Literature Review

ISLAMIC FINANCE: ETHICS, CONCEPTS, PRACTICE

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CFA Institute Research Foundation

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Islamic Finance: Ethics, Concepts, Practice

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Islamic finance, widely regarded as one of the fastest-growing segments of global finance, is the subject of many debates. Should religion have anything to do with finance? Can guidance on economics and finance be derived from Islam? What exactly is meant by the prohibition of *riba* in Islam? Is equity financing superior to debt financing for long-term economic prosperity? Is the Islamic financial sector "Islamic" only in form, not in substance? Can there be such a thing as an Islamic commercial bank operating within the prevalent monetary and banking system? Will following the legal minimum of Islamic commercial jurisprudence by commercial financial institutions lead to fulfillment of the higher objectives of Islam? These are but a sample of the larger debates regarding Islamic finance.

Such debates in Islamic finance invite many opinions. However, it is a matter of fact rather than opinion that Islamic finance is the most prominent faith-based finance in the world today. One way to describe it is "finance that is consistent with Islamic teachings." Specifically, Islamic finance must avoid "sin" (i.e., prohibited) businesses; it must also abide by the Islamic prohibitions of *riba* and excessive *gharar*, which are generally understood to include lending and borrowing of money at interest and sale of risk.[1] Consider a simple example: Islamic finance is not to be used to finance a brewery because the underlying activity—consumption of alcohol—is prohibited by Islam. Similarly, the money cannot be used for lending money at interest (as is the case in a conventional bond) or sale of risk (as in conventional derivatives and proprietary insurance) because of the prohibitions of *riba* and excessive *gharar*. An idea strongly

[1]We are of the view that translating the Arabic terms *riba* and *gharar* tends to cause more confusion than clarity. Therefore, throughout this review, we do not use any English translation of these terms.

associated with Islamic finance is that financiers and those being financed need to assume risk associated with business outcomes or ownership of an asset. Where risk is to be managed through insurance, it should be done through a mutual risk-sharing arrangement. Since the 2007–08 global financial crisis, often blamed on the bloated size and excesses of the financial sector, Islamic finance is seen as a curious form of finance that seems to be saying the kinds of things many want to hear from the financial sector—emphasizing ethics and making finance a servant (not the master) of the real economy where goods and services and produced.

What started out as relatively abstract literature on Islamic economics in the 1940s has become a rapidly growing body of knowledge in Islamic finance. This review seeks to cover the major themes of this literature. We cover materials written in English or for which English translations are readily available. Most of these materials have been published since the year 2000, when the industry and its literature experienced substantial growth and ideas in Islamic financial practice have become more specific.

We provide an overview of the available literature, a description of the existing state of knowledge, major themes and sub-themes associated with the topic, and a list of suggested readings. For the reader's convenience, this review does not assume any prior knowledge of Islamic finance. Some further clarifications are in order. A significant part of the literature on Islamic finance is legalistic—for example, discussing why something (e.g., futures and options) is prohibited or permissible in Islamic commercial jurisprudence. In the interest of the nonspecialist reader who is unlikely to be interested in the technicalities of Islamic commercial jurisprudence, we have included such material only to the extent necessary. Islamic finance sprang from Islamic economic thought, which is itself a wide body of knowledge. We cover only those elements of Islamic economics that are essential for understanding Islamic finance. We have divided the material into multiple sections and added highlights to the beginning of each section. Readers can thus select and read the sections that appeal to them the most.

Some topics in the literature have been written about extensively (e.g., the prohibition of *riba*); others have received far less attention (e.g., ecology as it relates to Islamic finance). If a topic is addressed sufficiently by a few titles, we limited the number of works included in the discussion and the list of suggested readings. For the ease of readers, we have also added a brief glossary of the Arabic terms used in this review.

This literature review

- introduces the subject and outlines the context to the literature,

- discusses Islamic economic thought and highlights its pertinence for Islamic finance,
- explains the major elements of Islamic law and prohibitions concerning Islamic finance,
- addresses the use of "nominate" contracts and promises in structuring Islamic finance products,
- touches on regulatory issues,
- spells out governance and social responsibility,
- discusses the political economy in which Islamic finance operates,
- elaborates on the "form versus substance" debate, and
- summarizes the findings of some of the empirical studies while offering concluding thoughts.

We have tried to make this literature review comprehensive and objective. We hope that it provides a simple and clear explanation of the concepts and debates in Islamic finance.

Introduction

This section will provide the background for the remaining sections. We supply a brief history of the industry and statistics about its size, composition, and growth.

Highlights of this section are as follows:

- The ideas associated with Islamic finance have wide appeal and are not necessarily exclusive to Islam.
- Unlike Islam, which dates back to the 7th century, modern Islamic finance practice is a 20th-century phenomenon.
- Modern Islamic finance is a small but growing industry; it consists largely of commercial banking; most of its assets are concentrated in a few countries, but it does have presence in many countries around the world.

Inclusive Field with Shared Ideals

Islamic finance is an inclusive field; its ideals are not unique to Islam, nor is its practice confined to Muslims. Just as monotheism is not exclusive to Islam, the ideas underlying "Islamic finance" and "Islamic economics"—including the prohibition of *riba* and the pursuit of economic justice—are not necessarily exclusive to Islam. Similar dos and don'ts are found in other religions, including the other two Abrahamic faiths, Judaism and Christianity, that predate Islam. The practice of Islamic finance is also not exclusive to Muslims. Non-Muslims are also participating in Islamic finance in different capacities, including as entrepreneurs, business partners, professionals, investors, customers, and thought leaders.

In fact, such ideas may also be shared by those who may or may not subscribe to any religion. It is not only Islamic economists, but also prominent mainstream scholars, such as Amartya Sen, Joseph Stiglitz, and Douglass North, who have challenged commonly accepted assumptions of neoclassical economics, the notions of utilitarian rationality, and perfectly competitive markets. Prior to *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Adam Smith—considered the founding father of modern economics—published *The Theory of Moral Sentiments* (1759), which regarded morality as natural, intrinsic, and built into us as social beings. Long before, Greek philosopher Aristotle described money as barren and lending money at interest unnatural.

Interest-free banking is not a subject alien to conventional economic thinking. Khan (1986) referred to the similarities in Islamic economic thought and some of the ideas expressed by such economists as Fisher (1945), Simons (1948), and Friedman (1969). Lately, the idea of limited-purpose banking developed by Kotlikoff (2010) has elicited interest in Islamic finance circles. A number of its features, like that of Fisher's "narrow banking," are aligned with strands of Islamic economic thought.

Islamic finance emphasizes risk sharing, but risk sharing is not unique to Islamic finance. Mutual insurance companies, such as Royal London, were created without any reference to Islam and before the arrival of modern Islamic finance. Similarly, some initiatives to move away from interest-based banking have been undertaken without any reference to Islamic finance. For instance, JAK Members Bank, a small cooperative bank in Sweden that aspires to a just economy, says the following, "We regard receiving money in exchange for labour and for risk-taking as legitimate; however we do not consider it legitimate to earn money simply with money."[2]

Criticisms of excessive debt and credit creation in Islamic finance literature are similar to those in the literature on mainstream finance. Equity financing—the preferred mode of financing in Islamic finance theory—is practiced across the world without any reference to Islam.

Perhaps a differentiating aspect of Islamic finance is that its ideas are derived from or inspired by Islam. In the wake of the bad press that Islam has received in international news media and the industry's inclusive nature, it is a matter of continuing debate in Islamic finance practice whether it should be marketed by another name, such as "ethical finance."[3]

Diverse Views

Islamic finance attracts diverse, if not opposing, views. For instance, two fundamental issues in the Islamic finance literature are (1) whether Islamic finance is indeed Islamic and (2) whether it adds economic value. Debates on these issues can be found in publications, conferences, and social media.

On the one hand, Mahmoud El-Gamal (2005), an academic based in the United States, dismisses the industry as "rent-seeking Shari'a arbitrage." Tarek El Diwany, a writer and consultant based in the United Kingdom, has likened Islamic commercial banking to the oxymoron "Islamic alcohol."[4] Others, such as Timur Kuran, an academic based in the United States, see Islamic finance

[2]See https://www.jak.se/content/interest-free#.VJCAjdLF_zI.
[3]See, for instance, www.slideshare.net/ThomsonReutersIFG/focus-session-3-summary.
[4]See the transcript of an interview with Tarek El Diwany at www.islamic-finance.com/revue_interview_4.htm.

as "deceit."[5] On the other hand, some Shari'a scholars[6] and bankers continue to declare it to be Islamic and economically competitive with, if not superior to, conventional finance. Hussain Hamed Hassan, a Shari'a scholar working in the industry, has argued that Islamic finance offers a solution to the recurring global financial crises.[7] Iqbal Khan, the founding CEO of HSBC Amanah, believes that Islamic finance "has the ability to unify and stabilize our communities and economies."[8] Joseph DiVanna (2006), a business consultant and writer, presents Islamic banking as offering a "value proposition that transcends cultures."

