both among the fastest growing segments of contemporary finance – would be conventional equivalents of profit-and-loss sharing arrangements. One of the critiques of collateral-based lending at a fixed, predetermined interest, is that it is inherently conservative. It favours the rich, and those who are already in business, and is only marginally concerned with the success of the ventures it finances. In contrast, under profit-and-loss sharing, Islamic institutions as well as their depositors link their own fate to the success of the projects they finance. The system allows a capital-poor, but promising, entrepreneur to obtain financing. The bank, being an investor, as opposed to a lender, has a stake in the long-term success of the venture. The entrepreneur, rather than being concerned with debt-servicing, can concentrate on a long-term endeavour that in turn would provide economic and social benefits to the community. Yet, disappointingly, profit-and-loss sharing constitutes only a small part (about five per cent) of the activities of Islamic banks.[10]

Under mudaraba, one party, the rabb al-mal (beneficial owner or the sleeping partner), entrusts money to the other party, called the mudarib (managing trustee), who is to utilize it in an agreed manner. After the operation is concluded, the rabb al-mal receives the principal and the pre-agreed share of the profit. The mudarib keeps for himself the remaining profits. The rabb al-mal also shares in the losses, and may be in a position of losing all his principal. Among the other rules of mudaraba are the following: the division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return; the rabb al-mal is not liable for losses beyond the capital he has contributed; the mudarib does not share in the losses except for the loss of his time and efforts. Such a financing system was common in medieval Arabia where wealthy merchants financed the caravan trade. They would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was stolen, lost, or sold for less than its cost. Mudaraba contracts were codified by medieval jurists and could take on extreme complexity. Different fiqh traditions have resulted in differences among the various schools. Hanafis and Hanbalis argue, for example, that the profit can be shared only when the activity is completed and the financier has been reimbursed his principal, while Malikis and Shafiis permit the distribution of the profit even before the operation is completed and the principal has been reimbursed. The mudaraba contracts also influenced other cultures. The commonly used *commandite* in French law grew out of the mudaraba contracts.

Musharaka is similar in its principle to mudaraba, except for the fact that the financier takes an equity stake in the venture. It is in effect a joint-venture agreement whereby the bank enters into a partnership with a client in which both share the equity capital, and sometimes the management, of a project or deal. Participation in a musharaka can either

be in a new project, or in an existing one. Profits are divided on a predetermined basis, and any losses shared in proportion to the capital contribution. The two methods can be combined. For example, the initial capital of a project can be financed by musharaka, while later working capital may be provided according to murabaha.

The liability of the financier is exclusively limited to the provided capital. That of the entrepreneur is restricted solely to his labour. However, if negligence, mismanagement or fraud can be proven, the entrepreneur may be financially liable. Under certain circumstances, for example if the mudarib has engaged in religiously illicit activities (speculation or the production of forbidden goods or services), or if the bank has imposed a collateral for its investment, the mudaraba or musharaka contracts can be considered null and void. Recent variations on mudaraba and musharaka are the 'diminishing' mudaraba (mudaraba mutanaqisa) and the 'diminishing' musharaka (musharaka mutanaqisa), where the bank's capital or the bank's share are progressively reimbursed, allowing the entrepreneur to progressively increase his share in the project.

Although most scholars consider profit-and-loss sharing as the most authentic and most promising form of Islamic contracts, there are a few dissenting voices. Objections fall into two categories: it is a medieval contract, that is not necessarily adapted to contemporary economic realities; and it may contravene the original meaning of riba (in the sense of lack of equivalency of counterparties) and may lead to one party taking advantage of the other, which happens if one of the participants has incomplete knowledge or a weak bargaining position. In addition, profit-and-loss sharing arrangements create managerial and regulatory problems that have yet to be fully mastered. For example, the mudarib can ask for more money than he needs, or he can engage in high-risk endeavours, knowing that he will not be committing his own money. The bank can also take advantage of a mudarib who is pressed for cash, or of depositors who know little about the deal. It can also structure the transaction so as to transfer the risk to the other participants.[11] To avoid such abuses, bankers are expected to exert due diligence, and all operations must be characterized by transparency. The mudarib must prove that he is reputable and experienced, and that he enjoys high moral standing within the business community. The project must be viable and assessed independently by the bank or by external consultants. The bank must ensure that its funds are properly spent, and that the venture being financed is properly monitored.[12]

To finance such arrangements, most Islamic banks offer accounts that act like investment funds. Depositors can reap profits from a venture's success, but risk losing money if investments perform poorly.[13] Investment accounts also differ from savings accounts in that they usually require a higher minimum amount, and a longer duration of deposits. Many institutions also offer special investment accounts, which are linked to

specific ventures. These are usually reserved for institutional investors or high net-worth individuals.

The return paid on investment accounts is determined by the yield obtained from all financial activities of the bank. After deducting such administration costs as wages, provision, and capital depreciation, the bank pools the yields obtained from all ventures, and the depositors, as a group, share the net profits with the bank, according to a predetermined ratio that cannot be modified for the duration of the contract. Different banks have different policies concerning the calculation and disbursement of profits. Some do it monthly, others quarterly, others still semi-annually or even annually.

Perhaps the greatest strategic challenge of Islamic financial institutions is to increase their involvement in PLS activities and overcome the institutional and cultural obstacles that have so far stood in the way.[14]

7.4 Stocks, Bonds, Commodities and Foreign Currencies

On the matter of investments in international markets, important changes have taken place between the first and the second aggiornamento. In the early days of Islamic finance, financial markets had yet to undergo their revolution. Equity markets, as illustrated by the sharp drop in the Dow Jones Industrial Average in 1974–5, were bearish. Commodity markets, led by oil, were in contrast bullish. Generalized floating currencies offered new opportunities for foreign exchange operations.

The early doctrine could be summarized as follows: trading in commodities markets was encouraged, since the buying and selling of 'real goods' was involved; foreign exchange trading, by analogy with early Islamic dealings in gold and silver, was permitted; bonds, whether corporate or governmental, were frowned upon since they involved interest. As for equities, legal scholars were divided. For some, equity investment was based on the principle of profit-and-loss sharing, since investors linked their financial future to that of the companies they invested in. For others, equities were not acceptable because many companies earned all or part of their income from illicit activities (banks rely on interest income; hotels, restaurants or airlines usually sell liquor; etc.). Even more significantly, most Western companies pay interest on borrowings and earn interest on their cash deposits.

Another principle of the early days of modern Islamic finance was that investments, whether in equities or commodities, could not be bought for short periods solely to make a profit. Placements had to be for the long term and for the purpose of promoting investment.[15] By the 1980s and especially by the 1990s, Islamic financial institutions had changed their outlook as a result of the dramatic changes in the international environment, and of their own experiences. Many leading Islamic banks had lost

considerable amounts on foreign exchange and commodities markets. Most of these investments were all the more controversial because they were essentially short-term and speculative, and had no developmental or community-related purpose. At the same time, with deregulation, more and more products were on the market. New types of bonds – such as zero-coupon bonds – could be riba-free. This proliferation of products favoured a case-by-case approach. Also, Shariah Boards became more inclined to adopt a pragmatic approach towards equity investment. The Al-Baraka group led the way in trading stock in Western firms.[16] Shares of indebted companies could be bought if the indebtedness was low (30 per cent of total funding is acceptable for many Shariah Boards.)[17] Also, profits could be 'purified' (that is, the share of profits derived from illicit activities could be given to charity). As for many of the new 'hybrid' products (for example, debt-equity swaps created in the wake of the Latin American debt crisis),[18] they were often considered acceptable by Shariah Boards.

7.5 Derivatives and New Financial Products

While options, swaps and futures have existed for some time, the word derivatives only entered the financial vocabulary in the late 1980s. It refers to financial products whose value is 'derived' from an underlying asset. Most derivatives were originally created as 'hedging' devices, or ways of controlling or reducing risks generated by fluctuating interest rates or currencies. By another definition, derivatives are 'bets on interest rates, currencies and commodities that result in real cash obligations or rewards'.[19] These different perspectives suggest the potential as well as the risks, religious and otherwise, involved in such new products. Since the explosion of the derivatives markets is a recent phenomenon, most scholars don't quite know what to make of a wide array of recently created products. Especially troublesome are those 'exotic' derivatives – often a euphemism for complicated products of dubious economic value devised by clever 'financial engineers'.

On the positive side, derivatives can play an important role in risk management. Also, financial innovation can be a good thing for Islamic finance, since by being 'sliced and diced', financial products can be tailored to the needs of religious-minded investors. Objectionable features can then be removed from a product. A bond issue, for example, can be divided into 'interest-only' or 'principal-only' components. The 'principal-only' component, just like zero-coupon bonds, can satisfy clients who do not want to deal directly with interest.

The flip side is that the element of volatility and the potential for gharar are greatly increased. Although riba-qua-interest is not directly involved, derivatives raise other riba-related issues. Indeed, riba in its original meaning is the 'unlawful gain derived from the quantitative inequality of

the counter-values in any transaction purporting to effect the exchange of two or more species (anwa', singular naw'), which belong to the same genus (jins) and are governed by the same efficient cause ('illa, plural ilal)'.[20] Even more significantly, derivatives contain a strong element of gharar (uncertainty), and raise a host of moral and ethical issues, such as taking advantage of want of knowledge (jahl), and fraud (ghosh). The Long-Term Capital Management (LTCM) losses, the Orange County bankruptcy, the Procter and Gamble lawsuit against Bankers Trust, and the collapse of Barings illustrate the dangers of derivatives.[21]

Islamic scholars and banks must navigate amidst those contradictory features of derivatives. A number of efforts have been undertaken to identify those derivatives that would be Islamically acceptable, and revise earlier approaches to financial innovation. In the early years of Islamic finance, forward and option transactions were not allowed.[22] In recent years, religious experts have adopted a more tolerant view, noting that a number of accepted Islamic contracts such as salam (where a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price) are not fundamentally different from futures or forwards. So is istisna, which permits the deferral of delivery and payment of processed commodities. But there are subtle nuances. In the words of Frank Vogel:

> Hadiths permit a salam contract in which one pays a year in advance for so many bushels of wheat at harvest time – certainly a risky transaction as to price. But they also forbid a salam contract tied to the crop of a particular tree or field.[23]

But when it comes to 'inverse floaters', 'kitchen sink bonds' and other very complex financial instruments, qiyas (analogical reasoning) cannot be very useful. In a world where derivatives can be so complicated that they are barely understood even by people who create and sell them,[24] medieval fiqh is of little help. Classical scholars had gone to great lengths to define conditions of valid contracts. Tomes were written analyzing issues of existence, deliverability, precise determination of the goods exchanged, of likeness, genera, fungibility, etc. Great care was given to such things as weighing and measuring the products, assessing their defects and physical changes, and to such matters as physical exchange, as well as when and where financial obligations were to be settled. A number of pre-Islamic contracts were forbidden because of the element of uncertainty: muzabana (exchange of fresh fruit for dry fruit); muhaqalah (the sale of unharvested grains in exchange for an equal quantity of harvested grains); mulamasah (a sales contract in which the sale was finalized with the buyer or seller touching a piece of cloth); munabudhah (a sales contract in which the sale was finalized with the buyer or seller throwing a piece of cloth towards the other).[25] The problem of these contracts, and of most classical analogies

that go back to medieval times – a fruit that has not yet ripened, a pregnant camel, a bird in the air, a fish in the water – is that they are of little relevance in an era of electronic settlements, e-cash and 24-hour trading.

