what should be produced, how and for whom; how decisions should be made and by whom; and, finally, how Islamic institutions could be revived to address the problems of modern societies.

FOUNDATIONAL CONCEPTS

Islam postulates a unique nexus of contracts among the Creator, man and society on the basis of the Divine Law that directly affects the workings of the various social, political, economic, and financial systems. Therefore, to understand the way in which economic affairs are to be organized in an Islamic system, it is first necessary to comprehend the nature of this relationship. What differentiates Islam from other systems of thought is its unitary perspective, which refuses to distinguish between the sacred and the profane and which insists that all of its elements must constitute an organic whole. Consequently, one cannot study a particular aspect or part of an Islamic system—its economic system, say—in isolation, without an understanding of the conceptual framework that gives rise to that part or aspect, any more than one can study a part of a circle without conceptualizing the circle itself.

The economist Douglas North contends that what distinguishes one economic system from another is the “institutional scaffolding”—the collection of rules and norms along with their enforcement characteristics—in that system. He defines institutions as rules of behavior designed to impose constraints on human interaction. These institutions “structure human interaction by providing an incentive structure to guide human behavior. But an incentive structure requires a theory of the way the mind perceives the world and its functioning so that institutions provide those incentives” (North 2005: 66). It is at this point that paradigms become relevant because paradigms in economics do have conceptions of man, society and their interrelationships. A paradigm can be defined as a conception of reality composed of a theoretical and empirical structure in a given field. When a critical mass of practitioners accepts that structure, that conception of reality becomes a paradigm. Such conceptions are themselves products of a meta-framework lurking in the background whose elements may or may not be explicitly specified but which, nevertheless, exist in the mind of the designer prior to the construction and presentation of a paradigm. For example, the meta-framework of neo-classical economics is classical economics, as the name implies.

There are basically two meta-frameworks that underlie all economic paradigms: Creator-centered or man-centered. The former derives its economic

analysis from rules of behavior (institutions) prescribed by the Creator for individuals and societies. Examples are economic paradigms that are based on Abrahamic traditions, Judaism (see, for example, Tamari 1987), Christianity (see, for example, Long 2000) and Islam. The latter, the secular tradition, takes as given, or derives, rules of behavior (institutions) that are designed by humans and approved by society.

The meta-framework for Islam specifies these rules of behavior within the context of its fundamental principles. The core and fundamental axioms of Islamic ideology are the belief in (1) the Unity and Oneness of the Creator (*tawhid*), (2) the prophethood (*Nubuwwa*), and (3) the ultimate return of everything to the Creator for the final accountability and judgment (*Ma'aad*).

The first and most important of these principles is the Oneness and Uniqueness of the Creator, a corollary of which is the unity of the creation, particularly the unity of mankind. The axiom of Unity and Oneness of the Creator requires the belief that all creation has one omniscient and omnipresent Creator—Allah (*swt*)—who has placed humans on this earth to pursue their own felicity and perfection.³ Further, it requires that the orbit of man's life is seen to be much longer, broader and deeper than the material dimension of life in this world.

A corollary of the axiom of the Unity of the Creator is that all His creation constitutes a unity as well. The *Qur'an* (31:28) calls attention to the fact that despite all apparent multiplicity, human beings are fundamentally of one kind; they were created as one being (*nafs*) and will ultimately return to Allah (*swt*) as one as well.

In a series of verses, the *Qur'an* exhorts people to take collective and unified social action to protect the collectivity from all elements of disunity.⁴ These and many other verses order human beings to work hard toward social unity and cohesion in constructing their societies, and preserve and defend that unity. Unity and social cohesion are so central among the Divine objectives set out for mankind in the *Qur'an* that it can be argued that all conduct prohibited by Islam is that which ultimately leads to disunity and social disintegration. Conversely, all righteous conduct prescribed by Islam is that which leads to social integration, cohesiveness and unity. As a result, Islam is a call both to the individual and to the collective and has given the latter an independent personality and identity, which will be judged on its own merits or demerits separately from the individuals that constitute the collectivity. The final judgment on individual actions will have two dimensions: one as the individual and the other as a member of the collectivity.

The second fundamental principle is the belief in the Creator's appointment of individuals to serve as His messengers and prophets to others of their kind. These are very select among humans. Every messenger and prophet affirmed and confirmed the messages revealed before them and invited the people of their time and place to remind people of the rules of behavior contained in the revelation and to apply those rules in accordance with the added complexity of human life and the growth of human consciousness at

specific points in time. The final, universal, perfect message was then delivered by the last of the messengers, Muhammad (pbuh).⁵

At some point in the cycle of life, each individual will be called to account to Allah (*swt*) for his/her actions and will be judged accordingly in the “life hereafter.”

These three axioms are comprehensive and govern all of man’s actions and decisions, and constitute an integrated, consistent and unified whole; compliance with these rules leads, in turn, to the unity of human society.

The meta-framework envisions an ideal society as one composed of believers committed to complying with the Creator’s rules. The individual members are aware of their “oneness” and conscious of the fact that self-interest is best served by seeing “others as themselves.” Such a society is one of the “golden mean” that avoids extremes, and a society that is so rule compliant that it serves as a benchmark for and a witness to humanity (*Qur’an* 2:143). This is a society which actively encourages cooperation in socially beneficial activities and prohibits cooperation in harmful ones (*Qur’an* 3:104, 110, 114; 9: 71). Moreover, in this society, consultation, at both individual and collective levels, is institutionalized in accordance with the rule prescribed by Allah (*swt*) (*Qur’an* 3:159; 42:38; 2:233). Similarly, all other rules of behavior prescribed in the *Qur’an* are institutionalized with a sufficiently strong incentive structure to enforce rule compliance; the objective being the establishment of social justice. The internalization of the rules of behavior by individuals and their institutionalization, along with the incentive structure and enforcement mechanism, reduces uncertainty and ambiguity in decision–action choices confronting the individual and the society.

The structure of such a paradigm can be described as being composed of a meta-framework and an archetype model. The former specifies rules (institutions) that are, to a degree, abstract and immutable. The archetype model articulates the operational form of these rules in a human community. The meta-framework specifies the immutable, abstract rules. The archetype model demonstrates how these rules are operationalized in a human community. The meta-framework specifies general universal laws, rules of behavior. The archetype model provides specific universal rules of behavior and the institutional structures needed for organizing a human society based on the immutable rules of the meta-framework (Mirakhor and Hamid 2009).

The abstract became operational in the hands of the one human being who was the one and only direct recipient of the source of the meta-framework; that is, the *Qur’an*. Through the words and actions of this perfect human, the meta-framework given by the Creator in the *Qur’an* was interpreted, articulated and applied to the immediate human community of his time. As the spiritual authority for his followers, he expounded, interpreted, and explained the content of the *Qur’an*. In his capacity as the temporal authority the messenger operationalized the rules (institutions) specified in the *Qur’an* in Medina. The economic system established in Medina is the archetype of Islamic economic systems and provides a core institutional structure which is immutable.

WHY IDEOLOGY MATTERS

The strength of ideology determines the strength of rule compliance, and therefore the strength of institutions, which, together with technology, determine the performance and efficiency of an economic system. Efficiency is measured by the cost of a given level of economic performance. The stronger the ideology, the less the divergence between the choices individuals make and those expected of them by the objectives of institutions, and, consequently, the lower the cost of enforcement of contracts and rules of conduct. By implication, in an ideal situation, with a strong ideology, in which all rules of conduct are complied with and are universally enforced, there will be no divergence between what institutions expect of individual choices and the actual choices. Therefore, in the ideal situation, asymmetry and moral hazard are minimized since a large part of uncertainty will be eliminated with rule compliance. The remaining risks will become insurable.

ISLAM'S CONCEPT OF JUSTICE

As mentioned earlier, a central aim of Islam is to establish a just and moral social order through human agency. This all-embracing desideratum of the Islamic system is the ruling principle from which human thought and behavior, the substantive and regulative rules of the *Shari'ah*, the formation of the community and the behavior of polity and of political authority derive their meaning and legitimacy. It is this emphasis on justice that distinguishes the Islamic system from all other systems. It is via the concept of justice that the *raison d'être* of the rules governing the economic behavior of the individual and economic institutions in Islam can be understood. What gives the behavior of a believer its orientation, meaning, and effectiveness is acting with the knowledge that justice evokes Allah's (*swt*) pleasure; and injustice, His displeasure. Whereas justice in Western thought is a quality of the behavior of one individual in relation to another and his actions can be perceived as unjust only in relation to the "other," in Islam it has implications and consequences for the first individual as well. That is, even when one does injustice to someone else, there is always reciprocity, in that through injustice to others, ultimately, one also does injustice to oneself and receives its results both here and in the hereafter.

Justice in Islam is a multifaceted concept, and several words or terms exist for each aspect. The most common word in use, which refers to the overall concept of justice, is the word *adl*. This word and its many synonyms imply the concepts of "right," as an equivalent of "fairness," "putting things in their right place," "equality," "equalizing," "balance," "temperance,"

and “moderation.” These last few concepts are more precisely expressed as the principle of the “golden mean,” according to which believers are not only individually urged to act in conformity with this principle, but also the community is called upon, by the *Qur’an*, to be a “nation in the middle.”⁶ Thus, justice in Islam is the conceptualization of an aggregation of moral and social values, which denotes fairness, balance, and temperance. Its implication for individual behavior is, first of all, that the individual should not transgress his bounds and, secondly, that one should give others, as well as oneself, what is due.