Within this spectrum of harsh criticism and strong praises, there are other views, held by both Muslims and non-Muslims, on the Islamic authenticity and socioeconomic value addition of Islamic finance. In this literature review, we have tried to capture this diversity of views.

Common Misconceptions

A host of misconceptions are associated with Islamic finance. These include the following:

- Muslims and Islamic finance are monoliths that conform to generalizations.
- Modern Islamic finance is a relatively old and mature industry.
- Muslims, in general, understand the theory and practice of Islamic finance and follow it in their financial lives.
- Islamic finance enjoys active government support in most Muslim-majority countries.
- Assets of Islamic finance tend to be greater than those of conventional finance in most Muslim-majority countries.
- Shari'a is the governing law in all countries with a Muslim majority, and Islamic finance transactions are governed only by Shari'a.
- Islamic finance is not open to non-Muslims.
- Islamic finance is mainly about charitable rather than commercial activities.

[5]Quoted in Barnes (2013).
[6]The term "Shari'a scholar," a translation of the Arabic *alim* (singular of *ulama*), is widely used in the Islamic finance industry to refer to experts in Islamic jurisprudence, in general, and in Islamic commercial jurisprudence, in particular.
[7]See the video recording titled "Islamic Economics—The Solution for World Financial Crisis" of a speech made by Hassan, reportedly made at Dubai International Peace Convention (2010): www.youtube.com/watch?v=Qh3me1gKQkA.
[8]Iqbal Khan, Royal Award for Islamic Finance Acceptance Speech: www.fajrcapital.com/iqbal-royal-award-speech.

- Islamic finance involves illegal activities, such as money laundering and even the financing of terrorism.
- The prohibited *riba* is the same as interest.
- Islamic finance is recession proof and immune from unethical practices.
- The Islamic finance industry is widely believed to be Islamic in form and in substance.

We hope this review will clarify these misconceptions.

Origins

Seeking guidance from Islamic teachings on economic decisions dates back to the time of Prophet Mohammad (who died in 632 CE) and is a tradition that is more than 14 centuries old. Financial decision making continued to be influenced by Islamic teachings without necessarily being referred to as "Islamic economics" or "Islamic finance" until the 20th century (i.e., more than a millennium stands between the origin of Islam in Saudi Arabia and the beginning of modern Islamic finance). The new references appear largely after the rise of modern interest-based banking and the independence of Muslim-majority countries from foreign rule following World War II. Because Islam tends not to distinguish between the temporal and the religious, there is a perennial desire among Muslims to live all aspects of their lives, including the financial, in a manner consistent with their faith.

Although some academic writings in Islamic economics and finance existed before the 1940s, the pioneering works are often traced to 1940–1950.[9] When modern banking and insurance were evolving, parallel developments in finance did not take place in the Muslim world, which is partially attributed to the colonization of many Muslim societies. In other words, although Islam is more than 1,400 years old, the literature on Islamic economics is generally less than 100 years old and the practice of Islamic finance is less than 50 years old. It is important to bear in mind that instead of growing organically over centuries, the theory and practice of Islamic finance have had to hurriedly catch up with

[9]In the introduction to their book *Islamic Finance in Western Higher Education*, Belouafi, Belabes, and Trullols (2012) note, "In the late 1920s, Sheikh Ibrahim Abu Al-Yaqdhan, a North African reformist, called for the creation of a bank based on the rules of Islamic jurisprudence and managed with modern banking tools. His call was swiftly smothered by the French authorities ruling North Africa at that time" (p. 5). Bala and Zaha (2009) write, "For instance, the institution Anjuman Mowodul Ikhwan of Hyderabad, India, made interest-free loans to Muslims as early as the 1890s. Another institution in Hyderabad, the Anjuman Imdad-e-Bahmi Qardh Bila Sud, was established in 1923 by employees of the Department of Land Development" (p. 3). Application of Google Ngram Viewer, a phrase-usage graphing tool that charts the yearly count of letter combinations or words and phrases found in books digitized by Google, did not find the term "Islamic finance" before the 1940s, but the term reached historical highs in the 2000s.

conventional finance over a few decades, which, unsurprisingly, has been a difficult process. The path of Islamic finance has been even more difficult because of the well-entrenched conventional financial system and a legal system that was transplanted in Muslim societies in the colonial era. Modern Islamic finance is thus often torn between (a) complying with Islamic commercial jurisprudence and the law of the land, which may not be in harmony, and (b) offering risk-sharing modes of financing with positive social impact in a financial landscape where interest-based monetary lending with little, if any, concern for social impact dominate.

Some of the earliest proponents of Islamic economics were such scholars as Abul Ala Mawdudi (1903–1979) from the Indian subcontinent, Sayyid Qutb (1906–1966) from Egypt, and Muhammad Baqir Al-Sadr (1931–1980) from Iraq. Early treatises in the field accorded a central role to Islamic morality, which is derived from classical Islamic sources and underpins the behavioral foundations of individual economic agents. One of the earliest works is considered to be *Islam and the Theory of Interest* (1946) by Anwar Iqbal Qureshi. More such works were published following the birth of the Islamic Republic of Pakistan in 1947 after nearly two centuries of British rule on the Indian subcontinent. Mohammad Ali Jinnah (died 1948), the founder of Pakistan and a Western-trained lawyer, spoke in favor of Islamic principles of banking and finance at the inauguration ceremony of the central bank of Pakistan in 1948.

In practice, Lembaga Tabung Haji in Malaysia and the Mit Ghamr project catering to rural farmers in Egypt in the 1960s, both social and developmental in nature, are widely regarded as some of the earliest initiatives in Islamic finance. Dubai Islamic Bank, which was established in 1975 in Dubai, was the first Islamic commercial bank. The multilateral development finance institution Islamic Development Bank in Saudi Arabia also began activities in 1975, and the first Islamic insurance company, the Islamic Insurance Company, was founded in 1979 in Sudan.

The modern Islamic finance industry has gained most of its size and prominence since 1990. The first Islamic equity index, the Dow Jones Islamic Market Index, was launched in 1999. The first corporate *sukuk* (or Islamic investment certificate, also known as an Islamic bond) was issued by Shell MDS in Malaysia in 1990, and the first sovereign *sukuk* was issued by the Central Bank of Bahrain in 2001. The recency of these developments explains why many consider Islamic finance a young and evolving field.

Size and Composition

Various industry reports come up with different estimates of the size of the industry. A number of reports put global Islamic financial assets at about US$1.5 trillion as of 2013. In comparison, the assets on the balance sheets of each of the largest conventional banks in the world are well in excess of US$2 trillion (i.e., depending on how the industry is measured, the global Islamic finance industry as a whole is smaller than a single conventional bank).

Caution must be exercised with the data on the size, distribution, and growth of Islamic finance because of various challenges with measurement. For instance, Iran's banking assets are the largest source of Shari'a-compliant assets because Iran "claims that its financial institutions are 100% sharia compliant" (Timewell and DiVanna 2008, p. 2). Converting these assets from local currency to US dollars (as in the case of Iran) can have a material impact on the resulting numbers because of exchange rate movements.

Islamic finance includes banking, capital markets, and insurance in different countries of the world, but in terms of its assets, the industry largely consists of commercial banking in countries with Muslim-majority populations. Commercial banking is estimated to account for a clear majority of Islamic financial assets. For this reason, Islamic finance is sometimes also referred to as "Islamic banking." Nearly 70% of these assets are accounted for by three countries—Iran, Malaysia, and Saudi Arabia (UK Islamic Finance Secretariat 2013). A major segment in Islamic finance is *sukuk*. Accordingly to Vizcaino (2014), "Global [*sukuk*] issues hit an all-time high of $134.3 billion in 2012, before falling to $114.3 billion in 2013."

After commercial banking and *sukuk*, the relatively small segments of funds and *takaful* (mutual obligation, joint guarantee, or Islamic insurance) account for most of the remaining Islamic finance assets.

Many of the well-known names among Western financial institutions and professional service providers participate in the Islamic finance industry. Conventional financial institutions are allowed to operate an Islamic finance "window" or an Islamic finance subsidiary. According to ICD and Thomson Reuters (2013), there were 249 stand-alone Islamic banks and 114 Islamic banking windows of conventional banks as of 2013.

Because of restrictions pertaining to Islamic commercial jurisprudence, Islamic financial institutions cannot operate a conventional window. Similarly, although companies that might not pass through exclusionary screening used by Islamic equity funds can issue *sukuk*, Islamic institutions cannot issue conventional debt securities.