Yet some of the Islamic prohibitions clearly strike at the heart of financial innovation. Michael Lewis, in his account of his experience at Salomon Brothers, wrote in reference to mortgage-based derivatives:

> Risk could be canned and sold like tomatoes. Different investors place different prices on risk. If you are able, as it were, to buy risk from one investor cheaply and sell it to another investor dearly, you can make money without taking any risk yourself. And this is what we did.[26]

The sale and transfer of risk is precisely at the centre of the prohibition against gharar. What makes the evaluation of such transactions all the more tricky is that the use of language can be deceiving. Lewis also wrote:

> In need of a euphemism for what we did with other people's money, we called it arbitrage, which was just plain obfuscation. *Arbitrage* means 'trading risklessly for profit'. Our investors always took risk; *high-wire act* would have been more accurate than *arbitrage*.[27]

Financial innovation is also all about the subdivision of financial instruments and the creation of equivalencies of debts and other instruments where none existed before. Yet classical fiqh frowns upon such things as settling a debt with another debt as well as on various forms of financial creativity. Various Hadiths attributed to the Prophet injunction against combining a sale and a stipulation (bay wa shart), against combining two bargains in one, or against the sale of a delayed obligation for a delayed obligation.[28]

Given the economic necessity of certain types of derivatives, Islamic scholars are bound to adopt a modernist approach that bypasses medieval fiqh and focuses on a clear understanding both of the spirit of Islam and of the actual contents of the new derivatives. At the same time, scholars must use caution in not going all out in embracing all financial innovations, as most are fraught with serious ethical, not to mention financial, flaws.

7.6 Islamic Mutual Funds

At the time of the first aggiornamento, mutual funds were little known in the Islamic world. It should be no surprise that the early literature makes little if any reference to them. In recent years, they have become a preferred vehicle for saving and investment. The principle of professionally managed funds is simple: investors pool their resources to invest in certain types of instruments (currencies, commodities, bonds, and most commonly, stocks). Funds are professionally managed and allow for considerable

flexibility. They offer a broad choice of products, and can accommodate a variety of fee arrangements and risk, maturity and fiscal preferences.

Recent years have seen a boom in socially responsible investing. Many funds have avoided certain categories of companies – for example, those with questionable labour or environmental practices, or those that did business in South Africa when that country practised apartheid. Similarly, it has long been common for religious groups to invest according to their beliefs. The New York-based Interfaith Center for Corporate Responsibility, for example, is a social-investing coalition of 275 Protestant, Catholic and Jewish institutional investors.[29]

Islamic investment funds are similar to socially responsible mutual funds in that they select their placements not on the basis of profitability alone but on non-economic criteria – in this case, compatibility with Islamic values. Driven by the abundant liquidity and the boom in financial markets, thousands of investments funds were started in recent years. In addition to Islamic financial institutions, virtually every major Western financial institution – such as Merrill Lynch, Goldman Sachs, Flemings, etc. – now offers Islamic investment funds.

While most funds stay away from highly speculative investments or from industries – gambling, alcohol, pork – that are strictly haram (forbidden), areas of controversy persist. Some stay away from interest-paying bonds (although zero-coupon bonds are usually deemed acceptable), conventional banking stocks, and heavily indebted firms. As for conglomerates and companies that derive only a small portion of their earnings from un-Islamic activities (for example, airlines that serve alcohol), or indices or market proxies that include 'un-Islamic' securities, certain funds shun them altogether, while others engage in a 'purification' process: the share of revenues from unacceptable activities is deducted and donated to charity.[30] Many funds have adopted the 30 per cent rule: it is acceptable to invest in a company that derives less than 30 per cent of its income from haram activities and whose indebtedness level is below 30 per cent.[31] To resolve such controversies and guide their investments, many funds have Shariah board or Shariah advisers.

In 1999, Dow Jones and Company has created the Dow Jones Islamic Market Index or DJIM, which tracks 600 companies (from within as well as from outside the Islamic world) whose products and services do not violate Islamic law. The index excludes companies involved in alcohol, pork, tobacco and weapons; firms in the entertainment business (such as hotels, casinos and cinemas); and those in conventional financial-services industry. The index also screens out companies with unacceptable financial ratios, such as high debt levels. In addition to pre-screening companies – assuring institutions and individuals that their investments don't transgress religious law – the index provides a yardstick against which investors can measure the performance of existing Islamic mutual funds.[32]

7.7 Development Banking

Development is still the great unfulfilled ambition of Islamic banks. For reasons discussed elsewhere, banks have been focusing primarily on short-term, trade-oriented transactions that offer a combination of low risk and profitability.[33] One recent trend has been participation in large financing projects. The muqarada technique in particular allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqarada bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

At the centre of development banking is the Islamic Development Bank (IDB or IsDB). The idea was first discussed at the Second Islamic Finance Ministers' Conference, which was held in Jeddah on 10 August 1974. The bank, whose membership is open to all of members of the Organization of the Islamic Conference (OIC), started its operations in 1975. It now has 51 members.[34]

The stated objectives of the bank as set out in its 1981 Articles of Agreement are: to foster the well-being of the people of Muslim countries; to achieve a harmonious and balanced development on the basis of Islamic principles and ideals; to meet the need for mutual financial and economic cooperation among the Muslim states; to meet the need to mobilize financial and other resources both from within and outside the member countries; and to promote domestic savings and investment and a greater flow of development funds into member countries.[35]

As with private Islamic banks, the stated goal of emphasizing profit-and-loss sharing agreements has met with early disappointment. Its main activities are export financing, leasing, and interest-free loans. The bank also provides technical assistance, promotes technical cooperation, and assumes a wide range of developmental roles.[36] Among the schemes promoted by the bank are the Import Trade Financing Operations (ITFO), the Islamic Banks' Portfolio (IBP), the Longer-Term Trade Financing Scheme (LTTFS), and the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), which provides export credit insurance or reinsurance against commercial and political risks.

The bank's initial capital was two billion Islamic dinars (Islamic dinars are equal to the Special Drawing Rights of the International Monetary Fund). In 1992, it was increased to six billion Islamic dinars. In order to supplement its capital resources, the bank introduced schemes such as the Investment Deposit Scheme, the Islamic Banks' Portfolio (IBP) and the Unit Investment Fund (UIF) to mobilize resources from the private sector. The bank maintains a Special Assistance Account, which is utilized to assist member countries afflicted by natural calamities and to finance health and

educational projects aimed at improving the socio-economic conditions of Muslim communities in non-member countries. The bank also established the Islamic Research and Training Institute (IRTI), which became operational in 1983. The IRTI undertakes research, conducts training, publishes studies, and organizes conferences on Islamic economics and banking and in related areas.

In 1998, the bank extended soft loans, or put together 'economic rescue packages' involving other Islamic or regional banks, for financially strapped countries, in particular Pakistan (following sanctions related to its nuclear policy) and Indonesia (which was badly hit by the Asian financial crisis of 1997). The bank is also evolving into a sort of lender of last resort for Islamic banks and governments.

The Saudi Arabian Monetary Agency (SAMA) acts as the depository institution for IDB funds. One occasional source of controversy has been the fact that those funds were receiving interest – in fact becoming the main source of profits for the bank.[37] The bank's charter expressly permits it to invest excess funds 'in an appropriate manner', and the criterion of overriding necessity (of development in the Islamic world), in addition to the lack of suitable investments has been repeatedly used to defend that policy.[38]

Most assessments of the institution have emphasized a dynamism that is seldom encountered among development banks.[39] Given the number of member countries, inevitable disagreements have occasionally arisen over politics, priorities and appropriate geographic focus. Following the signing of the Camp David Agreements in 1979, IDB assistance to Egypt was suspended. Interestingly, there has been no favouritism towards Islamist regimes. One analyst noted: 'Much Islamic Development Bank funding has gone to Turkey in recent years, hardly the most needy state in the region, but one that has consistently been able to identify sound and worthwile projects requiring funding'.[40] At the same time, relations with the Sudan were strained because 'some of the self-professed Muslim governments in Khartoum have not been to the liking of the Islamic Development Bank'. Among the most recent recipients of substantial aid are the new Central Asian states of the former Soviet Union.[41]

7.8 Zakat-related Products, Instruments and Practices

Zakat (literally, 'purification') has been regarded throughout Islamic history as the principal welfare system – a means of taking care of the needy in society, and of achieving some measure of income redistribution.[42] Zakat, or almsgiving, is one of the five pillars, or duties, of the Islamic faith.[43] The proper recipients of zakat funds are specified in the Koran: the poor and the needy, zakat collectors, travellers in difficulty, and captives (9:60).[44] Although in theory consisting in voluntary almsgiving, it could be

assimilated to a religious tax. Early Islam established elaborate rules as to amounts, collection practices, exemptions and the like. Every Muslim possessing a certain amount of resources was expected to contribute. Zakat was to be levied on traded goods and revenues from agriculture and business transactions, but not on personal property or belongings. Different rates (from 2.5 to 10 per cent) applied to different categories of products (produce, livestock, etc.). Although often regarded as a fixed, unchanging system, the zakat system has evolved since the early days of Islam according to the Islamic community's revenue and welfare needs. [45] A few scholars have placed far more emphasis on zakat than, say, on riba. For such scholars, zakat is quite simply the cornerstone of Islamic economics.[46]

In the contemporary setting, there have been debates about the nature, relevance and usefulness of zakat: should it be voluntary or compulsory? Should it be fused with the official tax system or kept separate? What items should be imposed and at what rates, or should the categories and rates of early Islamic days be kept unchanged? Should individuals give their contributions directly to a beneficiary or else to a special institution set up to distribute the funds? As more countries Islamicize their economies, governments have tended to reintroduce zakat as a cornerstone of both the tax and the welfare systems. In Pakistan for example, rules about zakat are established and enforced by the government.[47]

Since the first aggiornamento, zakat has been a part of modern Islamic finance. Indeed, most Islamic banks set aside a percentage of their profits for charitable activities, and a number of institutions specialize in grants, and interest-free and subsidized loans. Most Islamic banks are involved in zakat at two different levels. First, they are likely to contribute a percentage of their profits – over and above secular taxes – to charitable causes. Hence the frequent mention in financial statements of 'profits before taxes and zakat'. Second, many banks administer zakat funds, collecting and distributing money, often on behalf of their clients, for the needy and for a variety of charitable and welfare organizations (schools, hospitals, etc.). This can take the form of outright grants, or of qard hasan (interest-free loans given for charitable purposes). In some cases, the zakat funds are used to relieve a bank's distressed debtors.

A few Islamic banks are primarily, or even exclusively, 'social banks' as opposed to being profit-making ventures. Thus, the Nasser Social Bank, one of the first Islamic banks, created in the early 1970s as a successor of sorts to the Mit Ghamr bank,[48] initially focused on qard hasan (interest-free loans to underprivileged groups when faced with exceptional expenses arising from illness, weddings or funerals), and on financing pilgrimages to Mecca, pensions and welfare benefits. The bank also established a fund for administering social insurance. (In later years, the bank moved beyond such activities and started investing in economic projects.) Social banks raise, of course, questions of financing and regulation. The Nasser Social

Bank was initially supervised by the Ministry for Social Affairs and the Ministry of Finance, and received 2 per cent of the net profits of public enterprises to finance its services.[49]

Some Islamic banks use their own zakat contributions in a somewhat self-serving way, as a means of covering the cost of their bad loans, by extending qard hasan to their own borrowers who are experiencing financial difficulties, especially in connection with profit-and-loss sharing (PLS) transactions.[50]

7.9 Micro-lending or Micro-finance

Most micro-lending or micro-finance institutions (MFI) are not, technically, Islamic banks. Yet they may be closer to the moral economy of Islam than many self-styled Islamic banks, and will no doubt be a source of ideas and concepts for Islamic finance in the future. The micro-lending idea has gained a number of adherents, in particular among governments and international organizations in recent years. In February 1997, a micro-lending summit chaired by First Lady Hillary Clinton was held in Washington.