In practice, justice is operationally defined as acting in accordance with the Law, which, in turn, contains both substantive and procedural justice. Substantive justice consists of elements of justice contained in the substance of the Law, while procedural justice consists of rules of procedure assuring the attainment of justice contained in the substance of the Law. The underlying principles which govern the distinction between just and unjust acts determine the ultimate purpose of the Islamic path, the *Shari’ah*, which includes: the establishment of the “general good” of society (considered to be the intent of the *Qur’an* for human collectivity and the *Shari’ah* is the path by which it is achieved); building the moral character of individuals; and, finally, the promotion of freedom, equality, and tolerance, which are often stated as important goals of the *Shari’ah*. Of these, protecting the interests of society is accorded the greatest importance. Although there can be no contradiction between justice for the community as a whole and justice for the individual, the interest of the individual is protected so long as such interest does not come into conflict with the general interest of the community.

SHARI’AH—THE LAW

Islam legislates for man according to his real nature and the possibilities inherent in the human state. Without overlooking the limited and the weak aspects of human nature in any way, Islam envisages man in light of his primordial nature as a theophany of Allah’s attributes, with all the possibilities that this implies. It considers the human as having the possibility of being perfect, but with a tendency to neglect potentialities of the human state by remaining only at a level of sense perception. It asks, therefore, that in exchange for all the blessings provided by their Supreme Creator, humans seek to realize the full potential of their being, and remove all the obstacles which bar the right functioning of their intelligence. To order human life into a pattern intended for it by its Creator, humans are provided with a network of injunctions and rules, which represent the concrete embodiment of the Divine Will in terms of specific codes of behavior, by virtue of acceptance of which—through the exercise of his free choice—a person becomes a Muslim and according to which the individual lives both his private and social life. This network of rules—called the *Shari’ah*, which is etymologically derived from a root meaning “the road”—leads man to a harmonious life here and felicity hereafter.

The emphasis on the axiomatic principle of Unity forms the basis for the fundamental belief that Islam recognizes no distinction between the spiritual and the temporal, between the sacred and the profane, or between the religious and the secular realms. Islam seeks to integrate all human needs, inclinations, and desires through the all-embracing authority of the *Shari'ah*. Life is considered as one and indivisible. Therefore, the rules of the *Shari'ah* hold sway over economic life no less than over social, political, and cultural life; they persuade, determine, and order the whole of life. It is through the acceptance of and compliance with the rules of the *Shari'ah* that individuals integrate themselves not only into the community, but also into a higher order of reality and the spiritual center. Violations of these rules will have a disintegrative effect upon the life of the individual and that of the community.

The *Shari'ah* rules are derived, based on the *Qur'an* and its operationalization by the Prophet (pbuh), through a rigorous process of investigation and thinking across time and geographical regions. The expansion of the rules of Law and their extension to new situations, resulting from the growth and progress of the Islamic community, is accomplished with the help of consensus in the community, analogical reasoning—which derives rules by discerning an analogy between new problems and those existing in the primary sources—and through the independent human reasoning of those specialized in the Law. As a result, *Shari'ah* is invested with great flexibility in handling problems in diverse situations, customs, and societies and therefore has a wide range of solutions and precedents, depending on different circumstances.

History has *not* recorded instances when Muslim jurists were unable to provide Islamic solutions to new problems. Their opinions covered all aspects of life. They laid down brilliant theories, exemplary rules and solutions. Unfortunately, however, with the decline of Islamic rule in Muslim countries, the significance of the *Shari'ah* in running day-to-day life also declined and development of the *Shari'ah* remained dormant. In the last few decades, however, the reawakening among Muslims has generated enormous demand for the development of *Shari'ah*-based rules that address the problems of modern society.

BASICS OF THE SHARI'AH

The life of a Muslim at the individual and the societal levels is governed by different sets of rules. The first set, known as *aqidah* (faith), concerns the core relationship between people and the Creator and deals with all matters pertaining to a Muslim's faith and beliefs. The second set deals with transforming and manifesting the faith and beliefs into action and daily practices and is formally known as *Shari'ah* (Law). Finally, the third set is *akhlaq*, which cover the behavior, attitude, and work ethics according to which a Muslim lives in society. *Shari'ah*

(Continued)

is further divided into two components: *ibadat* (rituals) focuses on the rites and rituals through which each individual comes to an inner understanding of their relationship with Allah (*swt*); *muamalat*, on the other hand, defines the rules governing social, political, and economic life. Indeed, a significant subset of *muamalat* defines the conduct of economic activities within the economic system, which ultimately lays down the rules for commercial, financial and banking systems.

Ijtihad (from the root *jahd*, meaning “struggle”) plays a critical role in deriving rules for resolving issues arising from time-dependent challenges. *Ijtihad* refers to the efforts of individual jurists and scholars to find solutions to problems that arise in the course of the evolution of human societies and that are not addressed specifically in the primary sources. *Ijtihad* is based on the earlier consensus of jurists (*ijma'*), analogy (*qiyas*), judicial preference (*istihsan*), public interest (*maslahah*) and customs (*urf*). Secondary sources of the *Shari'ah* must not introduce any rules that are in conflict with the main tenets of Islam.

Over the course of history, different methods of exercising *ijtihad* have evolved depending upon the historical circumstances and the different schools of thought (*madhahib*) that prevailed at different times. The most commonly practiced methods are Hanafi, Maliki, Shafi'i, Hanbali and Jafari, which each assign different weights in decision-making to each source of Law; that is, the *Qur'an*, the *Sunnah*, *ijma'* and *qiyas*. For example, the Jafari school does not accept analogical reasoning in its entirety as a legitimate method to derive rules of *Shari'ah*, favoring instead the expert investigation and provision of solutions to new problems by jurists.

ISLAMIC ECONOMIC AND FINANCIAL SYSTEMS

Given our understanding of the role of institutions, rules, Law (*Shari'ah*) and the ideology of Islam, we can make the following propositions regarding an Islamic economic system (the core principles of which will be discussed in detail in Chapter 2):

- Islam has a view on how to organize political, social, and economic systems based on a set of ontological and epistemological propositions regarding individuals and their collectivities.
- Defining an economic system as a collection of institutions dealing with production, exchange, distribution and redistribution, and defining institutions as rules and norms, Islam proposes a distinct economic system

that differs in many important respects from those recommended by other schools of thought regarding how an economy is to be organized. To the extent that such an economy can be defined by its distinctive “institutional scaffolding,” it can also be defined as an Islamic economy to distinguish it from other types of economy.

- The behavioral rules and norms of an Islamic system—once clearly, rigorously, and analytically articulated—could yield empirically testable propositions that, in turn, could lead to policy analysis and recommendation on solutions to the problems of modern societies. To the extent that the emergence of a discipline devoted to studying and extracting economic rules of behavior in an Islamic economy is possible, analyzing the actual (as opposed to the ideal) performance of economies, devising incentive structures that promote rule compliance to allow convergence of actual and ideal, and recommending policy actions to accomplish such objectives, that discipline could be called “Islamic economics.” While an ideal Islamic economy is defined by the meta-framework and the archetypal model, Islamic economics would employ the accumulated store of human knowledge, including methods of analysis developed in the field of economics, to find ways and means of stimulating convergence between the actual and the ideal.

Since this book is about Islamic finance, a digression on the relevant basic principles may be helpful. Islam’s unconditional prohibition of *riba* (discussed in detail in Chapter 3) changes the landscape of a financial system. This prohibition implies the prohibition of pure debt security and ultimately of leverage through debt. It is important to note that debts based on a predetermined rate tied to the principal are prohibited. Other modes of financing based on the principle of the sharing of risk and reward are recommended. The elimination of interest and the promotion of risk-sharing modes of financing are the rationale behind Islamic finance practiced today. While acknowledging the expressions of skepticism, and even cynicism, regarding the present practices of Islamic finance, it appears that there is a consensus among an overwhelming majority of scholars on two fundamental propositions: (i) interest is *riba*, and (ii) risk-and-reward sharing is an Islamic alternative to a system based on interest-rate debt.

The notion of having a system that operated without interest and debt came under immediate challenge, with analysts suggesting the folly of adopting such a system. The prohibition of interest would, they argued, result in infinite demand for loanable funds and zero supply. A zero-interest system would be incapable of equilibrating demand for and supply of loanable funds. Such a system would mean that there would be no savings and, thus, no investment and no growth. There could be no monetary policy, they said, since no instruments of liquidity management could exist without a fixed, predetermined rate of interest. Any country adopting such a system could almost guarantee that there would be a one-way capital flight.

BASIC PRINCIPLES OF AN ISLAMIC FINANCIAL SYSTEM

Prohibition of interest: Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital, whether in loans or sales,” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” as widely practiced. A direct implication of the prohibition of interest is that pure debt securities with predetermined interest rates are also prohibited.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and the creation of additional wealth. By contrast, interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

Risk sharing: Because interest is prohibited, pure debt security is eliminated from the system and therefore suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses.

Asset-based: The prohibition of debt and the encouragement of risk sharing suggest a financial system where there is a direct link between the real and the financial sector. As a result, the system introduces a “materiality” aspect that links financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real-sector activity. There is a strong link between the performance of the asset and the return on the capital used to finance it.

Money as “potential” capital: Money is treated as “potential” capital—that is, it becomes actual capital only when it is combined with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

Prohibition of speculative behavior: An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainty, gambling, and risk.

Sanctity of contracts and the preservation of property rights: Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Islam places great importance on the preservation of property rights, defines a balance between the rights of individuals, society and the state, and strongly prohibits encroachment on anyone's property rights.