Some conventional banks have converted to full-fledged Islamic banks, such as Kuwait International Bank (formerly, Kuwait Real Estate Bank) and Sharjah Islamic Bank (formerly, National Bank of Sharjah). Islamic windows within conventional banks have been used as a takeoff platform for development of the Islamic finance industry in countries in Southeast Asia and the West. Commonly, Middle Eastern countries establish stand-alone Islamic banks (Solé 2007).

One of the concerns with Islamic windows is that full segregation of funds between the conventional and Islamic sides is difficult to achieve. Actions by the central bank of Qatar in 2011 required closing the windows of conventional banks ("S&P: Qatar's Islamic Banks on Fast Track to Growth" 2013). The commitment to windows for Islamic finance is also considered suspect because these institutions can pull out of Islamic finance with relative ease. For instance, in 2012, the HSBC Amanah announced the closure of its operations in the United Kingdom, United Arab Emirates (UAE), Bahrain, Bangladesh, Singapore, and Mauritius (Jenkins and Hall 2012).

The market share of Islamic finance is significant in a number of Muslim-majority countries, but it is much smaller than that of conventional finance. The market share also varies widely among countries and by the data source. The UK Islamic Finance Secretariat (2013) estimated market shares of Islamic banking to be 23% in Malaysia, 35% in Saudi Arabia, 17% in the UAE, and 5% or less in Turkey, Egypt, and Indonesia.

The industry's development has benefited from standard-setting bodies—most prominently, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1990, and the Kuala Lumpur–based Islamic Financial Services Board (IFSB), inaugurated in 2002. Another important body for the industry is the Organisation of Islamic Cooperation's (OIC's) International Islamic Fiqh Academy. It was established in 1981 and is based in Jeddah, Saudi Arabia. It is composed of senior Shari'a scholars representing Muslim member countries, and it is considered the most prestigious forum of its nature. Note that the standards of the AAOIFI and IFSB are not legally binding unless the concerned jurisdiction or institution makes them so. Similarly, the resolutions of the International Islamic Fiqh Academy are nonbinding, but they are influential and are frequently referred to in the discussions on Islamic finance.

Growth and Potential

Hardly a week goes by in which the world's elite financial news media—such as Bloomberg, the *Financial Times*, or Reuters—do not carry a news item on Islamic finance. Much of the attention that Islamic finance receives is not a result of its current size but of its reported double-digit growth rate in assets and its perceived potential.

According to the UK Islamic Finance Secretariat (2013), the balance sheets of Shari'a-compliant banks grew "by a further 20% in 2012 to a record $1.3 trillion." According to a 2013 special report on Islamic finance in *The Banker*, a frequently cited resource for Islamic finance statistics, growth in Shari'a-complaint assets slowed to 8.67% in 2013, down from 20.7% in 2012, although the compound annual growth rate for 2006–2013 has been in double digits at 16.02%. According to the World Islamic Banking Competitiveness Report 2013–14 (EY 2013a), another significant industry report, Islamic banking assets in Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, and Turkey—key markets for Islamic banking—grew at 16.4% a year during 2008–2012, with forecast growth of 19.7% over 2013–2018. The report expects these markets to grow "significantly faster than rest of the Islamic finance world" (p. 9).

The rapid growth of Islamic finance is a major reason many observers see tremendous potential for the industry's future. The potential is also appreciated by policymakers in Western capitals and emerging markets where Muslims are in a minority. As Shanmugam and Zahari observe in *A Primer on Islamic Finance* (2009), "Four locations—Kuala Lumpur in Malaysia, Dubai, Bahrain, and London—have their sights set on being the global center for Islamic finance" (p. 92). In 2014, the United Kingdom, Hong Kong, and South Africa issued debut sovereign *sukuk* (or Islamic investment certificates), not so much to raise financing, but to make deeper inroads in the Islamic finance market.

The popular sentiment about the potential of Islamic finance is best summed up by this 2008 news report:

> No one can say for sure how many [Muslims] will seek out banking that complies with Islamic law, or even pay a premium for it. But even a small fraction of 1.3 billion is a market no one wants to ignore. (Eaves 2008)

Growth in Islamic finance is partly attributed to growth in the relatively affluent sections of the Muslim population. According to the Pew Research Center, in 2010, the Muslim population was 23.4% (1.6 billion) of the world's population and projected to increase to 26.4% (2.2 billion) by 2030 (Pew Research Center 2011). Growth of Islamic finance is also fueled by excess liquidity in the Gulf states—a consequence of the region's oil riches (Imam and Kpodar 2010). Oil price surges raise both the supply and demand for Islamic finance in these nations. The effects are varied, from establishing new institutions in Muslim-majority countries to structuring Shari'a-compliant deals in the West.

The growth of Islamic finance has also contributed to growth in learning and development activities in the field. A range of academic and professional offerings in education, training, and qualifications are available in various countries, including prestigious Western universities. A prominent example is the University of Durham in the United Kingdom. In 2013, the University of Cambridge started an Islamic finance executive education program. An estimated 742 institutions globally are involved in education and knowledge dissemination in Islamic finance. In numerical terms, Pakistan, Malaysia, the United Kingdom, the United States, and the UAE are the top providers in the field (Yurizk 2013).

In terms of sources of future growth for Islamic finance, an emerging area is financing of the *halal* (licit) food industry and the Muslim lifestyle. According to "The State of the Global Islamic Economy" (2013), "From a commercial perspective, the Islamic economy naturally encompasses all those sectors driven by the Muslim population's adherence to some form of faith-based activity that has market impact" (p. 4), including finance and banking, food, family-friendly travel, fashion and clothing, cosmetics and personal care, pharmaceuticals, media, and recreation. This report estimated that the global expenditure of Muslim consumers in the food and lifestyle sectors was US$1.62 trillion in 2012 and was expected to reach US$2.47 trillion by 2018. (This commercial interpretation of Islamic economy differs from Islamic economic thought, as we discuss next.)

The news reports about the industry continue to highlight its growth and potential. According to the *Economist*,[10] "Despite strong recent growth for Islamic financial products, there still is room for further expansion, both in relatively unbanked Muslim countries in the developing world and in the West."

[10]"Big Interest, No Interest," *Economist* (13 September 2014): www.economist.com/news/finance-and-economics/21617014-market-islamic-financial-products-growing-fast-big-interest-no-interest.

Islamic Economic Thought

Islamic economic thought (or Islamic economics) constitutes the building block for the theory and practice of Islamic finance. Given the focus of this review on Islamic finance, we do not aim to provide a comprehensive examination of Islamic economics. In this section, we present the Islamic worldview and frame Islamic economics within it. We also highlight ways in which Islamic economics connects with wider debates on capitalism and distributive justice.

Highlights of this section are as follows:

- The Islamic worldview places moral checks and balances on the economic behavior of believers, but ideas associated with the market economy and capitalism are not necessarily inconsistent with Islamic economic thought.
- Islamic economics places special emphasis on social justice. It has a strong preference for risk sharing, profit sharing, or equity-like modes of financing and views debt with suspicion. The salient instruments for redistribution are profit-sharing contracts,[11] *zakah* (a social welfare tax), *sadaqa* (charitable giving), *waqf* (charitable endowment), *qard hasan* (interest-free loans), and inheritance.
- Islamic economic thought largely remains ideals without practice, and economic decision makers in Muslim-majority countries have shown little interest in translating the Islamic economic vision into reality.

Islamic Worldview

Islam emphasizes a moral purpose for human existence. Even the seemingly mundane act of earning an honest living constitutes an active form of worship in Islam. The Qur'an regards man as the "vicegerent of God on earth" (2:30). The notion of vicegerency underscores the idea of trusteeship, in which the individual is regarded as the trustee for God's resources. These resources are to be deployed for the ultimate good of society. Taqi Usmani (2002), one of the most influential Shari'a scholars in contemporary Islamic finance, explains the importance of divine guidance by noting that "there are areas in which human reason cannot give proper guidance or, at least, is susceptible to errors" (p. 10) and God has provided guidance through His Prophets. Usmani ("Present

[11]Some of the contracts are based on profit and loss sharing between contracting parties, similar to partnerships; others are based on profit sharing but losses are to be borne by the party providing the capital, similar to investment management. Therefore, we use the term "profit-sharing" contracts to refer to both types of contracts.

Financial Crisis Causes and Remedies From Islamic Perspective") argues that "the worldly benefits of [Islam's] social, political, and economic principles are not restricted to Muslims; they are meant for the common good of humanity at large."