Micro-lending purports to provide a market-based solution to one of capitalism's thorniest problems: integrating the poor into the economy. The major difference with zakat-based schemes is that it focuses on moving people off the dole and into productive enterprise. Self-help and self-reliance are at the centre of the system. The scheme turns the conventional banking logic on its head: rather than looking for creditworthy customers and basing lending decisions on credit history and collateral, MFIs lend small amounts of money to people – principally women – with no resources, as a means of integrating them in the productive economy. The following statement about Islamic finance could have been written in connection with micro-lending:

> To establish a grass-root foundation in the society and to narrow down the rich–poor gap, Islamic banks have a moral and social responsibility towards their economies by investing in long-term projects. This means channelling resources to the people who need them, especially the womenfolk and the poor.[51]

The best-known experiment in micro-lending is Muhammed Yunus's Grameen Bank, which was initially started in Bangladesh and has since been replicated in more than 50 countries.[52] Although interest-based and devoid of any explicit references to Islam, the Grameen Bank concept – not to mention the fact that it was created in an overwhelmingly Islamic country by a Muslim – is based on a central tenet of the moral economy of Islam. (Although Grameen Bank charges interest, a number of micro-lending operations do not.)

MFIs have largely fulfilled the ideal of self-help, preservation of local traditions, and entry into the productive economy.[53] According to Jacques Gélinas: 'The MFIs are in the process of destroying several very old myths: the poor are not creditworthy; they are not reliable borrowers; they are not resourceful enough to make savings; they are bad investors and even worse entrepreneurs.'[54] Grameen Bank boasts that 98 per cent of its loans are repaid on time.[55]

The main objection of Islamic scholars to micro-lending banks is that they lend at interest. On occasion, other controversies have arisen, for example in Afghanistan, where the Talibans forced out the Grameen Bank, accusing it of 'promoting shamelessness among Afghan women' and of having encouraged its Bangladeshi customers to turn to Christianity, in addition to having caused 70,000 Bangladeshi women to divorce their husbands.[56]

7.10 Insurance

The case of insurance is testament to the ability of Islamic finance to evolve in its interpretations and practices. For years, it had been an article of faith that insurance was not compatible with Islam, because it contained elements of gharar, maysir and riba. Since it was all about uncertainty and chance occurrences, insurance looked like a catalogue of prohibited practices: inequality between premiums paid and benefits collected (or not collected) from the insurance company; premiums placed in interest-bearing instruments; late payment of premiums resulting in interest and late-fees; uncertainty over subject matter and duration of contracts; etc. Not surprisingly, and unlike other financial instruments, there is no true antecedent to insurance in classical Islam.

At the time of the first aggiornamento, traditional attitudes still prevailed. In one of the official publications of the International Association of Islamic Banks (IAIB), one could find a damning indictment of an industry pervaded by 'usury, deceit, misrewarding, gambling, and betting'.[57] Especially troublesome in the eyes of many Muslims was life insurance, perceived as gambling on matters of fate and divine will.

But in recent years, after much debate,[58] Islamic doctrine has come to terms with most forms of insurance – including life insurance. One of the objections had been to deriving profit from insurance. The early insurance operations tended to be non-profit, but today most Islamic banking groups have their insurance subsidiaries. Indeed, business insurance is increasingly seen as necessary in a modern economy, if only to tame risk and uncertainty, and thus a legitimate business occupation. Even life insurance has lost the stigma that was long attached to it. Planning on receiving money upon someone's death is no longer seen as an illicit gamble on misfortune, if not a God-defying act, but rather as a positive step designed

to ease the lives of survivors. Some modifications were however to be added to conventional insurance schemes. The central principle of Islamic insurance is that of mutual guarantee (takaful), or solidarity. Contracts have been devised that combine takaful with the principle of mudaraba. A typical example, which incorporates profit-and-loss sharing principles, would provide for premium payers to become partners in the insurance company and thus be entitled to a share in the profits and losses of the company. In most cases, insurance policies are based on 'solidarity mudaraba' schemes, which have been described in the case of life insurance as follows:

> [T]he participant in a solidarity scheme pays in a specific amount in installments between his minimum age (20 years) and the age of 60. The maximum age for participation is 55 years. The participants' principal is invested in profitable but licit ventures and the profits are re-invested. If he dies before the age of 60, his legal heirs receive the paid-up principal to date, the accumulated profits to date, and in addition the amount which the deceased would have paid in had he lived to the age of 60. This latter amount is deducted from the Mudaraba profits of all other participants in the scheme, hence the term 'solidarity'. Otherwise, the participant is paid his principal and accumulated profits at the age of 60.[59]

Notes

1. The practice of the custodial contract by which the depositor hands over to the depositary property or money to be kept and returned intact at a later date goes back to the early days of Islam. See Abraham L. Udovitch, 'Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages', in *The Dawn of Modern Banking*, Center of Medieval and Renaissance Studies, University of California, Los Angeles, Yale University Press 1979, p. 259.
2. Saad Al-Harran (ed.), *Leading Issues in Islamic Banking and Finance*, Selangor, Malaysia: Pelanduk Publications 1995, p. xi, and Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 135.
3. Fuad Al-Omar and Mohammed Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books 1996, p. 19.
4. Vogel and Hayes, p. 9.
5. Vogel and Hayes, p. 143.
6. Al-Omar and Abdel-Haq, pp. 11–19.
7. Vogel and Hayes, pp. 143–5.
8. Al-Omar and Abdel-Haq, p. 66.
9. Abraham L. Udovitch, *Partnership and Profit in Medieval Islam*, Princeton University Press 1970, pp. 170–248.
10. Al-Harran, p. xi, and Vogel and Hayes, p. 135.
11. See for example Ziaul Haque, *Riba: the moral economy of usury, interest, and profit*, Lahore: Vanguard 1985, pp. 190–214.
12. Stéphanie Parigi, *Des Banques Islamiques*, Paris: Ramsay 1989, p. 137.

13. Shahrukh Rafi Khan, *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking*, Karachi: Oxford University Press 1988.
14. See Chapter 8.
15. *Al Mausua al Ilmiya wa al Ammaliya lil Bunuk al Islamiya (The Handbook of Islamic Banking)*, Cairo: International Association of Islamic Banks 1977, Vol. 5, pp. 427–37.
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from dawn to sunset for one month of the year, Ramadan; and, if a believer is able to do so, making at least one pilgrimage to Mecca.

44. Koran 9:60 '[Zakat] charity is only for the poor and the needy, and those employed to administer it, and those whose hearts are made to incline [to truth], and [to free] the captives, and those in debt, and in the way of Allah and for the wayfarer – an ordinance from Allah. And Allah is Knowing, Wise.'
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8

STRATEGIC, MANAGERIAL AND CULTURAL ISSUES

The rapid growth experienced by Islamic financial institutions is likely to last for at least a few more years, driven by the 'money revolution' and by the opportunities of a huge Islamic market that is still largely untapped. But the picture is not all rosy. The Islamic financial market is increasingly competitive, and growing pains have accompanied rapid growth. This chapter focuses on the strategic, managerial and cultural challenges facing Islamic banks. It should be noted at the outset that some of the issues discussed here are common to emerging markets in general and are not exclusive to Islamic banks or even Islamic countries. In most of these countries, there are too many banks, and even the largest ones lack the size and resources to compete internationally. Banks also suffer from an overhang of bad loans, and lag behind their Western counterparts in technology and expertise. The religious dimension nonetheless adds an extra layer of problems. More specifically, this chapter introduces the 'Islamic moral hazard'.

8.1 Competitive Challenges

When modern Islamic finance came into existence, the oil bonanza as well as the novelty of the concept allowed considerable latitude for experimentation. Funds were plentiful for the handful of Islamic institutions that were in a position to share a monopoly on the small but growing niche of clients looking for Islamically-correct investments. Many depositors did not seek any remuneration, thus providing banks with the cheapest possible funding.

In those years, Islamic financial institutions could flaunt their religious character by offering unique financial products. Indeed, prior to deregulation, conventional banks were still stifled by strict controls on product innovation. Strategic and managerial weaknesses could thus be hidden 'behind a curtain of self-righteous platitudes about spiritual ideals'.[1] Such weaknesses have become more glaring with the transformation of the world of finance, and in particular with the inroads made by conventional banks in Islamic finance. Competitive pressures are now appearing from all

sides. This section focuses on two related issues: the Islamic banking franchise, and profitability and social goals.

8.1.1 The Islamic Banking Franchise

A bank's franchise, which can be defined as its 'natural market' (or the reason why customers will normally choose it in preference to other banks), is a key competitive advantage. It is true that the Islamic market has greatly expanded, but it has also become increasingly competitive. Nowadays, every major international financial institution has Islamic operations, and most conventional banks in the Islamic world provide Islamic products, and, increasingly, separate Islamic 'windows'. In interviews with Islamic bankers, one can hear the following sentence repeated over and over again: 'Conventional banks can do anything we do, whereas we cannot do anything they do'.[2] Conventional banks can now have the best of both worlds, offering jointly and to different clienteles both conventional and Islamic products.

Pressures are increasing to force Islamic banks to reconsider their strategy. As the market expands and newcomers multiply, the options available to customers widen, and both depositors and borrowers are likely to demand more innovative products. At the same time, the new norms of global finance are imposing fresh constraints on Islamic financial institutions. They are increasingly pressured to adopt – at the very least if they have international ambitions – new regulatory, accounting, and managerial rules.[3] The transformation and globalization of finance – new delivery systems, securitization, 24-hour trading – have brought with them new rules and norms that are rapidly spreading. Some are being adopted under pressure, often as a component of 'structural adjustment' packages imposed on national economies by international organizations. Others are chosen willingly as a way of gaining credibility and acceptance in the international marketplace. One example would be the attempt to gain the international accreditation standard ISO 9000, which recognizes organizational efficiency, from management style to training to customer needs.

Whereas they were once at the forefront of innovation in their specific market niche, Islamic banks are now lagging, both in the creation and in the marketing of Islamic products. The predicament of Islamic banks is illustrated by the fact that conventional, and usually foreign, institutions are now often in a better position to introduce new financial products.[4] Examples abound of conventional banks being faster to introduce new Islamic products. In Pakistan for example, Grindlays offered musharaka agreements to its clients before any of the Pakistani banks did.[5] Non-Islamic involvement in Islamic banking has become one of the defining features of the second aggiornamento. Not only are many Islamic products

aimed at non-Muslims,[6] but in at least one instance, non-Muslims have started sharing in the ownership of Islamic banks, thus contravening one of the principles of the first aggiornamento.[7] In 1998, three of the largest foreign portfolio investors in Turkey – Alliance Capital Management's Turkish Growth Fund, international financier George Soros's Quantum Emerging Growth Partners, and the Bahamas-based New Frontier Emerging Opportunities Fund – acquired a 10 per cent stake in Ihlas Finans Kurumu, one of the Special Finance Houses. The investors argued that their $4.7 million investment offered investors good value and that the bank was likely to emerge strengthened from the crackdown on Islamic institutions.[8]

The mechanisms by which conventional and Islamic banks make their strategic decisions differ. Conventional institutions proceed through trial and error: countless ideas are considered and new products are launched in short order; a few succeed, most do not. Islamic financial institutions however cannot proceed in the same way, as they are hampered by the religious constraint: new products and new practices must first be cleared by Shariah boards for religious rectitude. Yet in a harsh competitive environment, it is crucial to be swift and innovative: the product cycle is such that in the early stages, profit margins are high but later, as competition intensifies and as the product is commodified, fat margins disappear.