By 1988, this challenge was met when academic research, using modern analytical financial and economic theory, showed that:

- A modern financial system can be designed without the need for an *ex ante*, determined, positive, nominal fixed-interest rate. Indeed, it was shown that there was no satisfactory explanation for the existence of such a rate.
- Moreover, it was shown that not having such an interest rate (that is, the absence of a debt contract) did not necessarily mean that there would be zero return on capital.
- The basic proposition of Islamic finance was that the return on capital would be determined *ex post*, and that the magnitude of that return was determined on the basis of the return to the economic activity in which the funds were employed.
- It was the expected return that determined investment.
- It was also the expected rate of return, and income, which determined savings. Therefore, there was no justification for assuming that in such a system there would be no savings and investment.
- It was shown that in such a system **there would be** positive growth.
- Monetary policy in such a system would function as in the conventional system, its efficacy depending on the availability of instruments designed to manage liquidity.
- Finally, it was shown that, in an open-economy macroeconomic model without an *ex ante* fixed-interest rate, but with returns to investment determined *ex post*, there was no justification to assume that there would be a one-way capital flight.

Therefore, the system which prohibited a fixed *ex ante* interest rate and allowed the rate of return on capital to be determined *ex post*, based on the returns to the economic activity in which the funds were employed, was theoretically viable.

In demonstrating the analytical viability of such a system, the research also clearly differentiated it from the conventional system in which, based on debt contracts, risks and rewards were shared asymmetrically, with the

debtor carrying the greatest part of the risk, and with governments enforcing the contract. Such a system had a built-in incentive structure that promoted a moral hazard and asymmetric information and thus required close monitoring. The costs could be managed if monitoring could be delegated to an institution that could act on behalf of the collectivity of depositors/investors; hence the existence of banking institutions.

In the late 1970s–early 1980s, Minsky and others demonstrated that such a system was inherently prone to instability because there would always be a maturity mismatch between liabilities (short-term deposits) and assets (long-term investments). Because the nominal values of liabilities were guaranteed, but the nominal values of assets were not, when the maturity mismatch became a problem, banks would attempt to manage their liabilities by offering higher interest rates to attract more deposits. There was always the possibility that this process would not be sustainable, resulting in an erosion in confidence and runs on banks. Such a system, therefore, needed a lender of last resort and bankruptcy procedures, restructuring processes, and debt-workout procedures to mitigate the contagion.

During the 1950s–60s, Lloyd Metzler of the University of Chicago had proposed an alternative system in which contracts were based on equity rather than debt, and in which there was no guarantee of nominal values of liabilities since these were tied to the nominal values of assets. Metzler showed that such a system did not have the instability characteristic of the conventional banking system. In his now-classic article, Mohsin Khan (1987) showed the affinity of Metzler’s model with Islamic finance. Using Metzler’s basic model, Khan demonstrated that this system produces a saddle point and is, therefore, more stable than the conventional system.

By the early 1990s, it was clear that an Islamic financial system was not only theoretically viable, but also had desirable characteristics that rendered it superior to a debt-based conventional system. The phenomenal growth of Islamic finance during the decade of the 1990s demonstrated the empirical and practical viability of the system.

The crises we have been witnessing in the international financial system since 1997 have set the stage for Islamic finance to demonstrate its viability as potentially a genuine alternative global financial system. The present international system is deficient in many ways, of which the two most important are:

- A debt-based system needs an effective lender of last resort, and the present international financial system does not have one and it is not likely that one will emerge anytime soon; and
- A debt-based system needs bankruptcy proceedings, debt restructuring, and workout mechanisms and processes that the present international financial system lacks. There are preliminary discussions under way for an international sovereign-debt restructuring mechanism to be established, but there are many complications. While such a mechanism,

if and when it comes into being, will help reduce the risk of moral hazard and lead to a better distribution of risk, it will not address the inherent and fundamental fragility of a system based largely on debt contracts.

The financial crisis of 2007–2009 reinforced and exposed many of the inherent vulnerabilities of a debt-based system: excessive leverage, failure of market discipline, complex derivatives remote from real economic transactions, and lapses of corporate governance. Askari *et al.* (2010) examined the crisis and have argued that an Islamic financial system would be more stable when followed in its essence.

MODERN HISTORY OF ISLAMIC BANKING AND FINANCIAL SERVICES

Although Islam has provided a blueprint of how a society is to be organized and how the affairs of its members are to be conducted in accordance with its prescriptions, with the exception of a brief period following its inception the system itself has not been applied in its entirety. The economy at that time was, of course, much less complex than the economies of modern times. The business practices of the day conformed to the principles of Islam and the element of “interest” was minimized. Indeed, the practice of interest was also condemned by other major religions and the institution of interest had yet to be developed. It is only in recent decades, when the element of interest became an integral part of economic life, that Muslims have been forced to become more conscious of its existence at a time of growing interest in the wider implementation of Islamic teachings.

It is for this reason that our discussion on the history of Islamic economics and finance is limited to developments since the nineteenth century. These developments towards implementing a *Shari’ah*-compliant economic, financial, and banking system can be divided into three phases.

Phase I: Pre-1960

Throughout the nineteenth century and through a good part of the twentieth century, several Muslim countries were under colonial rule. During the colonial period, these Muslim societies to varying degrees lost touch with their old traditions, values and cultural heritage. Although there is evidence of resistance to the imposition of colonial values and a desire to return to the Islamic tradition, such efforts were not widespread. It was only after the end of the colonial period that Muslims began to re-discover their identities and manifested the desire to regain the lost values in all aspects of life, especially in the economic sphere.

Siddiqi (2006: 2) recalls conducting a survey of writings on Islamic economics and banking in English, Arabic, and Urdu languages in the early 1970s, and makes the following observations:

Out of the items included in the bibliography only eight date before 1920. Out of these, only two deal with the subject of interest, the remaining dealing with distribution of wealth (2) history (2) trade (1) and waqf (1). Of the 14 entries in the following decade only one deals with interest, the remaining are spread over other subjects. The first writings on interest-free banking appear in the nineteen forties. Out of a total of 28 writings on Islamic economics during this period, three are on interest-free banking. Among the remaining, zakat and the Islamic economic system in general has the largest number of writings. Though the writers in this period include Ulema [scholars] trained in traditional schools, the writings on interest-free institutions are not by them. We have 156 entries for the nineteen-fifties which include several writings on interest and interest-free institutions but the writings on socialism, capitalism and on some other aspects of Islamic economy far outnumber these.

A formal critique and opposition to the element of interest started in Egypt in the late nineteenth century when Barclays Bank was established in Cairo to raise funds for the construction of the Suez Canal. The establishment of such an interest-based bank in a Muslim country attracted opposition from its inception. Further, a formal opposition to the institution of interest can be found as early as 1903 when the payment of interest on post office savings funds was declared contrary to Islamic values, and therefore illegal, by *Shari'ah* scholars in Egypt. In India, a minority community of Muslims in southern India took the first step toward their desire to pursue an Islamic mode of economic activities by establishing interest-free loans as early as the 1890s. This was mainly a welfare association collecting donations and animal skins from the public to provide interest-free loans to the poor. An interest-free credit society was also established in Hyderabad in 1923.

During the first half of the twentieth century, there were several attempts to highlight the areas in which the emerging conventional economic system conflicted with Islamic values. The need for an alternative economic system conforming to the principles of Islam soon came to the fore and economists began to explore *Shari'ah*-compliant contracts, especially equity partnerships. Some of the early Muslim intellectuals and jurists (*fuqaha*) who made significant contributions in developing alternatives based on the tenets of Islam include Maulana Syed Abul Ala Maudoodi (Pakistan), Imam Muhammad Baqir al-Sadr (Iraq), Anwar Iqbal Qureshi (Pakistan), Mohammad Nejatullah Siddiqi (India), Muhammad Uzair (Saudi Arabia), Umer Chapra

(Saudi Arabia), and Ahmad al-Najjar (Egypt).⁷ By 1953, Islamic economists had offered the first description of an interest-free bank on a two-tier *mudharabah* and *wakala* (agency) basis. By the end of the 1950s, Islamic scholars and economists had begun to offer theoretical models of financial intermediation as a substitute to interest-based banking.

Phase II: 1960s–1980s

By the start of the 1960s, the demand for *Shari'ah*-compliant banking was such that it resulted in the establishment of the *Mit Ghamr* Local Savings Bank in Egypt in 1963 by the noted social activist Ahmad al-Najjar. This is widely considered to be the first modern Islamic bank.

It is worth noting that Dr. Najjar chose to promote this institution as a social welfare institution rather than as an Islamic bank.⁸ His bank, based on the principle of rural banking within the general framework of Islamic values, borrowed some ideas from German savings banks. Unfortunately, this experiment lasted just four years. Around the same time, there were parallel efforts in Malaysia to develop a scheme that would enable Muslims to save money to perform the Pilgrimage without the contamination of interest that regular commercial banks were charging. The Pilgrims' Savings Corporation was established in 1963 and was later incorporated into the Pilgrims' Management and Fund Board (popularly known as *Tabung Haji*) in 1969.

The Nasir Social Bank in Egypt, established by presidential decree in 1971, was the first state-sponsored interest-free institution. The establishment of the Dubai Islamic Bank in the UAE in 1975 is considered to be one of the earliest private initiatives. The rapid accumulation of revenues ("petro-dollars") in several oil-rich Muslim countries in the Middle East in the 1970s offered strong incentives for creating suitable investment outlets for Muslims wanting to comply with the *Shari'ah*. This business opportunity was exploited by both domestic and international bankers, including some of the leading conventional banks.

In 1975, the Islamic Development Bank (IDB) was established on the lines of regional development institutions with the objective of promoting economic development in Muslim countries as well as offering *Shari'ah*-compliant development finance. The Jeddah-based IDB has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, finance and banking. During the 1970s, the concept of a financial *murabahah* (trust financing) was developed as the core mechanism for the placement of Islamic banks' funds. Academic and research activities were launched with the First International Conference on Islamic Economics, held in Mecca, Saudi Arabia, in 1976. The first specialized research institution, the Centre for Research in Islamic Economics, was established at the King Abdul Aziz University of Jeddah, Saudi Arabia, in 1978.