In a survey of the literature on Islamic economics, Zaman (2008) argues that "regarding humans as solely motivated by selfishness is repugnant to Islamic traditions for many reasons, and this creates substantial divergence between Islamic and Western views regarding economic affairs" (p. 17). The Qur'an subjects consumption to ethical constraints and accountability to God, discouraging waste by excess (7:31). Commenting on the dignity of work, prominent Shari'a scholar Yusuf Al-Qaradawi (1999) argues that the Prophet Mohammad taught his companions that "the whole of a human being's dignity is tied up with his work—any sort of work" (p. 135).

The preceding ideas offer only a flavor of the Islamic worldview, which informs Islamic economic thought and highlights the normative component of this literature. Conventional economics, in contrast, tends to claim that it is concerned with how things *are* rather than how they *should be*, and it does not "traffic in morality" (Levitt and Dubner 2006, p. 190). Although such claims about conventional economics being *positive* rather than *normative* are disputed by prominent writers, such as Michael Sandel (2012), they are still widely held. The theories of Islamic economics and finance, however, are clearly normative because Islamic ethics is embedded in them.

Islamic Economics

Islamic economics relies on the notion that Islam offers a moral ideal that can guide various aspects of an economic system—consumption, production, and distribution. It emerged as a body of ideas partly as an effort to assert Islamic identity in the economic sphere. Although some take the view that Islam, as a complete code of life, offers a distinct Islamic economic system, others seek to be guided and informed by Islamic teachings in the design of an economic system through human intellectual effort instead of trying to find a detailed economic or financial system in the primary sources of Islam.

The Qur'an offers few specific injunctions about economics, but Islamic teachings can guide individual behavior by shaping behavior, incentives, constraints, and choices. The sovereignty of God, responsibility toward society, and the promotion of social justice and equity figure prominently in the Islamic worldview. Islamic teachings discourage waste, excessive consumption, and unfair trade practices. Transactions are considered to be fair if they lead to neither an unearned gain nor an undeserved loss. By seeking to protect peoples' wealth, intellect, and posterity, the Islamic approach to development has important parallels with notions of sustainable development.

Presenting itself as distinct from capitalism and socialism, Islamic economics attempts to balance competing considerations. Individual freedoms are respected, but they are instrumental to and conditional on public welfare. The Islamic model is sympathetic to a market economy but is deeply concerned about negative social externalities. Individual self-interest, profit maximization, market competition, and personal freedoms are recognized as long as they are not in conflict with the broader welfare of the community.

In a similar spirit, although private ownership of property is permissible, this right to ownership of assets is not absolute. Under Islamic injunctions, God is the ultimate owner of all assets and mankind needs to exercise its right to ownership in the broader interests of society. At its heart, the Islamic approach to economics emphasizes a balance between competing considerations: wealth accumulation versus wealth distribution, private incentives versus public interest, the spiritual versus the material, the needs of the present generation versus the needs of future generations, and the "here" versus the "hereafter."

Critics note that Islamic economics consists mainly of a series of theoretical claims that often remain empirically unsubstantiated. Critics also note the absence of micro-foundations and doubt the internal consistency of some of the arguments in Islamic economics. Rather than being viewed as a comprehensive and systematic approach to economics, Islamic economics can be described as a set of ideas that define moral norms governing economic behavior. It merely sets out the Islamic ethics in economics, and by doing so, it builds a bridge with other ethical approaches. In fact, there are significant similarities between the moral economy of Islam and other ethical approaches. Khan (2013) argues that, despite lofty claims of developing Islamic economics as a distinct social science by the Islamic economists,

> most of what has emerged under the rubric of Islamic economics is a restatement of mainstream economics decorated with Islamic terminology or a collection of religious injunctions or a set of fond assertions which can be neither verified nor falsified. (p. xiii)

This is not an isolated view. Rosly (2005) has also opined that considering Islamic economics' excessive focus on *riba* and *zakah* (social welfare tax), it is not surprising that "Islamic economics is sometimes labeled as capitalism minus *riba,* plus [*zakah*]" (p. 3).

Another criticism relates to its emphasis on individual ethics and the neglect of political economy, which downplays the institutional requirements for creating an Islamic economy. Guidance on how moral cooperation will be sustained and Islamic norms enforced on a large, national scale is viewed as insufficient. The viability of an economic system does not depend simply on the beliefs and motivations of individuals but also on formal institutions that shape incentives and enforce moral ethics.

A related difficulty lies in translating basic moral precepts into enduring institutions and organizational forms. Reliance on old and well-established institutions—for example, *zakah*—produces limited institutional innovation.

Some of the basic tenets of Islamic economics are also amenable to multiple interpretations. For example, significant differences mark the coverage and collection of *zakah*, curtailment of property rights, and the extent of and need for state intervention.

Islam and Capitalism

Capitalism is associated with profit maximization, private property rights, competition, and reliance on markets. In principle, none of these are prohibited or discouraged in Islam, which is, indeed, a religion distinguished by its "pro-commerce" attitude. The economic order during the life and times of the Prophet Mohammad bore great resemblance to a market economy. But capitalism exists in many varieties. Even where markets are supposed to reign supreme, in some sectors, their scope and operation is limited by design or competition may be weak. One can argue that because of the significant share of spending by federal and state governments in the GDP of United States, it is a mixed economy as opposed to a market economy. In China, the state plays an active role in commercial enterprises, converting it into an economy often described as "state capitalism."

As Kahf (2004) argues, the objectives of Islamic economic thought—be they the satisfaction of basic human needs or improvement in the quality of economic life—are not exclusive to Islam. They resonate with the philosophical thought of socialism, communism, capitalism, and other "isms." What is different about Islamic economic thought, however, is the reliance on divine revelation as a source of knowledge and on its moral articulation.

The literature on Islamic finance tends to assume that Islamic prohibitions and ethics can lay the basis for the moral economy of Islam, a different economic order from what is produced by capitalism or socialism.

Economic Justice

Socioeconomic justice occupies a prominent place in the literature on Islamic economics and finance. It pertains to both distribution of economic wealth as well as opportunities. An important concern in this regard is the high degree of wealth concentration and limited access to financing opportunities. The modern banking system and capital markets tend to rely on lending that favors the resourceful, contributing to concentration of wealth and opportunity, with the associated inequality and social ills. Islamic finance, by contrast, insists on risk sharing in asset ownership and enterprises that is likely to distribute economic opportunity more widely and keep finance in the service of the real economy. Market-based risk-sharing modes of financing are important means of promoting economic justice in a financial system consistent with Islam. This is not to say that the preferred modes of Islamic financing, based on profit- and risk-sharing principles, cannot entail injustice. For instance, one party to a transaction may reserve for itself a profit share far beyond what is deemed reasonable. Also, profit-sharing ventures even in permissible businesses can cause grievous harm to society and the environment—for example, through water pollution. At the same time, interest-based financial transactions (e.g. conventional microcredit) can also advance economic opportunity. But the literature on Islamic finance is likely to see interest-based lending of money and trading of risk as *inherently* problematic—if not at the micro level in the short term, then for the overall economy in the long term.

Debt vs. Equity

Islamic economic thought prefers profit-sharing modes of financing in which the financier assumes some business risk. Although interest-bearing monetary loans are prohibited, debt resulting from credit sales and leases are deemed permissible. One reason is that, unlike the money lender, both a seller and a lessor (in an operating lease) assume the risk associated with ownership of an asset. The literature on Islamic economics repeatedly emphasizes the need for risk–reward sharing to ensure economic justice and financial stability.

Chapra (2009) clarifies this concept by noting that

> greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all the financial needs of individuals, firms, or governments cannot be made amenable to equity and [profit and loss sharing]. Debt is, therefore, indispensable, but should not be promoted for nonessential and wasteful consumption and unproductive speculation. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing. (p. 21)

Equity financing is different from traditional profit-sharing arrangements developed in Islamic commercial jurisprudence, such as partnerships (*musharaka*) and investment management (*mudaraba*).[12] Wilson (2012) highlights some of these differences. For example, Islamic partnerships are limited-time ventures, whereas a "company" is assumed to be a going concern.

[12]A *mudaraba* can be viewed as a special case of *musharaka*, where one partner provides all of the capital. In *musharaka*, partners bear loss in proportion to their investment, whereas in *mudaraba*, loss is borne by the partner providing the capital unless the manager is found to be negligent. For this reason, these arrangements are also referred to as profit-sharing contracts or profit-sharing and loss-bearing contracts rather than profit-and-loss-sharing contracts.

Traditional Islamic partnership lacks the limited liability that is a key feature of a modern company. Compared with partnerships where partners focus on profit, shareholders in companies focus more on capital gains. Having said that, profit sharing remains far removed from lending money at interest whether or not it is implemented through limited liability companies. In equity financing, no fixed positive return is contractually stipulated *ex ante*. Instead, the return depends on business performance, which is determined *ex post*.

Despite its emphasis on profit-sharing arrangements, the Islamic finance industry is mainly based on debt. This disjunction between the ideals and reality of Islamic finance is addressed in the form versus substance debate later.