The easy solution is of course to try and compete on the basis of the leniency of Shariah boards, in order to pursue whatever lucrative activities conventional banks are engaged in. The difficult solution is to improve management and lending policies, and in particular to concentrate on what may constitute the Islamic bank's truly differentiating products, those based on profit-and-loss sharing (PLS), a segment now neglected, if not completely abandoned by a majority of Islamic institutions.[9]

8.1.2 Profitability and Social Goals

With the deregulation movement of the 1980s, profitability has displaced size as the principal criterion by which conventional banks are compared and evaluated.[10] Relationship banking is also being replaced by price-based banking,[11] and bank analysts as well as the financial press consider purely financial criteria to be paramount. Islamic banks are a part of the global economy, and they are thus subjected to strong pressures to conform to such expectations. Yet they should not be judged solely on the profit criterion. Since the earliest days, it was clear that Islamic banks should not be driven by profit maximization, but by the provision of socio-economic benefits to their communities. According to the International Association of Islamic Banks (IAIB):

> [T]he Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.[12]

Islamic banks are quick to point out that they are not charitable organizations, and that they must turn a profit. But this should not be their sole, or even their primary, goal. Banks are expected to achieve a 'reasonable' rate of return (*arbah maakula*), though such a definition has remained imprecise. Some have suggested it should be related to the average return in the economy.[13] In Iran, a maximum rate of profit is determined by the Central Bank.

In the harsh environment of the global economy, banks must compete with conventional banks that usually focus exclusively on profit maximization. This allows them to offer better remuneration to their depositors and to their shareholders. It also allows them to generate the funds necessary to invest in innovation and technology. In 1995 alone, the 10 largest US banks spent more than $10 billion and the 10 largest European banks spent about $12 billion on information technology.[14]

Most strategic decisions involve socio-economic and moral considerations. Where conventional banks can adopt a hard-nosed attitude, engaging for example in ruthless cost-cutting, deciding to get rid of large numbers of employees and of unprofitable lines of business,[15] Islamic banks should consider other, non-financial factors, first. At a time of profit-driven consolidations, mergers, acquisitions and lay-offs, Islamic banks face a dilemma: how can they compete with conventional banks if they do not play by the same rules?

8.2 Management, Control and the 'Islamic Moral Hazard'

The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behaviour.[16] By the same token, one could identify an 'Islamic moral hazard' in that certain features of Islamic finance can encourage unscrupulous behaviour.

For understandable reasons, most scholars steer away from that issue. For many, it is axiomatic that banks and their customers are people of virtue, who act at all times in a righteous manner. While it is undeniable that religious fervour was for many people a reason to work for an Islamic

bank, or to conduct business with it, it was soon discovered that religion could be a double-edged sword. In the Koran there are numerous references to hypocrisy (9:43–9; 110). Since time immemorial, con artists have used the cover of religion as a means of rapid enrichment. Countless financial scandals have involved religious figures.[17] (One cannot help but think of a saying attributed to L. Ron Hubbard, founder of the Church of Scientology: 'If you want to get rich, start a religion'.) Even when the overwhelming majority of people are honest, all it takes is a few bad apples – a few dishonest customers or employees – for banks to incur serious difficulties. Indeed, one big swindle can bring a financial institution down.

Four factors are of special importance in that regard. One is the assumption of righteous behaviour on the part of employees and customers, which sometimes turns certain institutions into a magnet for dubious characters. The second is the use of religion as a shield against scrutiny. The third is the religious and legal ambiguity that often allows borrowers to escape their obligations with impunity. The fourth involves conflicts of interest involving the bank and its clients.

In the early years, Islamic bankers failed to act prudently and exercise the kind of due diligence expected of bankers, because of implicit assumptions about the virtue of their employees and customers. In particular, forays into profit-and-loss sharing activities proved disastrous. Bank executives acknowledged that they had trusted people who did not deserve their trust.[18] Hassan Kamel, chief executive of the (now-defunct) London branch of Al-Baraka, explained why his bank was not involved in profit-and-loss sharing (PLS) operations: 'The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that (the Islamic economists) assume the scenario of the entrepreneur being a good Muslim'.[19] Hamid Algabid noted that the same problem was encountered by most Islamic institutions:

> At the beginning, confidence was the rule. The good faith of the participants could not be questioned since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith.[20]

Internal control has also been a problem for the same reasons. In 1998 alone, the Dubai Islamic Bank, the oldest and one of the largest Islamic commercial banks, was hit by two scandals involving its employees. It incurred losses of $50 million when, according to a bank spokesman, 'a bank official extended business loans without conforming to the bank's credit terms'.[21] News of the losses caused a run on deposits: in one day, DIB clients are said to have withdrawn $138 million (or 7 per cent) of the bank's

total deposits, forcing the Dubai Central Bank and the United Arab Emirates authorities to ride to the rescue, and provide the liquidity and the guarantees necessary to reassure depositors.[22] Another, more bizarre, swindle also involved a large, unauthorized loan. In a lawsuit filed in Miami, Florida, the Dubai Islamic Bank charged West African tycoon Foutanga Dit Babani Sissoko of bilking it of $242 million. A branch manager, who claimed that he gave the funds to Sissoko because he was under his 'black magic' spell, was arrested.[23]

A second type of Islamic moral hazard occurs when the financial activities of certain Islamic institutions or groups become immune to scrutiny or criticism, whether for political or religious reasons. In Iran for example, a whole sector of the economy has been able to operate outside of any regulatory framework, allowing abuses to persist and go largely unpunished:

> Mullahs in control of [foundations], and their appointed managers are hardly accountable, and run them as personal fiefs. Widely publicized corruption scandals and investigation by the Majlis led to the resignation of certain clerics in charge in late 1994 and 1995. But the foundations are still widely believed to foster nepotism and patronage, which adds to their political clout.[24]

A more subtle but equally pervasive form of Islamic moral hazard is the advantage that can be taken from ambiguity. Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic. In the words of Noel Coulson:

> Commercial law … in the West is orientated towards the intrinsic needs of sound economics, such as stability of obligation and certitude of promised performance. In the religious law of Islam, on the other hand, equitable considerations of the individual conscience in matters of profit and loss override the technicalities of commercial dealings. It is the harmonization of these two very different approaches which poses the real challenge for developing Islamic law today.[25]

Islamic banks face a serious problem with late payments, not to mention outright defaults, since some people take advantage of every dilatory legal and religious device. Indeed, like other religions, Islam recommends forbearance and even loan forgiveness to borrowers in difficulty (Koran 2:280–1). In a secular system, such prescriptions can be ignored. But in a religious or hybrid system they cannot. Secular bankers can use a whole array of tools – such as late fees, lawsuits, forcing bankruptcy, etc. – to protect their interests as lenders. Islamic bankers are hampered by the lack of clear-cut norms and remedies. In most Islamic countries, various forms of penalties and late fees have been established, only to be outlawed or considered unenforceable.[26] Late fees in particular have been assimilated

to riba. As a result, 'debtors know that they can pay Islamic banks last since doing so involves no cost'.[27] In Pakistan, special banking tribunals have been created, but they are in competition with other tribunals and lack enforcement power. Attempts to expedite court processes typically are still bogged down by religious objections.

It should be noted that the same problems often hurt conventional banks in Islamic countries. In Saudi Arabia, problems of late payment are endemic, and banks receive little help from the judicial system. Peter Wilson observed that 'Saudi Arabia's bad loan problem is as old as the country's banking system, given the doctrinal dilemma of having an interest-based financial system in a country that officially prohibits interest.'[28] More specifically:

> The Kingdom's law courts reflect the uneasy balance in the country. There are Islamic or Shariah courts that fall under the jurisdiction of cleric-dominated Ministry of Justice and special commercial committees under the sway of the more progressive finance and commerce ministries. Enforcement, however, remains the domain of the Interior Ministry and each province's governor. The result is a legal quagmire, as the country's economic development has overwhelmed the abilities of the existing courts. Besides having to cope with an inadequate legal code, courts also have to contend with another force as well: the more than 7,000 princes who comprise the House of Saud and who in practice are beyond the jurisdiction of any court.[29]

In Pakistan, many borrowers took advantage of the ambiguity of a multi-layered legal system to avoid repaying much of their debt. Many businessmen who had borrowed large amounts of money over long periods of time seized the opportunity of Islamicization to do away with the accumulated interest of their debt, by repaying only the principal – usually a puny sum, considering years of double-digit inflation.[30]

The fourth type of Islamic moral hazard is related to the bank's relation with its depositors. Islamic banks share their profits with those of their customers who hold investment deposits. For example, 80 per cent of the net profits may be distributed to the depositors, and 20 per cent to the shareholders. Empirical surveys have shown that banks often arbitrarily change distribution ratios. When profits decline, depositors often still expect a competitive rate of return, or else they may take their savings to another Islamic institution, or to a conventional bank. Thus in Egypt, from the mid to the late eighties, the International Islamic Bank for Investment and Development (IIBID) distributed all its profits to investment account depositors, while the shareholders received nothing. In 1988, the bank even had to distribute to its depositors an amount exceeding its total net profit. The difference appeared in the bank's account as 'loss carried

forward'.[31] Clearly such practices fly in the face of sound banking management practices, and cannot be sustained for long, yet they are likely to happen in the absence of strict regulatory controls.

Islamic banks also suffer from the lack of an adequate infrastructure. The Islamic financial community is too fragmented, it lacks industry-wide norms and a true secondary market. The complex nature of the industry – national and transnational, its being subjected to both secular and religious norms – complicates the managerial task. On matters of accounting, attempts at harmonization (such as those of the Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI]) have met with resistance. Indeed, different accounting rules can make a big difference in a bank's performance and solvency. Non-cash items can be used to inflate profits. An institution's holdings of real estate, stocks or bonds can be valued 'historically', that is, according to their initial purchase price, or 'marked-to-market', that is, according to their current market value. Similarly, an infinite variation of rules occurs in case of non-payment or late payment. In certain countries, rather than declaring an entire loan past due, each instalment is declared past due; also, interest income not received can be capitalized; and new credits can be extended to borrowers in difficulty, thus postponing default.

Perhaps the most vexing managerial issue is the lack of qualified personnel. Bank officers must possess at once management skills appropriate to a conventional institution and religious training. The need (admittedly mostly theoretical) for expertise in profit-and-loss sharing also requires that the Islamic banker combines the skills of the commercial banker with those of the venture capitalist – which further reduces the pool of available talent.[32]

There are countless seminars, training programmes and educational facilities, but most have been found to be inadequate for a variety of reasons ranging from the fragmentation of the industry to the inadequacy of the state of knowledge and scholarship in the field. In 1981, the International Institute for Banking and Islamic Economics opened in Cyprus. It was the most ambitious programme ever, sponsored by all the existing Islamic banks, the Islamic Development Bank (IDB), and a number of governments and universities. The Kibris Islamic Bank was even created to serve as its 'application bank'. But both the institute and the bank closed abruptly after a few years, under mysterious circumstances.[33]

8.3 Marketing Issues and Challenges

Researchers asked 10 customers of a now-defunct Islamic bank in London why they had deposited their money with that bank: 'Eight of them said they had done so because it was Islamic. All of them said they were disappointed with the services and the treatment they got from the bank.'[34]

Today, given the intense competition in Islamic finance, few banks could retain such customers. Many banks are actually attempting to sharpen their marketing skills to attract and retain customers.[35] At the heart of the marketing effort lie a few basic questions: who are the actual and potential customers of Islamic financial institutions? What are their motivations and behavioural characteristics? What should banks do to reach them? Should the institution compete on the basis of religious credentials or on the basis of products and service?