The 1980s marked the beginning of a trend of rapid growth and expansion for the emerging Islamic financial services industry that continued through the 1990s. During that period, the Islamic Republics of Iran, Pakistan and Sudan announced their intentions to transform their overall financial systems to make them compliant with the *Shari'ah*. Other countries such as Malaysia and Bahrain instituted Islamic banking within the framework of their existing systems. The International Monetary Fund (IMF) initiated research in the macroeconomic implications of an economic system operating without the basis of interest. Similar research was conducted into the financial stability of a system based on the sharing of profit and loss. The significance and contribution of this research was recognized in 2004 when two IMF economists were awarded IDB's highest prize in Islamic economics.⁹ The Organization of Islamic Countries (OIC) Fiqh Academy and other *Shari'ah* scholars became engaged in the discussions for reviewing financial transactions.

During the early stages of the Islamic financial market, Islamic banks faced a dearth of quality investment opportunities, which created business opportunities for the conventional Western banks to act as intermediaries to deploy Islamic banks' funds in accordance with guidelines provided by the Islamic banks. Western banks helped Islamic banks place funds in commerce and trade-related activities by arranging a trader to buy goods on behalf of the Islamic bank and to resell them at a mark-up. Gradually, Western banks realized the importance of the emerging Islamic financial markets and began to offer their own Islamic products through "Islamic windows" in an attempt to attract the clients directly. Islamic windows are not independent financial institutions, but are specialized set-ups within conventional financial institutions that offer *Shari'ah*-compliant products for their clients. Meanwhile, driven by the growing demand for *Shari'ah*-compliant products and fear of losing depositors, non-Western conventional banks also started to offer Islamic windows. In general, these windows are targeted at high-net-worth individuals who want to practice Islamic banking—that is, approximately 1–2 percent of the world's Muslims.

Phase III: 1990s–Present

By the early 1990s, the market had gained enough momentum to attract the attention of policymakers and institutions interested in introducing innovative products. Recognizing the need for standards, a self-regulatory agency—the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)—was established. This was instrumental in highlighting the special regulatory needs of Islamic financial institutions and in defining accounting and *Shari'ah* standards, which were adopted or recognized by several countries. However, with the growth of the market, the regulatory and supervisory authorities, with the help of the IMF, established a dedicated regulatory agency, the Islamic Financial Services Board (IFSB) in the early

2000s to address systemic stability and various governance and regulatory issues relating to the industry.

Further progress was made in developing capital markets. Islamic asset-backed certificates, *sukuks*, were launched successfully in Bahrain, Malaysia and other financial centers. Among the issuers were corporations, multilaterals and sovereign entities such as the Islamic Development Bank, the International Bank for Reconstruction and Development and the Governments of Bahrain, Qatar and the Islamic Republic of Pakistan. During the equities market boom of the 1990s, several equity funds based on *Shari'ah*-compatible stocks emerged. The Dow Jones and *Financial Times* launched Islamic indices to track the performance of Islamic equity funds.

The number of conventional banks offering Islamic windows grew. Citibank was one of the early Western banks to establish a separate Islamic bank—Citi Islamic Investment Bank (Bahrain) in 1996—and the Hong Kong and Shanghai Banking Corporation (HSBC) now has a well-established network of banks in the Muslim world. With the objective of promoting Islamic asset securitization and private equity and banking in OECD countries, HSBC Global Islamic Finance (GIF) was launched in 1998. The list of Western banks keeping Islamic windows includes the American Express Bank Ltd., ANZ Grindlays, BNP-Paribas, Deutsche Bank UBS, and Kleinwort Benson. The leading non-Western banks with significant Islamic windows are National Commercial Bank of Saudi Arabia, United Bank of Kuwait, and Riyadh Bank.

Several institutions were established to create and support a robust financial system. These institutions include the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (CIBAFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI).

Islamic finance has begun to go global. Although Western financial centers and financial intermediaries have always played an important part in executing and innovating Islamic transactions, such activities have been mostly carried in the private sector and in a discreet fashion. By early 2000, this trend had begun to change, with several non-Muslim countries taking an interest in this emerging financial market. This can be attributed to several factors such as booming oil revenues leading to accumulation of investible funds looking for attractive investment opportunities; an increased awareness of regulatory issues relating to Islamic financial intermediaries; and the desire to tap into alternative funding resources by sovereign and corporate entities.

Islamic finance has had a long, if silent, presence in Europe. A major early development was the establishment in 1981 of the Dar al Maal al Islami Trust in Geneva, an investment company that held stakes in several Islamic banks.¹⁰ Many high-net-worth clients demanding *Shari'ah*-compliant investments deal directly with European banks, notably with UBS of Switzerland, the leading provider of *Shari'ah*-compliant wealth-management services.

The German Federal State of Saxony-Anhalt pioneered the *sukuk* in Europe with a five-year offering which raised €100 million (US\$120 million) in July 2004.¹¹ Although London has been active in the market, the idea of Islamic finance has yet to attract attention on a large scale elsewhere in Europe. In France, for example, where the Muslim population of six million is three times that of the UK, the authorities and regulators have been slow to realize the potential of this market.¹²

During the period 2005–2008, there was another wave of interest in Islamic finance, again prompted by increased oil revenues in the Middle East. However, unlike the surge in the 1970s which was limited to the high-net-worth class, the current growth is the result of demand from a much wider group that includes small investors and retail consumers. Several countries where Islamic finance was dormant are experiencing a sudden surge in demand for *Shari'ah*-compliant products. In Saudi Arabia, for example, such has been the public pressure to embrace Islamic finance that the country's largest bank, the National Commercial Bank, has converted its entire branch network to *Shari'ah* principles.¹³ Bahrain and Malaysia have also taken an active role in the development of Islamic finance and have made serious efforts to establish world-class financial centers to promote Islamic finance.

London's historical reputation and significance as a financial center, coupled with its attractiveness as a time-zone with respect to the Middle East, has made it a popular choice for Islamic financial transactions. It is said that more money from the most widely used Islamic financial instrument, the commodity *murabahah*, flows through London financial center than in any other center.¹⁴ With a Muslim population of almost two million in the UK, there was sufficient demand to establish the Islamic Bank of Britain in September 2004. By the end of 2006, this had attracted deposits worth £83 million (US\$165 million) from 30,000 customers and its assets stood at £120 million (US\$240 million).¹⁵ Similarly, the European Islamic Investment Bank (EIIB) began its operations in April 2006 with the objective of promoting *Shari'ah*-compliant investment banking. In 2008, the European Finance House (EFH), a unit of Qatar Islamic Bank, was awarded a banking license in the UK to provide *Shari'ah*-compliant banking. EFH plans to target the European Union's 14 million Muslims who will have access to Islamic financial products.¹⁶

Realizing the significance and potential for Islamic finance domestically and internationally, the UK government has taken steps to make its markets "Islamic Finance Friendly." In 2007, for example, it began to explore the possibilities for launching a sovereign *sukuk* designed to encourage the domestic Islamic financial market and develop a global benchmark. In the budget that year, *sukuk* were accorded the same tax status as conventional debt instruments and the income to *sukuk* investors was treated as interest income. These measures were introduced to send positive signals to potential *sukuk* investors and to ensure a level playing field with

conventional securities. As more steps are taken to develop London as a hub for Islamic finance, it poses serious threats for regional financial centers such as Bahrain and Malaysia. Some argue that this may lead to capital flight, which can hamper the development of the regional centers. However, others argue that London can play a complementary and enhancing role through providing financial innovations, cost-effective execution and access to other markets.

The presence of Islamic finance is beginning to be felt all over the globe and multilateral institutions are also engaging with the market. The World Bank and the IMF have made contributions to this field through research, and other institutions are also getting involved. The International Finance Corporation (IFC)—the private-sector arm of the World Bank—has executed several *Shari'ah*-compliant transactions. In 2009, IFC issued *sukuk* to the value of US\$100 million for funding Islamic finance projects in key sectors such as health, education, and infrastructure in the Middle East. In 2007, the World Bank-affiliated Multilateral Investment Guarantee Agency (MIGA) provided its first-ever guarantee for *Shari'ah*-compliant project financing, worth US\$427 million.¹⁷

The major developments in modern Islamic economics and finance are summarized in Table 1.1.

Institutional Development

The private sector has been much more active than the public sector in the growth of this market. Governments such as those of Bahrain and Malaysia have made serious efforts to establish centers for Islamic financial institutions and the institutional infrastructure to support development of the financial sector is slowly emerging. This includes institutions to deal with accounting and regulatory standards, corporate governance, credit ratings, and capital markets. These efforts to develop institutions are also supported by several stakeholders such as the IMF, central banks of leading Muslim countries, international standard-setting bodies, and financial centers.

As mentioned earlier, the IDB was established in 1975 as a regional development institution to promote economic development in Muslim countries through Islamic finance. Since then, it has established several sister institutions to develop the private sector, insurance facilities, and trade and export financing.¹⁸

The Islamic Research and Training Institute (IRTI)—the IDB's research arm—was established in 1981 to undertake research and training in a range of economic, financial and banking issues. It has become a rich resource center for, and has played a critical role in, developing a 10-year master plan for the Islamic financial industry.