Limited Liability

The concept of limited liability is not explicitly mentioned in the primary sources of Islamic jurisprudence. Because Islamic commercial jurisprudence relied on partnerships without limited liability, the idea of limited liability associated with corporations was imported into Muslim societies. Kuran (2010) argues, "Although certain institutions of early Islam prevented the emergence of the corporation from within Islamic civilization, once borrowed from abroad along with supporting institutions, it got absorbed into local legal systems and now faces no further resistance" (p. 50). Nevertheless, introduction of the concept of limited liability generated heated debates among Muslim jurists. The debate partly concerned whether limiting the liability is fair to the creditor.

Doubts continue to linger in academic circles about the permissibility of limited liability in Islam. However, in 1992, the Jeddah-based International Islamic Fiqh Academy ruled that "there is no objection in Shari'a to setting up a company whose liability is limited to its capital, because that is known to the company clientele and such awareness on their part precludes deception." (Islamic Development Bank 2000, p. 130). Limited liability is widely used in Islamic finance. For example, institutions offering Islamic financial services tend to be shareholder-owned companies with limited liability. Perhaps the doubts about limited liability pertain to how it facilitates use of interest-bearing debt and speculative activity, which could result in privatization of profits and socialization of losses, as witnessed during the global financial crisis of 2007–2008. Dwelling on "limited purpose banking," a proposed alternative financial system, Kotlikoff (2010) has argued in favor of unlimited liability for such entities that cannot work as mutual funds (e.g., hedge funds).

Redistribution of Wealth

The Qur'an cautions against a narrow circulation of wealth among the rich (59:7). Although legitimate acquisition of wealth is permissible, Islam discourages hoarding and accumulation of wealth for the love of money. Redistributive justice is a core feature of Islamic economic thought. It aims to strike a balance between private property rights and distributional concerns. In addition to risk-sharing contracts, some of the key instruments of wealth distribution in Islam are: *zakah* (social welfare tax), *sadaqa* (charitable giving), *waqf* (charitable trusts), *qard hasan* (interest-free loans), and inheritance. These welfare instruments, together with the promotion of risk-sharing contracts in Islamic finance, can enhance financial access (Mohieldin, Iqbal, Rostom, and Fu 2011). In the following subsections, we briefly describe these instruments.

Zakah. *Zakah* is a major redistributive instrument of Islam. It has been translated in various ways, including poor rate, tithe, alms tax, and legal alms. It is an annual tax on surplus income and wealth of Muslims and is equivalent to 2.5% of net worth in general. *Zakah* is of immense religious significance: It is stipulated in the Qur'an and is one of the five sacred pillars of Islam. The Qur'an frequently emphasizes paying *zakah* together with keeping up the prayer (such as 2:43). In fact, the interconnectedness of *zakah* with prayer is a defining characteristic of the Qur'an.

According to El-Ashker and Wilson (2006), *zakah* was operationally organized by Prophet Mohammad and politically enforced as a state right by the first caliph, Abu Bakr, who fought a war to collect the levy. The principal beneficiaries of *zakah* are the poor, though it can be extended others, such as the people who collect it (Qur'an 9:60). Substantively different from charity, *zakah* is a regular compulsory levy regarded as a right of the poor and an essential means of purification of wealth. *Zakah* can be administered individually or by the state. Practically, however, officially collected *zakah* is a relatively insignificant proportion of overall revenues in contemporary Muslim societies. The overall record of state-administered *zakah* has been mixed. Weak state capacity has meant that *zakah* administration shares some of the common ills of tax administration in developing countries: corruption, nepotism, and misuse of political influence. Owing to a lack of trust in the government, more *zakah* is believed to be routed through voluntary initiatives than the state.

Despite being a promising redistributive tool, few rigorous evaluations of the impact of *zakah* have been conducted, and debate exists on whether the coverage of *zakah* should be extended to include new forms of income and wealth (new activities and commodities) and whether it should be restricted mainly to a subsistence allowance or be put to wider use in income-generation activities (such as in financing business startups and public sector programs targeted at poor communities).

Zakah is generally considered as an individual responsibility, and whether it applies to Islamic financial institutions is a moot point. According to the Bahrain-based AAOIFI's Standard 9 concerning *zakah*, however, Islamic financial institutions are obliged to pay *zakah* (1) when the law requires an

Islamic financial institution to pay *zakah,* (2) when the financial institution is required by its articles of association to satisfy its *zakah* obligation, and/or (3) when the general assembly of shareholders of a financial institution has passed a resolution requiring the institution to do so.

Waqf. *Waqf*, loosely described as an Islamic charitable endowment, was a key innovation in the provision of social services in Islamic civilization. Kuran (2001) defines *waqf* as an "unincorporated trust established under Islamic law by a living man or woman for the provision of a designated social service in perpetuity. Its activities are financed by revenue-bearing assets that have been rendered forever inalienable" (p. 842). *Awqaf* (plural of *waqf*) were used to finance a diverse menu of public goods, ranging from hospitals, fountains, mosques, and orphanages to architectural monuments and public kitchens. They represent rare examples of permanently live organizations in early Muslim societies that acted as one of the earliest means of decentralized provision of public goods and services.

As an inseparable component of Muslim civilization, the role of *waqf* has also come under scrutiny. *Waqf* is sometimes viewed as a "static" instrument that prevents the reallocation of capital to more productive uses. This presumed deficiency stems from its intrinsic legal rigidity, which prevents departures from benefactors' deeds. *Waqf* is also criticized for lacking self-governance, which could have laid the foundations for a robust civil society. The *awqaf* are sometimes situated within the broader politics of property rights. There is evidence that, over time, religious endowments were sometimes used as convenient legal devices for protecting private property from state expropriation and for circumventing laws of inheritance.

A controversial variant of *waqf* is based on the asset-backed lending of cash. Departing from the *waqf*'s traditional dependence on property or real estate, the "cash *waqf*" endows cash as a movable asset. The cash *waqf* gained wide currency under the Ottomans, primarily owing to the financial needs of the state. Cash endowments also had high survival rates because original capital allocations were frequently replenished by ploughing back additional income generated from the investments (Cizakca 2004). The concept of *waqf* has found some application in *takaful* (Islamic insurance) and relevance in other areas, such as Islamic microfinance.

Sadaqa. Beyond *zakah*, Islam emphasizes generalized alms giving under the broad category of *sadaqa*. Unlike *zakah*, *sadaqa* is a voluntary charity that is best administered in a "private and unseen" manner. The term is also used as a catchall phrase for goods and money extended as charity to the poor. Charity in Islam is linked with purification and with the regenerative spirit of wealth circulation. Whereas *zakah* is meant to purify wealth, *sadaqa* is meant to purify the self. *Sadaqa* has found some application in Islamic finance. For instance, the charity Akhuwat in Pakistan collects *sadaqa* to extend interest-free microfinance, or *qard hasan*, which is discussed next.

Qard Hasan. By denying benefit to the lender, Islam turns monetary loans into charitable instruments. Perhaps owing to its charitable nature, *qard hasan* (an interest-free loan) is regarded by the Qur'an as a loan to God. This concept is different from debt created by commercial credit sales and leases. In either case, however, there is a strong expectation that the ensuing debt will be paid back within a designated time period unless the debtor is in straitened circumstances (see Qur'an 2:280 and 2:282). Similarly, according to the tradition of Prophet Mohammad, deferring payment of outstanding debts by the rich is injustice (Bensaid, Grine, Nor, and Yusoff 2013).

The practical treatment of *qard* in the Islamic finance industry is not without debate. Some banks treat their on-demand deposits as interest-free helpful loans (*qard hasan*) given by the client to the bank, and the bank thus guarantees the repayment. The Qur'an, however, encourages flexibility and generosity by the creditor in such loans, especially if the debtor is in difficulty (Farooq 2011). Furthermore, *qard hasan* is, in general, not deployed by Islamic banks on the asset side of the balance sheet, although the concept has inspired some pro-poor initiatives on a limited scale.

Inheritance. The compulsory inheritance provisions of Islam serve as another distributive function. Based on Qur'anic sources, these provisions constitute "one of the most detailed areas of Islamic law" (Sait and Lim 2006, p. 107). Under Islamic inheritance laws, only one-third of a person's total wealth may be bequeathed through a will; two-thirds must be passed on to legal heirs (after payments of debts and legacies)—that is, sons, daughters, and spouses. Moreover, the inheritance rules in Islam aim to preserve the extended family, not just the nuclear family. Thus, in the absence of direct descendants, fractional shares are specified for various "combinations of surviving relations" as legitimate heirs of the deceased's wealth.