There are two sets of reasons why people choose to deal with an Islamic financial institution. One is religious/solidary, the other is financial/commercial. In the early years, there was an implicit trade-off between the two since there often was a financial or commercial penalty in dealing with an Islamic institution. Remuneration on deposits, when it existed, was usually lower. The financial institution was also likely to lack experience and expertise and offer little convenience. To be sure, there was the possibility that returns on profit-and-loss sharing accounts would be higher than conventional interests, but such accounts also carried the risk of loss of all or part of the principal.

The early assumption of Islamic finance was that the devout would be willing to sacrifice a share of their wealth as an act of faith, or to express solidarity with their community. To use an economic formulation, the lower rate of return would be a premium paid by a Muslim to satisfy his religious preference. At least, such were the expectations of the first Islamic bankers.[36]

To this day, it is hard to truly measure the relative importance of the two factors. For one thing, as in any human endeavour, motives are complex. For another, surveys can be misleading since respondents are always likely to exaggerate the role of the religious motive. In addition, the sheer diversity of the 1.2 billion-strong Muslim community worldwide makes any generalization based on a small sample hazardous.[37] This is frustrating from the standpoint of bank marketing. Indeed, while there are countless marketing tools available to segment markets and analyze customers' needs and characteristics,[38] the religious dimension remains elusive.

Perhaps the best way of approaching an answer is to state an axiom: given a choice between two identical products (or two identical banks), one conventional and one Islamic, the devout Muslim will choose the Islamic one. This of course may not resolve the issue, since neither products nor banks are ever absolutely identical, yet it helps explain the growing convergence between Islamic and conventional banks (conventional banks creating Islamic products, windows, or subsidiaries; Islamic financial institutions broadening their product range, adapting to conventional benchmarks and appealing to non-Muslims).[39] This in turn poses another marketing question: are all Islamic banks and products equally Islamic?

Surveys show that the two decisive factors in deciding whether an institution is truly Islamic are, first, the existence of a Shariah board, and second (in the case of establishments that offer both conventional and religious products), whether there is a clear segregation of funds and operations. Other issues, such as the ownership of the institution (whether it belongs to a Western bank, for example) or whether they may cater to non-Muslims, seem to matter little.[40]

Not surprisingly, the religious dimension is the central part of the marketing effort of financial institutions. With various degrees of subtlety, marketing campaigns have warned against the ills of 'usurious interest', denigrated their 'usurious' competitors,[41] and associated success with religion. For example, one of the advertising slogans of the Egyptian Islamic Money Management Company Al-Rayyan was 'al-baraka wara al najah' or 'the blessings behind success'.[42] Marketing campaigns are usually stepped up during the holy month of Ramadan.[43]

Religious symbolism is visible in most Islamic financial institutions. The building and decor often reflect Islamic architecture. Koranic sayings often adorn the walls. Banks usually include a prayer room to help employees and customers fulfil salat, the Islamic obligation to pray five times a day. Beyond the traditional savings and checking accounts, banks often offer a haj fund, designed to help customers save for a pilgrimage to Mecca. Those institutions located outside the Islamic world (where Friday is therefore a working day) usually close from 11am to 3pm on Fridays. Some even close during the day to allow their employees and customers to perform their prayer obligations.

8.4 Problems of Liquidity

During the Gulf War in 1991, the Islamic banks in the Gulf region lost about 40 per cent of their deposits.[44] This highlights the vulnerability of Islamic financial institutions and justifies somewhat their aversion to risk. Lacking a deposit insurance programme that can reassure depositors and prevent massive withdrawals, Islamic institutions cannot depend on the flexibility afforded either by a secondary market, or by a ready discount window. Opportunities for securitization are limited, and there is no true Islamic interbank market to help fund daily liquidity. Conventional banks, in contrast, can reassure their depositors by providing deposit insurance. They also have flexibility in managing their assets and liabilities by reselling their loans to other financial institutions, by transforming those loans into tradable securities, using the discount facilities of their central bank, or borrowing at interest.

Of all the main financial instruments used by Islamic banks, only leasing operations can easily lend themselves to secondary trading. In the Islamic tradition, discounting debt obligations (selling them for less than their

face value) usually raises riba-related issues. The buying and selling of financial obligations is still controversial. In addition to the lack of a true Islamic banking infrastructure and interbank market, they face another (albeit mostly theoretical) hurdle: the ties between borrower and lender are supposed to be such that they cannot be casually severed.[45]

Coordination and homogenization are complicated by the disagreements among Shariah boards as to what activities are permissible, and how Islamic banking operations ought to be conducted. The very idea of creating an Islamic interbank market – perceived by some as buying and selling money – still divides them. In addition, bitter disagreements within the Islamic finance community[46] along with rivalries between financial institutions as well as countries have prevented the emergence of a true community of Islamic banks, whose role could theoretically be similar to that of nineteenth-century clearing houses. These were coalitions of banks created in the era predating modern bank regulation to address the problem of banking panics as well as other areas of common concern. They monitored member banks by restricting their activities, conducted strict bank examinations and enforced compliance. At times of financial panic, they would provide reassurance of repayment to depositors.

Over the years, there has been no lack of attempts at providing coordination and at promoting uniform practices. In 1981, on the occasion of the Fourth Meeting of Central Bank Governors in Khartoum, the Report of the Experts Committee on the Promotion, Regulation and Supervision of Islamic Banks was approved, with the recommendation that individual countries adopt it.[47] Yet the heterogeneity of Islamic financial institutions characteristic of the second aggiornamento has complicated that task. At a time of increased coordination among international financial institutions, Islamic financial institutions are lagging.[48] A few initiatives are nonetheless worth mentioning. The Arab Banking Corporation (ABC) has formed a clearing company that acts as a fund which invests in Islamically acceptable products. Banks can invest their excess balances in the clearing company for two to three days and receive a guarantee from ABC on the principal they put in plus the accrued profit for the period. In addition, the Islamic Development Bank has increasingly taken up the role of lender of last resort to Islamic institutions.

8.5 Cultural Issues and Challenges

Every community or institution has, in the anthropological sense, a culture. Culture has been defined as 'everything that people have, think, and do as members of their community'.[49] It is principally about ideas, values and attitudes as well as normative or expected patterns of behaviour. By the same token, every bank can be said to have its own culture: 'A bank's shared values constitute its culture. Such cultural values may relate to how

communications take place, how decisions are made, or how people get ahead in the organization. They are the signature, the "what makes us different", of a bank.'[50]

Pressures are increasing to force Islamic banks to reconsider their focus on short-term mark-up based deals and seek longer-term profit-and-loss sharing projects. Perhaps the greatest obstacle is a cultural one, related to risk and trust. Given the diversity of the Islamic world, a common cultural denominator is elusive. Many authors fear to tread on that ground for fear of appearing unscientific or politically incorrect. Yet the reality of the cultural element is inescapable.[51] Although a lot in this section is anecdotal and country-specific, broader patterns will emerge to account for the difficulties in developing profit-and-loss sharing arrangements that are at the core of the Islamic banking philosophy.

Culture is notoriously tricky to analyze. It is multifaceted, somewhat amorphous and hard to pin down; it is closely intertwined with history and institutions. Culture does not emerge in a vacuum. It is the product of historical processes and socio-economic variables. It is significant from our standpoint because it influences investors' preferences: in an uncertain political and economic environment, people like to hold gold; people accustomed to high inflation favour real estate and tangible assets; minorities who fear confiscation and expulsion feel safer owning jewellery and valuables that can be transported.

Different Islamic communities have had different histories, and thus different relations to money. Historical and anthropological observations capture some of these differences. Maxime Rodinson has noted, for example, 'the traditions of generosity for the sake of prestige, familiar to the leaders of the desert communities'.[52] Such a trait has undeniable political, economic and financial implications in today's patrimonial Gulf states.

In contrast, the image of financiers and businessmen as entrepreneurs à la Schumpeter, who thrive on risk and creative destruction, does not quite fit much of the contemporary Islamic context. Conservatism and risk-avoidance are the rule. Consider for example this description of the typical Egyptian businessman:

> A Cairene entrepreneur, even one who faces no serious competition, still has to cope with unpredictable changes in inflation, vacillating exchange rates, and capricious government policies. The country lacks genuine capital markets, so the odds are that the entrepreneur's capital represents the sum of his family resources, either saved over long years or inherited from some glorious ancestor. One of the reasons that rent seeking is such a popular technique among businessmen is that it holds risk to a minimum. It is a way of getting the government to guarantee against the risks of certain ventures. As a result, Egyptian businessmen are not unimaginative, but they are justifiably cautious.[53]

Risk avoidance, given their experience and the environment within which they operate, is perfectly rational behaviour for many entrepreneurs. Long-term investment requires a culture and institutions that are predictable and foster trust.[54] In order to take a calculated risk, the entrepreneur will expect political and economic stability in his environment, and consistency in the enforcement of the law. In much of the Islamic world, people still have memories of expropriation and arbitrary decisions by governments that have adversely affected their business ventures.[55] Rampant inflation also discourages long-term investment, and so do currency fluctuations which can wipe out savings overnight.[56]

Another factor is that the worlds of business and finance are likely to be politicized and embedded within social institutions (family, tribe, ethnic or religious group). 'Connected lending' (lending to entities otherwise related to the financial institutions) tends to be very high, and when loans go bad, custom and social mores prevent the use of modern enforcement techniques (foreclosures, forced bankruptcies, etc.). The protection of the law is not always assured, and the Islamic moral hazard discussed earlier is likely to make things worse. In many countries, delaying payment is a common practice, and defaulting borrowers – provided that they are well connected – are beyond the reach of the law.[57]

In that environment, successful financial institutions are often the most conservative ones. They are therefore unlikely to engage in risky entrepreneurial finance. Edmond Safra, scion of a Syrian Jewish family that had been involved in banking for generations, who later went on to create a financial empire in Switzerland, Brazil and the United States, and is still the preferred banker of many Middle Eastern potentates, states his philosophy of banking as follows:

> The book on banking was written 6,000 years ago. Banking is a simple, stupid business. First and foremost, you safeguard depositors' money – you, the banker, not the Federal Deposit Insurance Corporation. You invest it safely and pay your depositors a little less than the interest you receive. You keep your expenses low.[58]

His banking precepts were inherited from a long tradition.[59] One precept he learned from his father was that 'if you loan a man too much money, you turn a good man into a bad man'.[60] This may be an apt, if – considering the bad loan problems encountered by many Middle Eastern banks – forgotten, piece of advice.

The oil windfall has to some extent corrupted many elements of Middle Eastern business and finance, creating get-rich-quick mindsets and favouring greed. The propensity to speculate in international financial markets and sometimes in domestic ones may seem paradoxical, given the conservatism noted earlier (and of course in the light of the religious teachings of Islam), but it is easy to explain. Empirical studies show that

investors in a bullish market, especially when they think they are (by virtue of their 'connections') insiders, often feel that speculative risk is preferable to productive risk.[61] Safra's general comments hint at the cultural and institutional difficulties associated with a more complex, participatory form of finance such as profit-and-loss sharing.