The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), another of the IDB's sister organizations, was established in

TABLE 1.1 Developments in modern Islamic economics and finance

Pre-1950s	Barclays Bank opens its Cairo branch in the 1890s to process the financial transactions related to the construction of the Suez Canal. Islamic scholars challenge the operations of the bank, considering its dealings to involve interest. This critique also spreads to other Arab regions, and to the Indian sub-continent where there was a sizeable Muslim community. Majority of <i>Shari'ah</i> scholars declare that interest in all its forms amounts to the prohibited element of <i>riba</i> .
1950s–60s	Initial theoretical work in Islamic economics begins. In 1953, Islamic economists offer the first description of an interest-free bank based either on two-tier <i>mudaraba</i> or <i>wakala</i> . Mit Ghamr Bank in Egypt and Pilgrimage Fund in Malaysia start.
1970s	First Islamic commercial bank, Dubai Islamic Bank, opens in 1974. Islamic Development Bank (IDB) is established in 1975. Accumulation of oil revenues and petro-dollars increases demand for <i>Shari'ah</i> -compliant products.
The 1980s	Islamization of economies in Islamic Republics of Iran, Pakistan and Sudan, which introduce interest-free banking systems. Increased demand attracts Western intermediation and institutions. The IDB establishes the Islamic Research and Training Institute (IRTI) in 1981. Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
The 1990s	Attention is paid to the need for accounting standards and regulatory framework. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is established. Islamic insurance (<i>takaful</i>) is introduced. Islamic Equity Funds are established. Dow Jones Islamic Index and FTSE Index of <i>Shari'ah</i> -compatible stocks are developed.
2000–Present	The Islamic Financial Services Board (IFSB) is established to deal with regulatory, supervisory and corporate-governance issues. <i>Sukuks</i> (Islamic bonds) are launched. Globalization of Islamic finance as <i>Shari'ah</i> -compliant transaction starts to appear in Europe, Asia and North America. Growth of academic interest and research followed by offering of organized programs at reputable Western universities. Limited application of financial engineering through introduction of profit-rate swaps. Legal issues are raised in cross-border jurisdictions after defaults on <i>Shari'ah</i> -compliant transactions during and after the financial crisis.

Sources: Khan (1996), IDB (2005), and Iqbal and Mirakhor (2007).

1994 with the objective of enlarging the scope of trade transactions and the flow of investments among member countries. The ICIEC's main objectives are to provide *Shari'ah*-compliant export credit insurance and reinsurance to cover the non-payment of export receivables resulting from commercial (buyer) and non-commercial (country) risks and to provide investment insurance and reinsurance against country risk, emanating mainly from foreign-exchange transfer restrictions, expropriation, war and civil disturbance, and breach of contract by the host government. The Islamic Corporation for the Development of the Private Sector (ICD) was established in 1999 to promote the development of the private sector in member countries. Its objectives are to (i) identify opportunities in the private sector that could function as engines of growth; (ii) provide a wide range of productive financial products and services; (iii) mobilize additional resources for the private sector in member countries, and (iv) encourage the development of Islamic financial and capital markets.

In 2006, the IDB established the International Islamic Trade Finance Corporation (ITFC) to promote trade among OIC countries by providing *Shari'ah*-compliant trade finance, promoting trade among member countries, enhancing their export capabilities and increasing the developmental impact of trade financing in those countries. That same year, IDB members also established a special "solidarity" fund for reducing poverty, eliminating illiteracy, eradicating major communicable diseases and building the human and productive capacities, particularly in the least-developed OIC countries. This fund is organized as an endowment (*waqf*) fund, with targeted capital of US\$10 billion.

The AAOIFI was established as a self-regulatory agency to tackle the problem of *Shari'ah* compliance and gaps in applying conventional financial reporting standards to Islamic banks. Its membership consists of some 97 institutions spanning more than 24 countries and its *Shari'ah* Board is paving the way towards harmonizing Islamic banking practices throughout the world.¹⁹ A number of countries, including Bahrain and Sudan, either require Islamic banks to comply with AAOIFI standards or, as in the case of Qatar and Saudi Arabia, are specifying AAOIFI standards as guidelines.

The AAOIFI was successful in defining accounting and *Shari'ah* standards, which were adopted or recognized by several countries. However, with the growth of the market, in 2000 the regulatory and supervisory authorities established, with the help of the IMF, a dedicated regulatory agency, the Islamic Financial Services Board (IFSB), to address systemic stability and various governance and regulatory issues relating to the Islamic financial services industry. The IFSB took on the challenge and started working in the areas of regulation, risk management and corporate governance, which are discussed in more detail later.

Table 1.2 sets out the functions of many of the key organizations now operating in the field of international Islamic finance.

The General Council of Islamic Banks and Financial Institutions (GCIBFI) focuses on the media and awareness, information and research, policies

TABLE 1.2 Key institutions in the Islamic financial industry

Acronym	Organization	Function
IDB	Islamic Development Bank	Development institution developed in 1975 to promote Islamic finance and economic development Member/Sister Organizations ICD: Islamic Corporation for the Development of the Private Sector ICIEC: Islamic Insurance Company, providing insurance products for investments and export credits IRTI: Research and training arm of IDB ITFC: International Islamic Trade Finance Corporation Solidarity Fund: To reduce poverty in OIC countries ARCIFI: Arbitration and Reconciliation Center for Islamic Financial Institutions
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions	Accounting and <i>Shari'ah</i> standard-setting body
IFSB	Islamic Financial Services Board	Standard-setting institution to ensure best practices and help member countries with regulating Islamic financial institutions
IIFM	International Islamic Financial Markets	Trade association to promote capital markets
IIRA	Islamic International Rating Agency	Rating agency
LMC	Liquidity Management Center	Institution to provide liquidity enhancement to the financial system
CIBAFI	General Council of Islamic Banks and Financial Institutions	Trade association of Islamic banks to enhance member institutions' ability to better serve customers around the world through transparent banking practices

and strategic planning, and Islamic financial products. The Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI) aims to settle, through reconciliation and arbitration, financial and commercial disputes involving institutions that have chosen to comply with the *Shari'ah* to settle disputes.

The major objectives of the Bahrain-based IIFM are (a) to enhance cooperation among regulatory authorities of Islamic banks, (b) to address the liquidity problem by expanding the maturity structure of instruments, and (c) to explore the possibility of sovereign asset-backed securities. The IIFM is currently working with the International Capital Markets Association (ICMA) on the further development of primary and secondary markets for Islamic bonds (*sukuk*). The two groups are working together to develop a repurchase (repo) master agreement to help central banks manage liquidity in the *sukuk* market; as well as a master agreement for *murabahah* commodities contracts, which are used in interbank transactions between Islamic banks and between Islamic and conventional banks.²⁰

The IIRA aims to assist in the development of regional financial markets by providing an assessment of the risk profile of entities and instruments that can be used for investment decisions. The IIRA is sponsored by multilateral finance institutions, several leading banks and other financial institutions, and rating agencies from different countries. The organization has a board of directors and an independent rating committee as well as a *Shari'ah* board. The IIRA also provides a unique service of rating the level of compliance financial institutions have with the stipulations adopted by their *Shari'ah* committee in good faith, both in letter and in spirit. They also examine whether there is a mechanism within the institution to evaluate its compliance with the *Shari'ah* and whether the *Shari'ah* committee has enough authority, information, and resources to perform the examination and evaluation.

The Liquidity Management Center (LMC) was established to facilitate investment of the surplus funds of Islamic banks and financial institutions into quality short- and medium-term financial instruments structured in accordance with *Shari'ah* principles. Its shareholders include Bahrain Islamic Bank, Dubai Islamic Bank, Islamic Development Bank, and Kuwait Finance House. The LMC assists Islamic financial institutions in managing their short-term liquidity and supports the interbank market. In addition, the center attracts assets from governments, financial institutions, and corporations in both the private and public sectors in many countries. The assets are securitized into readily transferable securities or structured into other innovative investment instruments. The Center also provides short-term liquid, tradable, asset-backed treasury instruments (*sukuk*) in which financial institutions can invest their surplus liquidity and offers advisory services dealing with structured, project, and corporate finance as well as equity floatation.

RECENT TRENDS IN ISLAMIC FINANCIAL MARKETS

There is no formal or systematic source of statistics on Islamic finance but several estimates are often quoted by different commercial and non-commercial sources.²¹ According to the 10-Year Master Plan for Islamic Financial Industry prepared by the IDB and IFSB, by the end of 2005, more than 300 institutions in over 65 jurisdictions were engaged in Islamic finance. In a broad sense, the Islamic financial industry consists of a number of components such as Islamic banks, Islamic windows, capital markets, Islamic insurance (*takaful*) and other non-bank financial institutions. Islamic banking usually refers to offshore and onshore deposit-taking commercial and investment banking and is the most dominant sector of the market. Islamic windows are specialized windows available through conventional banks catering to the demands of Islamic products. Historically, Islamic banking and windows have been the most active sector but in the last decade other forms of financial products and services have been gaining momentum. Activities in the capital markets in the form of Islamic funds or Islamic bonds (*sukuk*) are increasing and there are institutions specializing in asset management, mutual funds, and brokerage houses. Islamic non-bank financial institutions, which include specialized institutions offering financial services through leasing (*ijarah*) or partnership (*mudharabah*), perform a similar function to conventional fund-management companies. There is a limited but growing number of institutions engaged in micro-finance, venture capital and private equity financing.

Table 1.3 shows the total size of different segments of the market, compiled from different sources. Given the lack of transparency in financial disclosure by financial institutions in developing countries, these estimates are, if anything, on the conservative side, and the actual size of assets under management is likely to be significantly higher.