Islamic inheritance law is noted for its inclusive and egalitarian character, but it is not without contention. Two aspects of the law are subject to debate: unequal rights for women (under Islamic law, women receive half the share of a man in a similar situation) and its role in fragmenting wealth and impeding capital development. First, some consider that the limits on the inheritance rights of women need to be viewed within a historical and social framework in which women had no inheritance rights to begin with. Some argue that women are compensated for this apparent "legal inequality" through maintenance grants from their husbands. Even the limited right to inheritance that Islam assigns is difficult to enforce in societies where social norms take precedence over law. Women may be disinherited by custom rather than law, especially in settings where they face a difficult trade-off between an inheritance claim and family relationships (see the following discussion).

Second, Islamic law has been viewed as a major factor in fragmenting wealth, inhibiting long-lasting business partnerships, and preventing capital accumulation in Arab societies. Fragmentation of property is also of consequence in agricultural production, where very small farms may be economically unproductive. The evidentiary basis for the claims linking inheritance with development, however, is weak. Whether concentration of wealth or its fragmentation is a bigger development obstacle remains an open question. Recent research (Robinson and Acemoglu 2013) demonstrates that high levels of land inequality can undermine institutional incentives for prosperity and are associated with economic and political inequality. Similarly, limited access to land is a prime cause of rural poverty in much of the developing world.

Inheritance is closely linked to private wealth management in Islamic finance. Services to write wills for inheritance are more likely to be provided by solicitors and financial planners than Islamic financial institutions.

Islamic Economics: Ideals without Practice

Although Islamic economic thought provides the intellectual backdrop for the Islamic finance industry, it is sometimes viewed as a set of idealized theoretical claims that do not neatly map onto practice. There is a serious question mark on whether Islamic economics can be described as a distinct field. The underlying content in Islamic teachings is seen as consistent with the global emphasis on sustainable development and growth, complemented, of course, by an insistence on morality and justice. Relatedly, empirical studies suggest that the prime cause for poverty and underdevelopment in Muslim societies is largely attributable to "bad governance" rather than to Islam (Iqbal and Mirakhor 2013). Islamic economics has also received limited official backing in Muslim societies. Governments have shown little awareness of or interest in the ideals espoused by Islamic economics. Reducing reliance on interest-bearing debt and encouraging profit-sharing modes of financing remain merely a paper aspiration. Rather than embodying Islamic economic ideals in enduring institutions, Islamic finance is sometimes used as a substitute for a more radical overhaul of the economic system. Islamic banking is largely made to fit in the existing legal, regulatory, and tax regime that is designed for conventional finance.

Islamic finance also operates within a political economy that is predicated on preserving rather than changing the status quo. Where a government has actively supported Islamic finance, the system retains an uncomfortable similarity to conventional finance. Some have questioned the direction of Islamic finance by asking why it is concerned with "morally regulating the operations of individual businessmen rather than promoting economic growth at the macro-level and distributing resources in accordance with Islamic principles of social justice" ("Islamic Finance, Petrodollar Recycling, and Economic Development" 2009).

The Occupy Wall Street movement caused a stir in Islamic finance circles, especially after a protestor was photographed carrying a placard saying "Let's Bank the Muslim Way?" In this context, Mushtak Parker, a journalist, has argued that Muslim-majority countries are "either embarrassed by the attention Islamic finance is receiving or are living in denial" (Parker 2011). He points out that, while in October 2011, the finance minister of Luxembourg favorably commented on Islamic finance, the king of Jordan was noticeably silent on the subject while addressing the World Economic Forum.

Use of the principles of Islamic economics and finance as a basis for constructing an alternative financial system has thus found limited official support. Just as human beings do not always behave like the economic man (*Homo economicus*), Muslims do not always act like the Islamic man (*Homo Islamicus*). Similarly, just because a country has a Muslim-majority population does not mean those entrusted with its economic policy find inspiration and direction from Islamic economic thought. We will explore this issue further in the section on political economy.

Siddiqi (2013), a prominent Islamic economist, has noted,

> Future Islamic Economics will be calling for five strategic changes in approach: Family rather than the market as the starting point in economic analysis; Cooperation playing a greater role in the economy, complementing competition; Debts playing a subsidiary rather than dominant role in financial markets; Interest and interest-bearing instruments playing no role in money creation and monetary management; and, lastly, Maqasid [objectives of Shari'a] based thinking supplanting analogical reasoning in Islamic economic jurisprudence.

To meet these objectives would be a tall order.

Shari'a and the Prohibitions Shaping Islamic Finance

Having set out the context of Islamic economics and finance, we now turn to the specifics of Islamic finance. We begin by describing Islamic Shari'a and jurisprudence and then discuss the Islamic prohibitions that shape the Islamic finance industry.

Highlights of this section are as follows:

- Shari'a is considered divine in Islam. Although it does not have a single and well-defined set of objectives, Shari'a objectives tend to be welfare oriented.
- Prohibitions of *riba* and excessive *gharar* shape the instruments of Islamic finance and are the key to its practice.
- According to the mainstream view, the scope of Islamic prohibitions of *riba* and excessive *gharar* include lending money at interest and the trading of risk without any asset or enterprise.

Shari'a

Shari'a is often translated as "the path," the "Islamic way," or "Islamic law." While noting that "no legal system has ever had worse press," Feldman (2008) notes that Shari'a can mean different things to different people, and "at its core, [it] represents the idea that all human beings . . . are subject to justice under the law."

Feldman's view is not without support. A report by Gallup observes that

> Although Sharia often connotes the image of a restrictive society, where residents are forced to comply with rules and obligations they would otherwise eschew, the Gallup Poll findings show that majorities of those who favor Sharia as a source of law associate it with many positive attributes. Ninety-seven percent of Egyptians, 76% of Iranians, and 69% of Turks in this group associate it with justice for women. Strong majorities in Iran (80%), Egypt (96%), and Turkey (63%) also think of Sharia as promoting a fair justice system. Additionally, majorities in Iran (77%) and Turkey (70%) associate Sharia with reducing corruption. (Rheault and Mogahed 2008)

Muslims believe that the Qur'an is the word of God and that the tradition of the Prophet Mohammad (*sunnah*, or the reported sayings, doings, and tacit approvals of the Prophet Mohammad) is God's approved way. Together, they are the basis of Shari'a.

Objectives of Shari'a

Chapra (1992) states that according to the prominent Muslim philosopher Al-Ghazali (died 1111), the objective of the Shari'a is "to promote the well-being of all mankind, which lies in safeguarding their faith (*din*), their human self (*nafs*), their intellect (*aql*), their posterity (*nasl*), and their wealth (*mal*). Whatever ensures the safeguarding of these five serves public interest and is desirable" (p. 19).

There is no one, comprehensive, and commonly agreed-on list of Shari'a objectives. Kamali (2008) argues that, unlike Islamic jurisprudence, Shari'a *objectives* are "not burdened with methodological technicality and literalist reading of the text" (p. 24). For example, Shari'a scholar Yusuf Al-Qaradawi added human dignity, freedom, social welfare, and fraternity as important objectives of Shari'a. In a similar vein, Kamali (1999) has advocated adding economic development and science and technology to the list of objectives.

Islamic Commercial Jurisprudence

Many aspects of Islamic finance are not covered in Shari'a but in *fiqh*, or jurisprudence (also translated as understanding of Shari'a)—specifically, in Islamic commercial jurisprudence (*fiqh ul ma'amlat*).

In interpreting the Qur'an and the tradition of Prophet Mohammad, jurists rely on multiple tools of reasoning that have broadly fallen under the umbrella of independent reasoning (*ijtihad*).

Kamali (2005) notes that *fiqh* (or jurisprudence) is the output and "the methodology of *usul al-fiqh* [or principles of jurisprudence] really refers to methods of reasoning such as analogy (*qiyas*), juristic preference (*istihsan*), presumption of continuity (*istishab*) and the rules of interpretation and deduction" (p. 12).

Islamic jurisprudence necessarily involves human endeavor, which inevitably generates competing interpretations. Shari'a scholar Khalid Zaheer ("What is Islamic and What is Not"?) notes that "anyone familiar with the work done on Islamic shari'ah in the last fourteen hundred years will not hesitate to agree that juristic differences amongst Muslims scholars are a general rule rather than an exception."

An illustration of juristic differences in Islamic finance can be found in futures trading. Usmani ("Permissibility of Certain Financial Contracts") argues that "future transactions are totally impermissible regardless of their subject matter" and "it makes no difference whether these contracts are entered into for the purpose of speculation or for the purpose of hedging" (p. 4). This statement likely reflects the majority view. By contrast, Kamali (2007) contends that "commodity futures fall under the basic principle of permissibility, with the proviso that we engage ourselves in a continuous process to enhance vigilance and develop more refined safeguards against abuse, excessive speculation, and *gharar*" (p. 339). This is considered a minority view.