Many observers have noted the correlation between Islamic views of risk and contemporary practices, especially in the Arab Middle East.[62] As other parts of the book show (in particular Chapter 3), the injunctions against gharar are not injunctions against risk per se, but against speculation and uncertain contracts as well as against selling and otherwise transferring risk to third parties. Also, the prohibition of riba has made finance as a whole suspicious in the eyes of many Muslims. Perhaps the major remaining obstacle is in achieving coherence and consistency in laws and institutions, in the hope that in due course it will transform the culture and eliminate the Islamic moral hazard.

In justifying the paucity of long-term investment, there is a lot of blame to go around. Governments do not offer sufficient incentives: '[I]ndividuals and enterprises are at the mercy of administrative interpretations and applications, and can only succeed through the informal facilitation and evasions of bureaucratic functionaries'.[63] Banks, reluctant to develop PLS products, set the bar so high that few investments qualify. Many borrowers have manipulated the system to their advantage. Only a concerted effort can resolve the problem. The challenges ahead are two-fold: banks themselves need to work at transforming their cultures; they also need to work at changing their surrounding political and business culture. Indeed, the necessity of change may be expressed in economic terms, but strong political impediments stand in the way.[64]

As a first step, Islamic banks must work to change their own operations, procedures and culture. A prerequisite to instilling a culture fostering the development of profit-and-loss sharing products is a better understanding, on the part of bank managers and executives, of the logic of venture capital.[65] This will result in the creation of successful, long-term oriented products and in turn, by building a track record, instil the necessary confidence in the public.

The challenge of cultural change is all the greater in that it should not simply consist in adopting the culture of global finance, with its often predatory and amoral features, but should temper it with the moral values of Islam. Nabil Saleh wrote:

> It is not uncommon, in secular transactions, for one of the parties to be stronger than the other, or perhaps cleverer or more experienced; so the disadvantaged party is in need of some kind of protection and guidance before an agreement is concluded or a bargain struck. This was even more the case during the Prophet's time, when substantial difference in terms of enlightenment and development existed

> between bedouins and townsmen, and even between townsmen belonging to different settlements. One established hadith tells that Muhammad forbade a transaction known as talaqi al-rukban, which is a sale whereby a townsman meets a tribesman outside the market place and buys the tribesman's goods at a price cheaper than the price prevailing in the market, thus taking advantage of the seller's ignorance of the market price.[66]

One cannot help but relate this quote to contemporary accounts of the brave new world of finance. In his account of his experience as a mortgage bond salesman at Salomon Brothers, Michael Lewis describes the ways in which today's 'townsmen' (New York traders) fleeced the 'tribesmen' (regional Savings and Loans managers). He writes:

> The men on the trading floor may not have been to school, but they have Ph.D.'s in man's ignorance. In any market, as in any poker game, there is a fool. The astute investor Warren Buffett is fond of saying that any player unaware of the fool in the market probably *is* the fool in the market. … Salomon bond traders knew about fools because that was their job. Knowing about markets is knowing about other people's weaknesses. And a fool, they would say was a person who was willing to sell a bond for less or buy a bond for more than it was worth. A bond was worth only as much as the person who valued it properly was willing to pay. And Salomon, to complete the circle, was the firm that valued the bonds properly.[67]

Similarly, Lewis identifies the inevitable conflicts of interest that accompany financial innovation: 'If it was a good deal, the bankers kept it for themselves; if it was a bad deal, they'd sell it to their customers'.[68]

Or consider Frank Partnoy's account of his experience selling complicated derivatives such as repackaged asset vehicles (RAVs), and principal exchange rate linked securities (PERLS) for Morgan Stanley. Such risky vehicles – 'complex foreign exchange bets packaged to look like simple and safe bonds' – were sold to unsuspecting clients. The following quotes encapsulate the culture of the derivatives business:

> Morgan Stanley carefully cultivated this urge to blast a client to smithereens.

> No one seemed to care about whether clients actually understood what they were buying.

> A salesman cared only about making the sale, not about the damage it might cause later. All derivatives salesmen knew that eventually some of their trades would blow up, and some of their clients would then go up in flames.

Wall Street has made, and continues to make, a huge amount of money on derivatives by trickery or deceit.

Derivatives are the most recent example of a basic theme in the history of finance: Wall Street bilks Main Street.[69]

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31. Kazarian, p. 179.

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9

ECONOMIC ISSUES: ISLAMIC FINANCE AND DEVELOPMENT

Insofar as '[m]oney is the only good that trades against all other goods', the financial sector 'is unique in the degree to which its markets, prices, institutions, and policies impinge upon all others.'[1] More specifically, in any modern economy, financial systems are central to long-term economic development:

(1) They facilitate trade: at the most rudimentary level, money minimizes the need for barter and thereby encourages commerce and specialization.

(2) They facilitate risk management, by pricing risk and providing mechanisms for pooling, ameliorating, and trading risk.

(3) Financial intermediaries mobilize resources from disparate savers to investment in worthwhile investment projects.

(4) Financial systems obtain information, and evaluate firms, projects and managers.

(5) Financial systems provide corporate governance. It is difficult if not impossible for individual investors to evaluate and monitor the performance of firm managers. Consequently, financial intermediaries are often charged with compelling managers to act in the best interests of firm claim holders (stockholders or creditors).[2]

Promoters of Islamic finance have argued that Islamic finance was not only consistent with capitalism (i.e., with a market-driven allocation of resources), but that it was in many ways better suited to a dynamic economy. More specifically, Islamic finance could bring about more efficient mobilization of savings, more equitable and just distribution of resources, more responsible and profitable lending, as well as less volatile business cycles and more stable banking systems.[3]

This of course is the theory. The difficult part has been to translate the broad principles of Islamic finance into concrete reality. More specifically, in order to contribute to the process of economic growth and development, banks must learn how to transform savings into real investments, and

how to do it efficiently – transforming small deposits into larger loans, acting as risk arbitrageurs for investments with different rates of return and risk levels, devising an attractive mix of financial instruments, etc. Following some comments on Islam and economic liberalism, this chapter considers four sets of economic issues and challenges: the mobilization of savings, economic development and fund allocation, Islamic capital markets, and macro-economic policies.

9.1 Islam and Economic Liberalism

Dominant approaches to development have changed dramatically since the 1980s. Until then, development theorists emphasized 'top-down' industrialization, with the state playing the main role in the economy. Economies were supposed to grow through centrally planned development and import substitution policies.[4] Even in those countries committed to free enterprise, government agencies in charge of economic development established broad policy guidelines, and the role of the state kept increasing. The nationalization of oil and banking in Saudi Arabia and other Gulf states in the 1970s is a case in point. In most countries, the financial sector was used as a tool to implement the developmental goals of governments.[5]

Since the 1980s these policy dogma have been reversed: export-led industrialization, privatization and disengagement of the state have become the order of the day. The growing interest in Islamic economics and finance is not unrelated to these policy developments.[6] In the words of Karen Pfeifer:

> Far from being a throwback to the social system of the Middle Ages, Islamic economics is … a set of ideas evolving in the last decades of the twentieth century to explain and address the economic problems faced by the citizens of predominantly Islamic countries. Islamic economics responds to the achievements and failures of, first, state capitalism, and, second, the international capitalist system's antidote to state capitalism – economic liberalization.[7]

One should however be wary of drawing broad conclusions in regard to state–market or public–private relations. In assessing Egypt's infitah (open-door) policy, Robert Springborg observed:

> Instead of undertaking basic structural reforms which would create an environment truly conducive to private investment, the government of Egypt has been preoccupied with tinkering with the legal superstructure. The tinkering has produced some more liberal conditions governing investment, but the gain is partially offset by uncertainty resulting from the tinkering itself. Moreover, even while

> seeking to entice private investment through special incentives, the Egyptian authorities have presided simultaneously over the further expansion of the state's role in the economy. Public revenue as a percentage of GDP climbed steadily during the infitah, rising from 34.4 percent in 1975 to 43 percent in 1984. The state, far from withdrawing from this arena in favor of private enterprise has occupied a greater share of it.[8]

9.2 The Mobilisation of Savings

9.2.1 The Special Role of Banks

In most Islamic countries, banks are by far the main source of finance because alternatives, such as capital markets, are under-developed. They operate the payments systems, purchase most government bonds, and are essential to the operation of all parts of the economic system. In such an environment, banking assets tend to grow much faster than the economy as a whole. Conversely, since banks hold the lion's share of financial assets and are the dominant financial intermediaries, banking crises tend to hit developing economies particularly hard.[9]

The Bank for International Settlements (BIS) has noted that rapid economic growth in the 1990s 'has led to an extraordinary expansion in the ratio of bank credit to GDP that has no recent parallel in the industrial countries'. The ratio in Indonesia rocketed from 8.1 per cent in 1980 to 49.1 per cent in 1995. In Malaysia the figures are 33.1 per cent and 76.9 per cent. (In the US in the same period the ratio rose from 62.1 per cent to just 63.3 per cent.)[10] Such rapid growth is likely to create 'lending bubbles' as abundant funds chase a limited number of truly creditworthy ventures and tend to concentrate in short-term and speculative areas. As soon as a downturn occurs, many of these loans are likely to become irrecoverable and the cost of supporting, recapitalizing or restructuring the banking sector is likely to amount to a large percentage of the Gross Domestic Product (GDP).

Banking in much of the Islamic world also tends to epitomize 'crony capitalism'. To an even greater extent than in industrial countries, banks in emerging markets have very close ties with governments, and bankers are likely to belong to close elite circles.[11] In its survey of Middle Eastern billionaires, *Forbes* notes that banking is a 'proven route to riches': 'All of the 11 billionaires and 2 of the heavy hitters from the region are bankers or own stakes in banks.'[12] One of the consequences is that regulators often come under pressure to turn a blind eye to the imprudent practices of some bankers. '"What do you do if the president's brother owns a bank," asks one Southeast Asian supervisor. "The answer is you leave him alone"'.[13]

Within such an environment, the role of finance is skewed. Rather than going to worthwhile investment projects, financing goes primarily to 'well-connected' borrowers. Other functions mentioned above – obtaining information, evaluating firms, projects and managers, and providing corporate governance – are similarly distorted. Also, banks are often considered 'trophies' that inexperienced businesspeople pay a high price to acquire, and sometimes mismanage, at a high cost to the economy as a whole.[14]

9.2.2 Informal Finance

In most developing countries there is an informal or parallel financial sector that is unregulated and does not appear in official accounts. It includes black-market money changers and traders, but also deposits and savings accounts as well as loans. One mechanism, known as rotating savings and credit associations (ROSCAs), is described as follows by the World Bank:

> ROSCAs intermediate in the most basic way. A small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The money collected (the fund) is then given in rotation to each member of the group.[15]

Historically, informal markets have emerged either out of the inability of the official sector to accommodate certain types of transactions, or out of the refusal of certain groups – for a variety of reasons ranging from lack of trust or fear of confiscation, to the avoidance of currency-reporting requirements, to tax evasion – to integrate the official government system. Within informal networks, religion, ethnicity, kinship or neighbourhood affiliations provide a sense of trust and act as substitutes for legally enforceable obligations.[16] The risk of social ostracism is indeed an effective enforcement mechanism.[17]

Economists disagree as to the merits of informal sectors. For hardcore free-marketeers, such sectors – insofar as they emerge spontaneously and are not 'distorted' by government intervention or hamstrung by 'financial repression' – represent true markets.[18] According to this view, a combination of excessive regulation, artificially low interest rates – which act as a disincentive to savings – and directed credit – which in effect subsidizes certain sectors, certain groups, and certain regions at the expense of others – is harmful to economic development.[19] In countries such as Yemen, the informal banking sector has for a long time been a factor of economic stability.[20]

Critics however see inherent limits in informal markets. They are likely to remain small-scale, and thus exclude significant segments of the

population. And conversely, if they expand too fast (as was the case with Egypt's Islamic Money Management Companies [IMMCs]) they are even more prone to fraud and abuse than the official sector under comparable circumstances. They also deprive the government of much-needed revenues and prevent the conduct of a coherent macro-economic policy.