Islamic banks have experienced high growth, as shown in Table 1.4 which lists growth rates of assets and deposits in selected countries in the Middle East and North Africa (MENA) region. From this, it is clear that

TABLE 1.3 Total assets under management as of 2010

Sector	Amount (US\$ billion)
Islamic banks	400
Islamic windows	250
<i>Sukuk</i>	120
Islamic funds	45
<i>Takaful</i>	5
Total	820

Source: IFIS and other estimates

TABLE 1.4 Growth rates of assets and deposits across countries

Country	Banks in Sample	Assets		Customer Deposits	
		Growth Rate (%)		Growth Rate (%)	
		2006–07	2007–08	2006–07	2007–08
Bahrain	12	48.54	39.00	58.33	32.07
Egypt	2	21.27	10.53	22.89	9.54
Jordan	2	(9.30)	25.86	(8.59)	16.34
Kuwait	2	47.04	19.33	51.05	24.94
Lebanon	1	362.09	145.54	(3.02)	21.43
Qatar	2	34.64	47.94	26.63	31.98
Saudi Arabia	3	23.16	27.94	28.65	22.32
UAE	5	40.28	17.07	46.16	19.56
Yemen	1	7.29	20.08	6.13	18.73
MENA Region	30	34.50	24.50	37.47	22.28

Source: Ali, Syed Salman (2011), *Islamic Banking in the MENA Region*, Washington, DC, USA. http://siteresources.worldbank.org/INTMNAREGTOPPOVRED/Resources/MENAFlagshipIslamicFinance2_24_11.pdf

the growth rate was high during the 2006–2007 and 2007–2008 period but there were signs of a slowdown after that. This can be attributed to economic slowdown after the financial crisis.

In general, the trend is that competition is increasing for Islamic banks, as conventional banks are also pursuing this business aggressively. Several Islamic banks that once enjoyed a virtual monopoly in the market are now threatened by conventional banks that may have better marketing networks, name recognition, and economies of scale. For example, according to some estimates, Islamic banks accounted for 71 percent of Islamic assets in 2008 as compared with the almost-100 percent share recorded in 2003.²²

During the subprime financial crisis, Islamic banks were largely immune because they did not have any investments in toxic debt-based assets. However, Islamic banks were not insulated from the regional economic slowdown arising from the global economic recession. It was observed that, during the first half of 2009, banking assets in the GCC countries declined by 1.1 percent, while assets of the five largest Islamic banks increased by 1.3 percent. This compares with a rise of 17 percent and 21.5 percent, respectively, in 2008.²³

With the economic recession, concerns have grown with respect to the quality of assets of Islamic financial institutions for several reasons. First,

Islamic banks had considerable investments in the real-estate sector and as result of the decline in property prices and values the market value of assets has deteriorated. Second, Islamic banks tend to have geographical and sectoral concentrations, which has exposed them to additional risk. It is expected that because of prudent practices such as holding excessive liquidity and adequate equity capital, Islamic banks will weather this storm and will continue to grow their assets and deposits base.

Islamic capital markets which grew rapidly were also impacted by the financial crisis. This is evident from the drop in the issuance of Islamic bonds (*sukuk*) in the post-crisis period. There were also several cases of legal disputes concerning *sukuk* which sent negative signals in the market and put downward pressure on demand. However, as legal issues were sorted out in orderly fashion, the market has seen a rebound in demand. For example, the *sukuk* issued by the IDB in 2010 was well received in the market and its demand exceeded the amount offered.

Finally, in another positive move, several central banks signed an agreement in October 2010 to establish a liquidity facility for Islamic financial institutions with the objective of providing liquidity-enhancing products in the market and to offer liquidity through trading short-term financial instruments.

ENDNOTES

1. For example, see Kuran (1995).
2. Chapra (2000).
3. The term (*swt*) is an abbreviation of *subhana-wa-ta'ala*, meaning “The Exalted One.”
4. The verses emphasizing the principle of unity include: “And indeed this is my straight path therefore follow it—and do not follow other ways because that will lead to disunity amongst you” (6:153) “Grab hold of the rope of Allah collectively and do not disunite” (3:103) “Cooperate with one another unto righteousness and piety and do not cooperate with one another unto unrighteousness and enmity” (5:2).
5. The abbreviation “pbuh” (“peace be upon him”) invokes the peace and blessings of Allah (*swt*) on the Prophet, and is a sign of respect.
6. *Qur'an* 2:143.
7. Khurshid (2009).
8. Martin (2007).
9. The IDB award for distinguished achievement in Islamic economics was awarded to Dr. Mohsin Khan and Dr. Abbas Mirakhor.
10. Wilson (2007).
11. *Ibid*.
12. Oakley, David, “Capital Takes a Leading Role,” FT Report—Islamic Finance, May 23, 2007, *Financial Times* (London, UK).
13. RedMoney 2007.

14. Oakley, David, “Capital Takes a Leading Role,” FT Report—Islamic Finance, May 23, 2007, *Financial Times* (London, UK).
15. Martin, op. cit.
16. *Financial Times*, February 5, 2008.
17. http://www.miga.org/news/index_sv.cfm?aid=1696
18. For further details, see IDB (2005).
19. Alchaar (2006).
20. Kerr, Simon, *Financial Times* reports: Islamic Finance, May 24, 2007.
21. CIBAFI is making efforts to maintain statistics on Islamic financial institutions.
22. S&P Outlook (2010).
23. Ibid.

CHAPTER 2

The Economic System

At the core of the Islamic economic system lies a body of immutable rules, defined by the principles of *Shari'ah*, which affect economic behavior and outcomes and which are both time-and-place-invariant. On the periphery of the system, there are rules which have an impact on economic behavior, but which are subject to change depending on the circumstances. These latter are results of decisions taken by legitimate authorities in an Islamic society in pursuit of policies—for example, deliberate interventions in economic affairs—to further their aims. These policies and actions taken in pursuit of specific objectives must, nonetheless, be *Shari'ah*-compatible. While Islamic economic systems adopted in various localities may vary with respect to these peripheral economic rules and institutions, they cannot differ with respect to their core rules and institutions. For example, while one Islamic country may differ from another with respect to its foreign trade policies, there can be no such differences in, say, the institution of inheritance in those countries.

To understand the economic system of Islam, we need to discuss some of its key characteristics. Before that, however, a general statement regarding the Islamic economy is necessary. It can be stated categorically that Islam requires, as one of its specific objectives, a healthy, dynamic, and growth-oriented economy, without which the higher aims of Islam cannot be accomplished. A dynamic and growing economy is considered healthy only when its rules, institutions, organizations and their operations, as well as the behavior of the individual and the collectivity, are in conformity with the *Shari'ah*.

An economic system is a collection of institutions set up by society to deal with the allocation of resources, production and goods and services, and the distribution of the resulting income and wealth. This applies equally to Islam, with a single, major, exception, which simply requires that the word “society” is replaced by the words “the Law-Giver.” Thus, a definition for an Islamic economic system would be along the following lines:

A collection of institutions (that is, formal and informal rules of conduct and their enforcement characteristics) designed by the Law-Giver (that is, Allah (swt) through the rules prescribed

in the Qur'an, operationalized by the sunnah of the Prophet (pbuh) and extended to new situations by ijihad) to deal with allocation of scarce resources, production and the exchange of goods and services and the distribution of the resulting income and wealth.

INSTITUTIONAL PERSPECTIVE OF ISLAMIC ECONOMICS

The collection of the rules of behavior prescribed for individuals and collectivities in a given society constitute the institutional structure of that society and define the overall system to which the society adheres. The rules of behavior—whether enshrined in instruments such as social contracts, constitutions and legal framework, or embedded in social conventions, customs, habits and cultural values—are sustained by enforcement mechanisms that provide proper incentives of rewarding compliance with and punishing violations of the rules. The incentive structure must be such that the rules of behavior become self-enforcing or, where this is not possible, that effective mechanisms (the courts, police, ombudsmen, and so on) are in place to enable them to be enforced appropriately.

The institutional framework of the ideal economy is composed of a collection of institutions—rules of conduct and their enforcement characteristics—designed by the Law Giver, prescribed in the meta-framework and operationalized by the archetype model (as outlined in Chapter 1) to deal with allocation of resources, and so on. The objective of these institutions is to achieve social justice (*qist*).

Rules of Conduct as "Institutions"

Rules of behavior are designed to accomplish three objectives: (a) to reduce the cognitive demand on individuals in the face of uncertainty; (b) to specify acceptable and unacceptable behavior; and (c) to make actions by individuals predictable. Together, they reduce uncertainty by making the response of individuals to states of nature in their environment predictable.

Rules specify what kind of conduct is most appropriate to achieving just results when individuals face alternative choices and must take action. They impose restrictions on what society's members can do without upsetting the social order on whose existence all members count in deciding on their own actions and forming their expectations of others' responses and actions. Compliance with the rules determines the degree of certainty in the formation of these expectations, prevents conflict, reconciles differences, coordinates actions, facilitates cooperation, promotes social integration and social solidarity, and strengthens the social order.

To obtain these results, two conditions must exist; one is necessary and the other sufficient. The former requires that rule compliance is enforced,

through persuasion if possible, coercion if necessary. The sufficient condition requires that the rules of conduct are enforced universally in all cases irrespective of circumstances and/or consequences. The degree of effectiveness of rule enforcement is determined by the degree to which the objective of achieving social justice becomes an integral part of the subjective interiority of the members of the society.

The stronger the compliance by individuals in the society, the more self-sustaining and self-enforcing the rules become. For this outcome to be attained, the rules must be internalized by individuals as endogenous elements of their own minds which find external expression when the rules become shared beliefs among individuals in the society. The stronger are the shared beliefs, the stronger would be the coordinated collective actions and the more stable the society.