In the modern Islamic finance industry, "Shari'a compliance" generally refers to meeting the technical requirements of Islamic commercial jurisprudence as determined by the concerned Shari'a scholars from whom a religious ruling (*fatwa*) is sought.

Prohibitions Shaping Islamic Finance

Prohibitions regarding the purpose and structure of financing are key to the practice of Islamic finance. These prohibitions pertain to activities specifically prohibited in the Qur'an and the tradition of the Prophet Mohammad. Prominent examples in this regard are consumption of alcohol and pork and lending money at interest. Islamic finance is barred from financing these activities. The scope of such prohibitions extends to cover activities not specifically prohibited in the divine sources—for example, smoking tobacco, which is injurious to health. The two main prohibitions regarding the structure (and purpose) of finance and insurance are *riba* and *gharar*. These are described next.

***Riba*.** The debate on *riba* lies at the core of Islamic economics and finance. Literature on the subject indicates two types of *riba*. One is prohibited by both the Qur'an and the tradition of Prophet Mohammad and involves a time delay before the money is returned. The other is prohibited by tradition of the Prophet Mohammad only and apparently does not involve such a delay.

El-Gamal (2001) points out that not all forms of economic interest are considered *riba* nor is the scope of *riba* confined to common conceptions of interest. For instance, selling something on credit at a greater price than the spot price would be seen as charging interest in economic terms but is generally not seen as *riba* prohibited by the Qur'an. Exchanging two volumes of a good of inferior quality with one volume of the same good of superior quality on the spot may be deemed *riba* and prohibited by the tradition of the Prophet Mohammad even though no interest is involved.

Riba is sometimes translated as "usury," but in the modern context, usury refers to an *excessive* rate of interest; its classical meaning refers to *any* rate of interest. Rahman (1964) argues that translating *riba* "is not only futile, but is also the source of much confused thinking on the subject" (p. 1).

In terms of the economic impact of the prohibition, the critical element is lending money at interest. That lending money at interest falls within the scope of the Qur'anic prohibition of *riba* seems to be widely accepted. The prohibition is generally interpreted as absolute. Whether the interest is simple or compound, high or low, for consumption or for business, between people or institutions, or between rich or poor does not matter.

A frequently quoted Qur'anic verse on the prohibition of *riba* states that "Allah has permitted trading and prohibited *riba*" (2:275).

Frequently cited sources on whether or not *riba* includes lending money at interest are (1) the comprehensive decision by the Shari'at Appellate Bench of the Supreme Court of Pakistan in 1999 relating to an earlier judgment by the Federal Shari'at Court in 1991 and (2) the resolution concerned with this issue passed in 1985 by the International Islamic Fiqh Academy of the OIC.[13]

Some have continued to dispute that the prohibition of *riba* includes modern-day interest charged on monetary loans. But many of them do not refute the arguments offered in favor of the mainstream view that lending money at interest falls within the scope of *riba*. For instance, one view is that *riba* refers to an excessive rate of interest rather than any rate of interest charged on monetary loans (Saleem 2006). Such views tend not to be supported by the arguments given in the sources referred to earlier in this section. At times, the motivations of those offering alternative explanations of *riba* are also questioned and traced to politics rather than religion. Henry (1999) notes that

> Egypt's revered mufti, Muhammad Abduh, is alleged to have made a *fatwah* (ruling) to this effect, as did a successor, Shaykh Muhammad Sayyid Tantawi, in 1988. . . . Abduh, however, was operating under the thumb of an informal British protectorate, and Tantawi's initiative also appears to have been politically motivated. (p. 6)

The literature tends to take the view that the rationale for the prohibition of *riba* is not clearly spelled out in the Qur'an and the Prophetic tradition. In an earlier literature survey of Islamic finance, Zaher and Hassan (2001) note that Islamic economics has rationalized the prohibition of *riba* based on "justice, efficiency, stability, and growth" (p. 2).

Various writers have said that injustice is not the sole explanation behind the prohibition of *riba*. For instance, in today's economy, one does not exploit a government or a large corporation by buying its bonds.

Using behavioral finance analysis at the micro level, El-Gamal (2006) rationalizes the prohibition of *riba* and *gharar* as a defense against human idiosyncrasies in financial decision making—specifically including time preference anomalies that lead to inconsistency and asymmetrical assessments of small gains and losses.

El Diwany (2003) argues that compound interest on debt is in conflict with the laws of nature. Whereas in the physical world, everything deteriorates—"fruits rot and buildings become dilapidated" (p. 1)—compound interest does the opposite by growing toward infinity. Discounting, the opposite of compounding, has a built-in short term and entails ecological challenges. El

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[13]See the translation of "The Text of the Historic Judgment on Interest Given by the Supreme Court of Pakistan" at www.albalagh.net/Islamic_economics/riba_judgement.shtml.

Diwany argues that climate change and deforestation are worsened by the current monetary system, which relies on constantly expanding interest-bearing debt for economic growth. To pay the interest on monetary loans (which, unlike dividends on equity investments, must be paid regardless of business outcome), man is driven to exploit nature more and more, be it farming or fishing or something else.

The time value of money in Islamic economics and finance has also been a subject of much debate. Although goods may be sold on credit at a price higher than the spot price, one is prohibited from making money from money without any asset or enterprise because it is seen as *riba*. Unlike goods, money is not accepted as a commodity. This critical distinction in the concept of *riba* serves as the basis for most of Islamic commercial banking.

A debate in Islamic finance has been taking place on inflation indexation of interest-free monetary loans. Although some, such as Zaheer (2007), have argued in favor of inflation indexation to ensure fairness to the lender, the mainstream position views the indexation of monetary loans in contravention to the prohibition of *riba*. One reason offered is that inflation is not a new phenomenon and that there is no precedence for indexation in Islamic commercial jurisprudence. Another reason is that interest in the current monetary system is a cause rather than an effect of inflation. Interest-free loans are offered to help the borrower, not to hedge against inflation risk. Yet another reason is that the borrower is obliged to return the same amount even in the case of deflation, and if the lender wants inflation protection, the loan can be extended in the form of a commodity (Ayub 2007).

The extent to which the avoidance of conventional banking among some Muslims is a result of *riba* or attributable to other reasons, such as limited access to a banking system, is difficult to ascertain.

Excessive *Gharar*. *Gharar* is commonly translated as "uncertainty" or "excessive and avoidable uncertainty" regarding essential elements of a contract, such as the price in a contract of sale. Noncommutative contracts, in which the contracting parties do not give and receive an equivalent asset (e.g., a gift) are considered outside the scope of *gharar*. Unlike *riba* concerning monetary loans, which are prohibited by both the Qur'an and the Prophetic tradition, *gharar* is prohibited only by the Prophetic tradition. Warde (2010) believes that the prohibition against excessive *gharar* is exclusive to Islam.

Al-Dhareer (1997) identifies 14 types of *gharar* and provides four necessary conditions for *gharar* to invalidate a contract:

1. It must be major.
2. The contract must be a commutative financial contract.

3. *Gharar* must affect the principal components of the contract.
4. No need is met by the contract containing *gharar* that cannot be met otherwise.

The majority of classical jurists, according to Vogel and Hayes (1998), interpret *gharar* as ignorance about material aspects of a contract and nonexistence of the object of sale. The influential Shari'a scholar Ibn Taymiyyah (died 1328), however, connects *gharar* with the meaning of "risk" that leads to the evils of *maysir* (see later discussion), which is prohibited in the Qur'an. This approach reduces the scope of *gharar* and provides more freedom to contracting parties.

When *gharar* is understood as ignorance and uncertainty about material aspects of a commutative contract, *gharar* becomes a question of degree rather than its presence or absence. These aspects may change with improvements in technology, legal framework, and customary practice. Clearly, the assessment of the degree of risk is subjective. Some jurists, for example, may deem a contract permissible while others prohibit it because of their different views on the degree of *gharar*.

El-Gamal (2001) explains *gharar* as trading of risk without any asset and argues that to prohibit trading of risk, with due allowance for exceptions, is economically efficient. One exception is when the elimination of a particular contract would cause a more severe efficiency loss (e.g., the contract of *salam* in Islamic commercial jurisprudence, which requires spot payment and future delivery).

There is less clarity on the rationale underlying this prohibition. Possible justifications include the fact that *gharar* leaves room for dispute, produces an unjustified gain, and risks the inability to deliver the promised goods. A more contemporary justification may be negative externalities or unjustified loss caused by the sale of risk, such as that experienced in the global financial crisis of 2007–2008.