This is where Islamic finance can be seen as an attractive middle ground. One of the strong selling points of Islamic finance is that it attracts funds that would otherwise have remained outside the national financial system – sent abroad, kept 'under mattresses' or otherwise hoarded, or at best confined to the informal sector. In the Islamic world, two main reasons are said to account for the refusal of some people to deposit their money in banking institutions: religious factors relating to interest payments, and the lack of trust in domestic financial institutions – the fear that they will collapse or that deposits will be confiscated by the government.[21]

Estimates as to the amounts left out of traditional banking circuits vary. Hikmet Guler, general manager of Turkey's Faisal Finance Institution Inc., estimated that Turks were holding $50 billion outside the banking system.[22] Assuming that the estimate is realistic, the implication – in a country with a parallel Islamic sector that has only $1.5 billion in deposits – is that were Islamic banks allowed to expand and operate with fewer constraints, most of these funds would find their way into the official banking sector.

Yet it is not enough to create Islamic financial institutions. Such institutions must provide the necessary facilities, inspire confidence and provide attractive investment options. Insofar as conventional banking is usually concentrated in prosperous enclaves and barely penetrates poor, rural, and remote areas,[23] the task of Islamic institutions is to fill that gap. But expanding a network to rural areas and servicing small accounts are not the best ways of building profitable operations.

Perhaps even more difficult than the logistical aspects are the psychological ones. In areas where people are used to keeping their (usually meagre) savings under the proverbial mattresses, the language and symbolism of religion may help, but is likely to be insufficient, at least from a developmental perspective. Indeed, a further challenge to Islamic banks is to promote investment accounts, that is, accounts that will serve to finance profit-and-loss sharing operations. In contrast to conventional savings accounts which are usually short-term (and often insured), these accounts are oriented toward the long-term, and their fate depends on the success (or failure) of the corresponding investments. The possibility of losing one's savings does little to reassure the suspicious. Hence the need to engage in a serious education and marketing effort, and most importantly to make a sustained effort at building confidence and a track record. Financial institutions must develop instruments that are convenient to small savers, intelligible to people unaccustomed to modern banking, and remunerative enough to be appealing.[24]

9.2.3 Assessing the Performance of Islamic Banks

There are no comprehensive or comparative surveys on the subject, but anecdotal evidence as well as a number of case studies suggest that the promise of bringing into the system a heretofore neglected segment of the market has not been fulfilled. Elias Kazarian's study of the Egyptian case suggests that much of the increase in Islamic bank deposits occurred at the expense of conventional banks (and was driven by the increase in the remuneration of accounts); that most of the activities of Islamic banks have been in large cities as opposed to the countryside, where they are most needed;[25] and that their main customers were likely to be the well-to-do, and not the poor or the lower middle class.[26]

9.3 Islamic Banks and Economic Development

In the process of transforming savings into investments, Islamic financial institutions are different from conventional lenders insofar as they must take into account social and developmental factors. In that respect, Islamic banks are expected to play the role once played by state banks and development agencies. Those functions, as described by the *Handbook of Islamic Banking*, can be summarized[27] as follows:

– Broad social-economic benefits: investment policies must reflect the needs and the aspirations of the majority of the population, which must be included in the development process. Banks must favour projects in the food, housing, and health services sectors, in order to ensure their adequate supply and affordability.

– Job creation and focus on promising economic sectors: the emphasis should be on value-added sectors, as well as those sectors favoured by national plans and objectives. Such sectors include agriculture, industry, and technology-intensive activities because of their potential for job creation, improvement of the balance of payments, and the promotion of technology and education.

– The promotion and stimulation of entrepreneurship: through profit-and-loss sharing (PLS) mechanisms such as mudaraba and musharaka, banks must give priority to small enterprises. Financing must be specific to each firm's economic and financial conditions. Banks must provide technical advice in order to improve the process of production. After a venture becomes self-sustaining, the bank should sell its share to the entrepreneur or other beneficiaries, in order to free up funds that can be used to finance new ventures.

– The promotion of social justice and equality and the alleviation of poverty, through the establishment of a zakat fund, for the collection

and distribution of funds to the poor, and the provision of interest-free loans (qard hasan) to deserving individuals.

– The regional distribution of investments must follow two sometimes contradictory principles: the promotion of regional balance, i.e., channelling money to under-invested areas thus forestalling the need to migrate to more prosperous areas, along with the principle of investing savings mostly in the area where they have been mobilized, thus ensuring that people benefit from their savings.

Those ideals reflected the mood and values of the period of the first aggiornamento. For one thing, state planning and top-down industrialization were still the norm. There was also a heady sense of solidarity and new beginnings, mixed with populism. For example, Islamic banks were not allowed to take part in the production and marketing of luxury activities (israf wa taraf), at least not until the basic needs of society were met.[28] Islamic finance was perceived as the key to economic development, providing long-term funding to businesses that would otherwise have no access to finance. More generally, it was supposed to bring about balanced economic development, social justice, and an equitable distribution of income and wealth.

Undoubtedly, the gap between promise and performance was greatest in the area of economic development. Despite the support and special privileges (such as guarantees against nationalization) obtained by Islamic banks, they behaved like risk-averse agents. The early goal of concentrating on profit-and-loss sharing was soon abandoned. The objective of penetrating the hinterland and serving rural areas was not fulfilled.

Most evidence highlights the tendency of Islamic banks to invest in short-term commercial transactions as opposed to industry or agriculture. In Sudan, an agricultural country, only about 4 per cent of the investments were allocated to agriculture while 90 per cent went to import–export operations.[29] In Egypt, statistics compiled between 1979 and 1991 compared Islamic banks unfavourably with conventional banks on matters of productive and domestic investment. Not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it in foreign currency.[30]

9.4 Islamic Capital Markets

Islamic finance, with its long-term, equity-based orientation, was supposed to be an acceptable substitute for capital and stock markets. But as we saw, banks have been reluctant to finance mudaraba and musharaka operations. There is thus a renewed interest in creating and nurturing national financial markets – all the more so since capital and equity market, usually considered the most efficient means of financial intermediation, are

almost a prerequisite to participation in the global economy. A number of factors are driving the trend towards the creation of national capital and equity markets: the new ideological consensus, pressures from international organizations, privatization and deregulation, the emergence of large institutional investors, etc.[31] Such markets present a number of advantages: they broaden the options of investors; they attract and encourage national saving as well as the repatriation of funds held abroad; they attract foreign investment; they provide much-needed liquidity; they encourage sound management and good corporate governance, etc.[32] At the same time, they present substantial risks. The Souk el-Manakh experience (the collapse of the informal Kuwaiti stock market in 1982) – whose financial fallout (estimated at $40 billion) is felt to this day in the Kuwaiti banking system – is still a vivid memory. Foreign investment is sorely needed, but fickle short-term capital that comes and leaves suddenly increases volatility and can have a destabilizing effect on the economy as a whole.

One of the main problems with capital markets is their potential for speculative excess, which poses economic and religious objections. From an economic standpoint, Keynes's line is worth repeating: 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation'.[33] Products designed to hedge and minimize risk can themselves become instruments of speculation. From a religious standpoint, markets raise issues of gharar as well as riba. Increasingly however, mainstream Islamic doctrine is reconciling itself to the idea of capital markets, even of certain types of speculative operations, provided that they do not amount to market manipulation. According to one specialist:

> Islam is not against speculation if it is made by genuine investors who have worked hard and analyzed the macro- and micro-economic and financial fundamentals, and therefore have the right to speculate once the environment at the stock exchange is conducive to do so. On the contrary, what Islam is against is insider trading and the role of rumours, whose main interests are to manipulate the market and force their counterparts (the genuine investors) to sell off their shares at lower prices.[34]

The dilemma of emerging markets is that while they lack the institutional experience and attendant financial culture that older financial centres have, they are expected to create, more or less instantly, a transparent and well-managed system that inspires confidence: a market with breadth and depth, with credible national players and regulators, and a state-of-the-art system for placing, processing and settling orders; and a market that cross-lists securities from other regional markets, and that is open to foreign investors. This in itself is a tall order. But even more than laws and institutions, markets require a culture, which cannot be legislated.

9.5 Macro-economic Policies

Banking has a direct impact on money supply – as every economic textbook explains, 'banks create money' – on government borrowing, and on most macro-economic aggregates. Three issues are of special importance: one is regulatory control – how Islamic institutions are regulated and whether they are given special status[35] – which is discussed in Chapter 10. The others are related to the use by governments of the 'interest-rate tool' to regulate the economy, and to the public debt.

The 'interest-rate weapon' is an essential tool of liquidity management, credit allocation, and, more broadly, macro-economic policy. By raising or lowering a variety of rates, regulators can directly influence the money supply. In an interest-free system, such a tool cannot in theory be used. Advocates of Islamic banking argue that other tools can be just as effective. Among such tools are the modification of reserve requirements for banks, the manipulating of budget surpluses or deficits, the imposition of new 'lending ratios' (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or 'refinance ratios' (which refer to the central bank refinancing of a part of the interest-free loans provided by the commercial banks).[36] The problem is that such solutions are mostly theoretical constructs, which vastly exaggerate the role of interest-free loans.

In reality however, no Islamic regulatory system has completely eliminated interest. When it comes to relations with the outside world, interest is still used. The three pioneers of full Islamicization – Pakistan, Iran and the Sudan – happen to be heavily indebted countries, whose foreign debt carries interest.

As for domestic borrowing, these countries have not been able to create sufficient Islamic financing instruments to cater for the financial needs of the public sector. A number of theoretical concepts – such as issuing bonds where interest would be replaced by a rate that would vary according to the economy's growth and inflation rate, or mudaraba schemes – have yet to be fully put into practice. One complication is that governments do not have the same criteria of profitability as the private sector, and social rates of return have yet to be operationalized in a way that can satisfy investors.

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10

REGULATORY ISSUES AND CHALLENGES: GLOBAL NORMS AND RELIGIOUS CONSTRAINTS

In the early years of modern Islamic banking, a number of ambitious Islamic regulatory schemes were devised. There was talk of an Islamic Central Bank, of a global zakat fund, and of other collaborative schemes.[1] Scholars worked on an Islamic approach to bank regulation.[2] Most of these ideas were never put into practice: they were simply overtaken by events. Today, regulators have lost the margin of manoeuvre they once enjoyed. Most of the norms and practices of financial regulation are established internationally, with little input from regulators outside the industrial world. Although Islamic banks have thrived in the global economy, their compliance with many of the new norms is problematic. This chapter examines the regulatory issues and challenges facing Islamic finance.