The *Qur'an* makes clear that rule compliance is the guarantor of social justice, social cohesion, unity and order in any human collectivity (*Qur'an* 5:2; 3:103; 8:46). This is so central among the objectives of the meta-framework that it can be claimed that all rules of behavior prescribed are those that lead to social justice, integration, cohesion, solidarity and unity. Conversely, all prohibited behavior is that which ultimately leads to social injustice and disintegration. Central among the rules that constitute the institutional structure of the ideal economy are rules governing property; production, exchange, distribution and redistribution; and market conduct, as discussed below.

Rules of Conduct and the Social Order The function of rules of conduct is to provide the means by which individuals can overcome the obstacles presented by their ignorance of particular facts that must exist to determine overall justice in the social order. Rules specify what kind of conduct is appropriate in certain circumstances. Rules are specific means to specific ends. They are, essentially, restrictions on what individual members of society may do without upsetting the social order. All individuals count on the social order in deciding on their individual choices and actions. Therefore, rules should guide individuals in their actions. If emotions and impulses tell them what they want, the rules tell them whether or not they can have it and how they will be able and allowed to get it. Additionally and importantly, observance of rules of conduct integrates individuals into society. Rules serve to prevent conflicts, reconcile differences and facilitate cooperation among individuals. Compliance with them promotes social integration and unity and preserves the intended social order.

Enforcement Mechanism The enforcement characteristics of Islamic rules are that each and every individual is made responsible for knowing the rules for themselves and then for ensuring that others know them as well. The enforcement mechanism is embodied in the most important of all social duties for Muslims—to ensure that all individuals are both familiar with and comply with the rules of just conduct prescribed by Islam.

If these rules are not generally known or understood because both individuals and their collectivities have avoided their duty, compliance will be lacking or fundamentally weak. In that case, imposition by fiat of an Islamic economic superstructure, whatever that may mean under the circumstances, will not produce the desired result. But once the rules are known and understood, individuals, the government and society at large all have the duty and the responsibility to ensure compliance and enforcement.

More specifically, Islamic economics can be considered as a discipline concerned with: (a) the rules of behavior (institutions) prescribed by Islam as they relate to resource allocation, production, exchange, distribution and redistribution; (b) the economic implications of the operations of these rules and; (c) the incentive structure and policy recommendations for achieving compliance that would allow convergence of the actual economy with the ideal economic system envisioned by Islam.

CORE ECONOMIC INSTITUTIONS IN ISLAM

With this background, let us examine the rules prescribed by Islam with respect to core values of the society concerning property rights, contractual agreements, trust, and many others. These rules in turn lay the foundation for core economic institutions in Islam and ultimately, the collection of these institutions define the economic system prescribed by Islam. The core economic institutions which ultimately define the economic system prescribed by Islam are as follows.

Property Rights

While the individual's right to property affirms the natural tendency in man to possess—particularly something resulting from his own creative labor—the concomitant private property obligations, from the point of view of justice, are designed to give effect to the interdependence of the members of the community, with a view to recognizing explicitly that they cannot live in isolation. The private property obligations, therefore, reject the notion that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be. These obligations write the principle of sharing into the delineation of interests in property and consider private ownership to be subject to a trust, or a duty, in order to effect sharing. Hence, private initiative, choice, and reward are recognized in Islam's conception of property rights, but such recognition is not allowed to subvert the principle of sharing or to lead to violations of the rights of the community. If, as a result of the growth of society, division of labor, or increasing complexities of markets, either the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, an intervention by the legitimate authority to take corrective measures would be deemed justified.

The word “property” is defined as a bundle of rights, duties, powers, and liabilities with respect to an asset. In the Western concept, private property is considered the right of an individual to use and dispose of a property, along with the right to exclude others from the use of that property. Even in the evolution of Western economies, this is a rather new conception of property that is thought to have accompanied the emergence of the market economy. Before that, however, while a grant of the property rights in land and other assets was the right to use and enjoy the asset, it did not include the right to dispose of it or exclude others from its use. For example, the right to use the revenues from a parcel of land, a corporate charter, or a monopoly granted by the state did not carry the right of disposing of the property. It is thought that the development of the market economy necessitated a revision of this conception of property since it was thought that the right not to be excluded from the use of assets owned by another individual was not marketable; it was deemed impossible to reconcile this particular right with a market economy. Hence, of the two earlier property rights principles—the right to exclude others and the right not to be excluded by others—the latter was abandoned and the new conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is retained without diminishing the role of the market as a mechanism for resource allocation and impulse transmission within the framework.

The key principles of Islamic property rights are as set out below:

- The first principle is that the Supreme Creator is the ultimate owner of all properties and assets, but in order that humans become materially able to perform duties and obligations prescribed by the Law Giver, they have been granted a conditional right of possession of property. This right is granted to the collectivity of humans.
- The second principle establishes the right of collectivity to the created resources.
- The third principle allows individuals to appropriate the products resulting from the combination of their labor of these resources, without the collectivity losing its original rights either to the resources or to the goods and services by individuals.
- The fourth principle recognizes only two ways in which individuals accrue rights to property: (i) through their own creative labor and/or (ii) through transfers—via exchange, contracts, grants, or inheritance—from others who have gained title to a property or an asset through their labor. Fundamentally, therefore, work is the basis of the acquisition of rights to property. However, work is performed not only for the purpose of satisfaction of wants or needs but is considered a duty and obligation required of everyone.
- The fifth principle, referred to as “the immutability or invariance of ownership”¹ constitutes that the access to and use of natural resources for producing goods and services is also everyone’s right and obligation. So long as individuals are able, they have both the right and the

obligation to apply their creative labor to natural resources to produce goods and services needed in the society. However, if individuals lack the ability, they no longer have an obligation to work and produce without losing their original right to resources.

- The sixth principle imposes the duty of sharing the natural resources. This principle regards private property-ownership rights as a trust held to effect sharing. Before any work is performed in conjunction with natural resources, all members of society have an equal right and opportunity to access these resources. When individuals apply their creative labor to resources, they gain a right of priority in the possession, use or market exchange of the resulting product without nullifying the rights of the needy in the proceeds of the sale of the product.
- The seventh principle imposes a limitation on the right of disposing of the property—presumed to be absolute in the Western conception of property rights. Individuals have a severely mandated obligation not to waste, destroy, squander, or use property for unlawful purposes.

Islam recognizes that the Divine Providence has endowed individuals with unique and unequal abilities and that some individuals have greater mental and/or physical capacities and, consequently, are capable of obtaining title to a larger amount of property and assets. But this only means that such individuals' responsibilities and obligations are greater than those of others. However, once these individuals have discharged their duties of sharing, in the prescribed manner and in the prescribed amount, and provided they are not in violation of the rules of *Shari'ah*, their rights to their possessions are held inviolate and no one has any right to force appropriation (or expropriation) of that person's property to anyone else. This right is held so sacred that even when rules had to be developed for emergency cases of expropriation for projects of public utility it was called "legitimate violation" (*ikrah hukmi*). Even then, such actions could be taken only after adequate compensation was paid to the owner of the property. To violate the legitimate property rights of a person is considered to be "oppression" and "exploitation," just as there is "discord and corruption on earth" when individuals do not discharge their private property obligations.

While the above principles strongly affirm people's natural tendency to possess, the concomitant obligations give rise to the interdependence of members of society. Private initiative, choice, and reward are recognized but not allowed to subvert the obligation of sharing. The inviolability of appropriately acquired private property rights in Islam deserves emphasis. As one legal expert observed, given the divine origin of Islam:

... its institutions, such as individual ownership, private rights, and contractual obligations, share its sacredness. To the authority of law, as it is understood in the West, is added the great weight of religion. Infringement of the property and rights of another person is not only a trespass against the law; it is also a sin against the

religion and its God. Private ownership and individual rights are gifts from God, and creative labor, inheritance, contract, and other lawful means of acquiring property or entitlement to rights are only channels of God's bounty and goodness to man. . . . All Muslim schools teach that private property and rights are inviolable in relations between individuals as well as in relations with the state. . . . It is not only by their divine origin that the Muslim institutions of private ownership and right differ from their counterpart in the Western system of law; their content and range of application are more far-reaching . . . If absolutes can be compared, it can be safely said that the right of ownership in Muslim law is more absolute than it is in the modern system of law. . . . The Muslim concept of property and right is less restricted than is the modern concept of these institutions. (Habachy 1962)

The *Shari'ah* outlines the obligations concomitant with property rights. Among the obligations is, first, the responsibility of sharing the proceeds or the use of property—and, secondly, the obligation not to waste, destroy, squander, or to use the property for purposes not permitted by the *Shari'ah*. To do so would be to transgress the limits set on one's rights and an encroachment on the rights of the collectivity. This position of the *Shari'ah* is in conformity with the Islamic conception of justice and the rights and responsibilities of the individual and the community.

Contracts

In any economic system, individuals not only make choices for themselves, but they also interact with other members of the society through transactions facilitated by explicit and implicit contracts entered into within the bounds specified by the institutional setting of the society. A contract is a time-bound instrument with an objective. The contract stipulates the obligations that each party is expected to fulfill in order to achieve the objectives of the contract.

The concept of contracts in Islam is not only important in the legal aspect of exchange, as an institution necessary for the satisfaction of legitimate human needs, but it is also a concept upon which the *Shari'ah* is based. The whole fabric of the Divine Law is contractual in its conception, content and application. The foundation of the *Shari'ah* is the covenant between Allah (*swt*) and man, which imposes on man the duty of being faithful to his word. The *Qur'an* reiterates that "Allah (*swt*) will not fail in His Promise."

Throughout the legal and intellectual history of Islam, a body of rules constituting a general theory of contracts—with explicit emphasis on specific contracts, such as sales, lease, hire, and partnerships—was formulated on the basis of the *Shari'ah*. Contracts are considered binding, and their terms are protected by the *Shari'ah*, no less securely than the institution

of property. This body of rules established the principle that, in matters of civil and economic dealings, any agreement not specifically prohibited by the *Shari'ah* is valid and binding on the parties and can be enforced by the courts, which treat the parties to a contract as complete equals.

Islam forcefully anchors all social-political-economic relations on contracts. More generally, the whole fabric of the Divine Law is contractual in its conceptualization, content and application. Its very foundation is the Primordial Covenant between the Creator and humans—the *Mithaq*—which imposes an obligation to comply with the rules prescribed by their Supreme Creator as its Cherisher Lord (*Rabb*). In Islam, faithfulness to the terms of all contracts entered into is linked to the fulfillment of obligations incurred under the Primordial Covenant.

The rule of remaining faithful to the discharge of contractual obligations derives its power and authority from the generalization of the responsibility of remaining faithful to the Primordial Contract.² A believer will only take on contractual obligations intending to fulfill them.³ Believers are said to protect their contractual obligations as a shepherd protects his sheep.⁴

Muslims are constantly reminded of the importance of contractual agreement, as they are required by their faith to honor their contracts.⁵ As directed in the *Qur'an*, Muslims put their contracts in writing in order to reduce the possibility of any misunderstanding or ambiguity concerning the responsibilities of the parties to the contract. *Shari'ah* scholars often point out that one of the reasons why the Islamic system of *muamalat* (transactions) is so highly articulated is that it is based on solid principles of contracts and the rights and obligations of the parties to the contract. The dynamic of contracts and the process of *ijtihad* inherent to *Shari'ah* have ensured that Muslim jurists continue to comment and build upon the theoretical constructs.

The concept of contracts in Islam transcends its usual conception as a legal institution “necessary for the satisfaction of legitimate human need.” The entire fabric of the Divine Law is contractual in its concept and content and, as Habachy (1962) points out, binds humans to their Creator:

This is not only true of private law contracts, but also of public law contracts and international law treaties. Every public office in Islam, even the Imamate (temporal and spiritual leadership of the society), is regarded as a contract, an agreement (áqd) that defines the rights and obligations of the parties. Every contract entered into by the faithful must include a forthright intention to remain loyal to performing the obligations specified by the terms of contract.

Trust

Trust is considered the most important element of social capital in Islam and the cornerstone of the relationship of individuals with Allah (*swt*) and

with others in society. Islam places a strong emphasis on trust and considers being trustworthy as an obligatory personality trait. The root of the word for “trust” (*amanah*) is the same as that for “belief” (*iman*) and the *Qur’an* insists that a strong signal of true belief is faithfulness to contracts and promises. It makes clear that performing contractual obligations or promises is an important and mandatory characteristic of a true believer.⁶

In short, Islam has made trust and trustworthiness obligatory and has rendered them inviolable, except in the event of an explicitly permissible justification.

The life of the Prophet (pbuh) is a shining illustration of the implementation of the guidance of Allah (*swt*) in maintaining trust and remaining trustworthy. Regarded as eminently trustworthy even before his divine appointment (the community conferred upon him the title of *Al-Ameen*—“Trustworthy”), the Prophet expended a great deal of effort in modifying when possible and changing when necessary the behavior of the community in respect of trustworthiness. There are numerous statements, actions, and circumstances attributed to him in which trust was the pre-eminent concern.⁷

In the *Shari’ah*, the concepts of justice, faithfulness, reward and punishment are linked with the fulfillment of obligations incurred under the stipulations of the contract. Justice links man to Allah (*swt*) and to his fellow men. It is this bond that forms the contractual foundation of the *Shari’ah*, which judges the virtue of justice in man not only by his material performance, but also by the essential attribute of his intention (*niyya*) with which he enters into every contract. This intention consists of sincerity, truthfulness, and an insistence on rigorous and loyal fulfillment of what he has consented to do (or not to do). This faithfulness to contractual obligations is so central to Islamic belief that the Prophet (pbuh) defined a believer as “a person in whom the people can trust their person and possessions.” He is also reported to have said that “a person without trustworthiness is a person without religion.” So basic is the notion of contracts in Islam that every public office is regarded, primarily, as a contract and an agreement which defines the rights and obligations of the parties. The highest temporal office, that of *khalifa*, is inaugurated by *mubaya’a*, which is a contract between the ruler and the community that he will be faithful in discharging his duties.

As we have seen, contract and trust are interdependent. Without trust, contracts become difficult to negotiate and conclude, and costly to monitor and enforce. When trust is weak, complex and expensive administrative devices are needed to enforce contracts. Both the *Qur’an* and the tradition of the Messenger stress the importance of trustworthiness as the benchmark that separates belief from disbelief.⁸ Trustworthiness and remaining faithful to promises and contracts are absolute, regardless of the costs involved or whether the other party is a friend or a foe.⁹ There is also a network of micro-level rules that ensure transparency and the unhindered flow of information. This includes, *inter alia*, the requirement incumbent upon sellers that they must inform the buyers of prices, quantities and qualities; a body of rules governing the consumer’s option to annul a transaction under

various circumstances; the rule of non-interference with market supplies; the rule against hoarding; and the rule against collusion among market participants (Mirakhor 2007).

Risk Sharing

Another core principle of Islamic economics is the notion of risk sharing. This is based on the principle of liability, which states that profit is justified on the basis of taking responsibility, possibly even becoming responsible for the loss and the consequences. This legal maxim, said to be derived from a saying of the Prophet (pbuh) that “profit comes with liability,” implies that *Shari’ah* distinguishes lawful profit from all other forms of gain and that entitlement to profit exists only when there is also the liability, or risk, of loss.

The central proposition of Islamic finance is risk sharing and the prohibition of interest-based transactions in which a rent is collected as a percentage of an amount of the principle loaned for a specific time period without the full transfer of the property rights over the money loaned to the borrower. One result of this type of transaction is that the risk is borne by the borrower. Rather, Islam proposes a mutual exchange (*al-bay’*) in which one bundle of property rights is exchanged for another, thus allowing both parties to share the risks of the transaction—something which is sanctioned. The emphasis on risk sharing is evident from one of the most important verses in the *Qur’an* with respect to economic relations (2:275). The verse states that: “. . . they say that indeed an exchange transaction (*bay’*) is like a *riba* (interest-based) transaction. But Allah has permitted exchange transactions and forbidden interest-based transactions.” The nature of property rights inherent in these two transactions hints at one of their crucial differences. *al-Bay’* is a contract of exchange of one commodity for another where the property rights over one commodity are exchanged for those over the other. In the case of a *riba* transaction, a sum of money is loaned today for a larger sum in the future without the transfer of the property rights over the principle from the lender to the borrower. Not only does the lender retain rights over the sum lent but property rights over the additional sum to be paid as interest is transferred from the borrower to the lender at the time the contract of *riba* is entered into. Arguably, the above verse renders exchange and trade of commodities or/and assets the foundation of economic activity in the Islamic Paradigm.

From this, important implications follow. Exchange requires freedom for parties to contract. This in turn implies freedom to produce, which calls for clear and well-protected property rights to permit production to proceed. To be able to exchange freely and conveniently, the parties need markets. To operate successfully, markets need rules of behavior and enforcement mechanisms to reduce uncertainty in transactions and ensure the free flow of information. They also need trust to be established among participants; competition among sellers, on the one hand, and buyers, on the other; transaction costs to be reduced; and the risk to third parties in having to bear externalized costs of two-party transactions to be mitigated.

Market Conduct

Rules governing market conduct relate to appropriate behavior on the part of all participants in the market. The *Qur'an* acknowledges the need for markets and affirms their existence, placing emphasis on contracts of exchange (*bayc*) and trade (*tijÉrah*). As a rule, it emphasizes market transactions based on mutual consent; that is, based on freedom of choice and freedom of contract which, in turn, requires acknowledgment and affirmation of private property rights. The archetype model discussed in Chapter 1 operationalized the concept of exchange and trade as well as the use of market as the mechanism for this purpose. A market supervisor is appointed to ensure compliance with the rules of conduct in the market place, which are internalized by participants before their entrance into the market. Compliance with the rules of market behavior ensures prices that are fair and just. So long as market participants comply, no direct interference with the price mechanism is permitted, even though the legitimate authority is responsible for supervising market operations.

The market's institutional structure is built around five pillars: (a) property rights, (b) the free flow of information, (c) trust, (d) contract and (e) the right not to be harmed by others, and the obligation not to harm anyone. Together, they serve to reduce uncertainty and transaction costs and enable cooperation and collective action to proceed unhindered.

Work and Work Ethics The concept of work in Islam (*al-amal*) is far broader, and has different characteristics and objectives, than the concept as it is understood in the Western economic tradition. In Islam, the work ethic is defined by the *Qur'an* itself, which stresses the need for work and action by human beings. It is because of this emphasis on work that Islam is considered “the ideology of practice and the practice of ideology” and “a religion of action” (Mirakhor 1988). The *Qur'an* exalts work and raises it to the level of worship, and considers it as an inseparable dimension of faith itself. Conversely, it considers idleness—or the squandering of time in pursuit of unproductive and non-beneficial work—as the manifestation of lack of faith and of unbelief.

Man is called upon to utilize time in pursuit of work by declaring that Allah (*swt*) has made the day as a means of seeking sustenance. A person who through hard work seeks Allah's “bounty”—which includes all appropriate means of earning one's livelihood—is most highly praised. All able-bodied persons are exhorted to work in order to earn their living. No one who is physically and mentally able is allowed to become a liability to his family or to the state through idleness and voluntary unemployment. The work which everyone is required to perform must be “good” or “beneficial” (*al-amal as-salih*), but no work is considered inconsequential in relation to its rewards or punishments in this world and in the next. One will have to reap whatever rewards or retributions are due as a result of his work.