10.1 Financial Regulation

Financial regulators must perform a number of tasks: ensuring that the financial sector is safe and sound; mobilizing savings by channelling them towards the most productive uses; and devising an efficient conduit for payments around the economy. Before the disruptions of the 1970s, regulators performed a mostly technical task outside of the political limelight. In recent years however, virtually every country – including those with well-established regulatory authorities and traditions – has been rocked by banking crises. Significant regulatory failures have occurred in the US (the Savings and Loans and bank failures of the 1980s), Britain (the BCCI scandal, the Barings collapse), and France (the Credit Lyonnais fiasco), to name just a few countries.[3] Emerging markets – the category to which most Islamic countries belong – are even more vulnerable, since they often lack a regulatory framework and tradition, and suffer from a wide array of structural problems. Typically, they are overbanked and in need of consolidation. Many are plagued with a bad loan overhang, and suffer – to an even greater extent than industrial countries – from the 'crony capitalism' syndrome, whereby cosy ties between politicians and bankers prevent effective compliance, let alone reform.[4] Whenever banking crises occur, their impact can be devastating. According to the statistics of

the Bank for International Settlements (BIS), the cost of supporting, recapitalizing or restructuring banks in emerging markets has cost $200 billion between 1982 and 1997.

Once confined to developed countries, the new rules of global finance are now extending to the rest of the world. Four broad sets of factors account for this evolution: the spread of the liberal ideology, the integration of emerging countries in the global economy, the growing involvement of international financial institutions in emerging markets, and the proliferation of currency and banking crises. National and developmental goals were once central to financial policy. But the developmental orthodoxy has changed in line with the 'Washington consensus' which favours free-market solutions, export orientation, fiscal discipline and, most recently, the overhaul of existing financial systems. Indeed, financial turmoil, most recently in Asia, has accelerated the push for bank reform. The IMF and the World Bank have determined that their programmes were undermined by troubled financial sectors; and international banks (as well as pension funds and mutual funds), given their increased exposure to emerging markets, have a lot more at stake than they did a few years ago. New norms are now expected promptly to be adopted by all countries. By October 1998, regulators worldwide were committed to the implementation of the 'Core Principles for Effective Banking Supervision' issued in 1997 by the Basle Committee. Similarly, as of March 1999, the 102 signatories of the December 1997 Free Trade in Financial Services Agreement (under the aegis of the World Trade Organization) were expected to liberalize their markets.

10.2 The Ideological Debates on Financial Regulation

Regulation is a balancing act. Different, often contradictory, goals – flexibility and consistency, freedom and strict controls, innovation and crisis-avoidance, consolidation and conflicts of interest, efficiency and consumer protection, openness and protection of national firms – must be applied in proper dosages by people familiar with the political and cultural environment. The audit systems and incentive structures must be flexible yet strict enough to allow innovation but prevent rogue operations. In case of fraud or heavy losses, the temptation is great to adopt a policy of 'regulatory forbearance' – bending the rules to avoid closing insolvent banks – as a way of preventing panic. But this often leads to distrust and simply postpones the day of reckoning. Yet overreacting can create a credit crunch. Other dilemmas are related to the need to ensure fair competition. The logic of economic freedom in a global economy tends to lead to bigness and thus unfair competition among firms of vastly different sizes. In addition, as firms are allowed to enter new lines of business, the potential exists for conflicts of interest detrimental to the interests of

consumers and investors. For example, as financial institutions get involved in the financial advisory business, the need to sell their products compromises their commitment to impartial advice. Yet building fire-walls between advisory activities and sales goes against the spirit of deregulation.

Such dilemmas are amplified by the transformations of global finance. Once clearly defined, financial functions are now blurred. Different types of finance – commercial banking, investment banking, securities, insurance – call for different forms of regulation. Yet the same financial institution can be a lender, an investor, a guarantor, a portfolio manager, etc. Balance sheets have changed beyond recognition. (Complicating matters further, many transactions do not even appear on balance sheets at all.)[5] In addition, traditional bank products such as loans are being securitized, creating more headaches for regulators who must decide what is a bank, and what types of products need what type of controls. Insofar as financial institutions engage in a wide array of activities, regulators must resolve a number of issues. Should there be functional regulation whereby a financial institution would deal with different regulators for its commercial, investment banking or insurance activities? Or should a financial institution have a single regulator which would oversee diverse functions? In one instance the financial institution would have to comply with complex and perhaps contradictory rules and be entangled in turf battles fought among regulators. In the other, the regulator may lack the expertise to oversee a wide array of activities and may risk being 'captured' by the firms it regulates.

Debates on financial regulation, in addition to being influenced by historical traditions and regulatory cultures, tend to go through cycles and are ideologically loaded. In the wake of financial failures, regulatory authorities are likely to tighten the rules, only to relax them when the memory of such failures fades. Partisans of laissez-faire argue in favour of minimal supervision, claiming that strict supervision does more harm than good and that the 'private provision of bank regulation through the marketplace' is far preferable to intrusive government regulation. The theory is that 'the market' through its proxies – analysts, rating agencies, the business press, etc. – evaluates financial institutions at all times, thus imposing its own discipline on participants. Such an approach also takes a benign view of bank failures, which are seen as a cost of doing business, rather than a cause for panic – or a pretext to tighten regulation. Simply put, the ideological issue can be reduced to a trade-off: laissez-faire fosters financial innovation, but also encourages fraud and abuse; conversely, strict regulation can help prevent problems but stifles innovation and dynamism.

In sum, regulators must thus be strict yet flexible, collegial but not too cosy. The problem is that while lip service is often paid to the principle of independence, regulators not beholden either to politicians or to the

industry they regulate are more an ideal than a reality. In most countries, bankers tend to be prominent figures, often involved in politics, or at the very least generous to politicians. Recent scandals suggest the many ways in which regulators can be influenced. In the case of the American Savings and Loans scandals, dubbed by Martin Mayer 'the worst public scandal in American history', money paid by operators to politicians (in the form of campaign contributions or sweetheart loans) led to bad laws and lax regulation: insolvent institutions were kept in business, fraud and abuse ran rampant, etc. (The bail-out initiated in 1989 will end up costing American taxpayers anywhere between $200 billion and $500 billion.)[6]

An additional problem of regulation is one of resources. The knowledge and skills necessary to be a competent regulator in today's complex, uncertain and constantly changing environment are such that governments can seldom afford the best possible regulators. The private sector in contrast can afford those lawyers, strategists and product innovators who are in a position to keep the industry one step ahead of the regulators.

In Islamic countries, the complications arising from international pressure are compounded by the added – and often conflicting – demands of religion. Religion is a touchy subject, and has on occasion been used as a cover for fraudulent activities. Independence and integrity are all the more important since regulatory issues are even more likely than in a conventional setting to degenerate into major political crises. Furthermore, despite similarities with conventional ones, Islamic products and practices do not fit neatly into existing legal, regulatory and accounting systems. In addition to establishing standard prudential rules (concerning capital and reserve requirements, capital/assets and other ratios), Islamic banking regulators have to devise rules to govern such issues as new finance methods, conditions of ownership of Islamic institutions (minimum capital, maximum individual ownership, etc.), fiscal status of income, and the like. In sum, they must operate under the watchful eyes of 'markets' and religious authorities, while complying with international practices and standards.

10.3 The Changing Paradigm of Financial Regulation: From National Control to Global Supervision

In 1944, John Maynard Keynes, who was then actively involved in shaping the post-war financial order, stated: 'We intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money.'[7] In the system of 'embedded liberalism' that prevailed for much of the post-World War II era, governments were committed to a liberal economic order, but reserved the right to control capital movements.[8]

Under such a system, the regulation of financial institutions was characterized by strict controls, clearly defined boundaries, and limits on foreign participation in the national market. Cartel-like arrangements within sectors prevailed, as well as stable relationships between borrowers and lenders. Financial markets were divided into distinct and clearly defined segments: commercial banks, investment banks, securities firms, insurance companies, etc. Interest rates were 'administered' as opposed to being left to market forces, and most financial operations were tightly regulated. Except for the United States and the United Kingdom, public ownership of banks (by federal or local governments) was common, allowing governments to channel credit to favoured sectors of the economy.[9] Even when banks belonged to the private sector, the logic was not fundamentally different, since government–bank relations were defined by a quid pro quo: managers gave away some autonomy in exchange for protection from outsiders. To be sure, a measure of openness was allowed in many countries, but this did not prevent national firms from remaining somewhat insulated from foreign competition since the occasional authorization given to a foreign firm to operate in the domestic market was designed not to upset existing cartels.

A chain of events, starting with the birth of 'euromarkets', led to a gradual internationalization of financial markets.[10] Change has greatly accelerated in recent years, resulting in a global financial market – which in turn calls for a global regulatory regime.[11] 'Harmonization' of norms is necessary, at a time when capital can move freely, to prevent 'regulatory arbitrage' (the switch by investors and financial institutions to lower-cost regulators). Also, there is a need to create a global 'level-playing field', so that investors and financial institutions from certain countries do not benefit from unfair advantages. Hence the need to agree on common standards and close 'loopholes' such as those provided by offshore financial centres.[12] Another rationale for consolidated global regulation is the fear of contagion. As financial systems are increasingly interconnected,[13] the possibility of problems spreading across the globe are ever-present, raising the spectre of systemic risk – a wholesale collapse of the world's financial system.

The need to contain crises and ensure the integrity of the global system (based on the underlying view that markets should operate fairly and safely in order to encourage the widest possible confidence in them, thereby promoting high levels of savings and investment) explains why, since 1995, financial regulation has taken centre stage in the annual summits of the Group of Seven (G7) heads of government. A succession of financial crises affecting firms – BCCI, Daiwa Bank, Sumitomo, Barings, etc. – or countries – Mexico, Thailand, Indonesia, Korea, Russia, etc. – has lent greater urgency to regulatory cooperation. With each crisis the new orthodoxy has been refined and the reach of global regulators expanded.

The most recent changes in global financial regulation were accelerated by the Asian financial crisis. Until July 1997, the 'tiger economies' of Southeast Asia were held out as models of well-run economies. Reports by the International Monetary Fund and the World Bank praised their macroeconomic management and predicted continuing growth and success. Rating agencies were still awarding high ratings to their debts. The successive crises that spread in domino fashion, starting in Thailand, caught the world by surprise.[14] Since the 'fundamentals' of these economies were sound, a frantic search for new culprits ensued. A new consensus soon emerged, helped in no small part by the steady deterioration of the Japanese banking system: the financial systems of these countries were to blame. Rescues of Thailand, Indonesia and South Korea by the International Monetary Fund (IMF) were directly linked to the transformation of these countries' financial systems, which came to epitomize 'crony capitalism'. Regulators from the developing world, including Islamic countries, now must be trained and counselled on an on-going basis by more experienced regulators. They have little choice, since the acceptance of new norms is the sine qua non to being allowed to expand abroad, or to have access to international financial markets.

10.4 The Making and Enforcement of the New Global Norms

An overlapping network of governments (directly and through the G7 and G10),[15] private corporations (including most large financial banks, securities companies and insurance companies), and international organizations (the World Bank, the International Monetary Fund [IMF], the Organization of Economic Cooperation and Development [OECD], the World Trade Organization [WTO], etc.) has played a key role in promoting global financial standards.[16] This section focuses on two little-known organizations, the Group of Thirty, a private think-tank, and the Bank for International Settlements (BIS), 'the central bank of central banks', both of which were instrumental in shaping the new norms of financial regulation.

The Group of Thirty, established in 1978, describes itself as 'a private, independent, nonpartisan, nonprofit body' whose aims are 'to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and to policymakers'. It is 'supported by contributions from private sources: foundations, banks, non-bank corporations, central banks, and individuals'. In reality it is dominated by the large financial conglomerates, and its role could best be described as that of a consensus-making body on matters of global finance. Through its papers, conferences and symposia, study groups and specialized committees, the Group of Thirty has in recent years