***Maysir*.** The Qur'an prohibits *maysir* (2:219). As described by Ibn Qutaybah (Rosenthal 1975), *maysir* is similar to a charitable lottery, which involves both contributions from participants and random draws, with the benefit being passed on by the winners to the needy. Note that, in this case, *maysir* is prohibited despite the benefits being passed on to the needy. *Maysir* is also understood to include all kinds of gambling. Vogel and Hayes (1998) translate *maysir* as "games of chance" and "gambling." *Maysir* can thus be viewed as extreme *gharar* because any uncertain future event can be used for gambling.

Gambling is commonly associated with trying to make a gain through trading of risk, such as the zero-sum game of betting on the outcome of a throw of dice. Usually, it does not involve any productive economic activity and is associated with short-term outcomes that are beyond the control of contracting parties. Speculation is harder to define than gambling, although it may share similar characteristics. Taken to its extreme, speculation can verge on gambling. An example is betting on price movements in financial markets in narrow time intervals. Compared with the impact of gambling, the impact of speculation in financial markets and on society can be dramatic. For instance, commodity price volatility induced by speculative trading can generate negative externalities on a large scale.

Prohibitions: The Key to Practice

The prohibitions against *riba* and excessive *gharar* are the key to understanding product structuring in Islamic finance.

Together, the prohibitions against *riba* and *gharar* help explain the emphasis on assets, enterprise, and risk sharing in Islamic finance. If you cannot lend money at interest, then to earn a profit, you have to trade or lease an asset or engage in a business (i.e., you have to assume the risk associated with ownership of an asset or enterprise). Similarly, if you want to avoid trading of risk and, instead, manage risk through insurance, the preferred mode is mutual risk sharing. These points explain why risk sharing is so strongly associated with Islamic finance.

The prohibitions also stand in the way of using many financial instruments that are based on interest-bearing debt and trading of risk, such as conventional bonds and derivatives. The prohibitions also constrain the trading of debt, even if it is created with genuine credit sales, because trading debt (as opposed to trading real assets) at values other than par values is generally seen as the prohibited *riba*.

These prohibitions also make short selling problematic. Dusuki and Abozaid (2007) point out that short selling stocks is in conflict with a reported saying of Prophet Mohammad that states do not sell what you do not possess. They note that because of the organized borrowing and lending of securities, the excessive *gharar*—the presumed reason underlying the reported Prophetic saying—pertaining to potential nondelivery is alleviated, but the stipulated excess or interest in securities lending runs counter to the prohibition of *riba*.

Although the prohibitions reduce the freedom to contract, the emphasis on risk sharing keeps finance simple and tied to the real economy, facilitates redistribution of wealth, and promotes social solidarity. For instance, financing startups that could generate new economic opportunities are better suited to risk-sharing modes of financing (e.g., equity) than debt. Equity owners in a business have far more incentive than bondholders to make the business work when it is facing difficulties. Risk sharing protects against financial instability because losses are passed on to the providers of capital, minimizing the need for bailouts. Without pressure to appease the stock market by maximizing profit, mutual risk-sharing structures for insurance are better suited than conventional proprietary insurance to bring ethical considerations in financial decision making and not focus on short-term results. Such risk sharing makes trading derivative products (e.g., credit default swaps) difficult, if not impossible, where the contracting parties bet against each other to earn a windfall from someone else's loss. This helps explain how Islamic finance is embedded within Islamic ethics, which is concerned with social welfare in not just the purpose but also the structure of financing.

Islamic Finance in the Global Economy

The global financial system relies heavily on lending money at interest and the trading of risk—be it in banking, insurance, capital markets, or even monetary policy. If prohibition of *riba* and excessive *gharar* are interpreted to include lending money at interest and the trading of risk, clearly Islamic finance is required to swim against the tide of the global financial system, where many prevailing instruments—from treasury bills to currency derivatives—involve one or both.

In this situation, for Islamic finance to survive and grow and follow Islamic prohibitions at the same time, it is likely to follow a gradualist approach and make some compromises in the name of necessity (*darura*) and public interest (*muslaha*). However, if Islamic finance makes too many compromises while pursuing private profit, it risks losing its substance and credibility. This dilemma is central to the story of modern Islamic finance as we explore in subsequent sections.

Islamic Finance in Practice

Having discussed Islamic economic thought and the prohibitions shaping Islamic finance, we next explain how nominate contracts and promises are used in Islamic finance with regard to the prohibitions of *riba* and excessive *gharar*.

Highlights of this section are as follows:

- Islamic financial transactions in banking, capital markets, and insurance are structured through nominate contracts and promises (or legally binding unilateral undertakings).
- The application of these contracts and promises today is materially different from that of their classical equivalents.
- The most common contract used in Islamic finance practice is *murabaha* (or trust sale); it is also referred to as banking *murabaha* to the purchase orderer.

Nominate Contracts and Promises

Structuring products in Islamic finance often takes place by replicating a conventional financial product but making it Shari'a compliant. Whether a bank account or hedge fund, the products had already been developed in conventional finance before they were replicated in Islamic finance. Proponents see this structuring as an exercise in Shari'a compliance, but critics argue that it circumvents the prohibitions of *riba* and *gharar* and does not add economic or social value. Much of this debate, revolving around nominate contracts, promises, and their application, is legalistic.

Nominate Contracts. When contrasting a permissible deferred-payment sale (where the credit price is more than the spot price) to a prohibited interest-bearing loan, jurists often consider a valid contract as the core difference. Particular emphasis is placed on contracts recognized in classical Islamic jurisprudence. These contracts—on their own or in combination with other contracts and promises (*wa'ad*)—are used to structure Islamic financing.

Contracts commonly used in modern Islamic finance include *murabaha* (trust sale), *ijara* (leasing), *salam* (a forward sale with spot payment), *istisna* (manufacturing with forward delivery and flexible payments), *wakala* (agency), *mudaraba* (profit sharing or investment management), *musharaka* (partnership or co-ownership), *qard hasan* (an interest-free loan), *arbun* (an option), and *tabarru* (donation).

In *murabaha*, or a trust sale, instead of lending money at interest, the financier buys a good and sells it to the customer on installment credit with a disclosed profit. This contemporary version of *murabaha* is also referred to as "banking *murabaha* to the purchase orderer." The disclosure of the profit and reliance on the expertise of the seller help explain why it is classified as a trust sale among the different types of credit sale. The application of trust sale is deemed to make the financing arrangement Shari'a compliant while the financier secures a fixed return. From the perspective of Islamic commercial jurisprudence, evidence must be clear that the legal title and possession of the asset were passed to the financier before the financier sold it on to the customer.

Because it is a contract of sale, *murabaha* could create some legal issues under the secular law of a country; that is, the seller may be deemed responsible for warranties, returns, indemnities, environmental liability, and so on.

If the difference between the spot and credit prices, which the economist might consider as interest, is classified as profit on legal grounds, further complications can arise. This is because early payment discounts are usually at the seller's discretion regardless of the length of the contract. This is unlike conventional monetary loans, where early payment discounts may be specified in the contract and be legally binding. Combinations of credit and spot sales can thus effectively mimic an interest-bearing monetary loan. For instance, a financier can sell a good to a client on credit and then immediately repurchase it on spot at a lower price. This controversial method, a credit sale with immediate spot repurchase (*bai-al-inah*), is widely practiced in Malaysia. Similarly, a seller can sell a good to a client on credit, who immediately sells it onward to a third party on spot at a lower price. This practice is known as monetization (*tawarruq*). Both of these methods leave the financed party receiving money now to be paid back with more money later, and the asset plays only a ceremonial role. A major difference between the two modes is that more parties are involved in monetization than in sale with immediate repurchase. These controversial methods are often viewed as legal stratagems that circumvent the prohibition of *riba*.

Despite the use of classical Arabic terminology, the modern versions of nominate contracts may be materially different from their classical versions. Some scholars have justified the modification of classical nominate contracts because "Islamic banks operate in a completely different environment when compared to what had been elaborated by the classical jurists" and "new *ijtihad* [independent reasoning] is needed to modify the classical *fiqh* [jurisprudence] doctrines so that they become relevant in meeting the sophisticated financial needs of contemporary Muslim" (Shaharuddin 2010, p. 129).

In this review, we do not explore details of these contracts, except that of the most widely used contract of trust sale—namely, *murabaha*. We discuss it in detail in the section on form versus substance. We believe readers of this review will primarily be interested in developing a general understanding of

Islamic finance. For readers interested in the specifics of these contracts, the Suggested Readings list provides direction to relevant publications.

Promises. The case of a promise (*wa'ad*) serves as a useful example of how classical Islamic commercial jurisprudence has been modified for modern Islamic finance. A promise is a widely used tool in financial structuring in Islamic finance; it is unilateral in nature and does not have to fulfill the formal requirements of a contract as defined in Islamic commercial jurisprudence. In fact, the most widely used contract in Islamic finance, *murabaha*, also uses a promise. In *murabaha*, the financier assumes ownership of an asset only if it has a legally binding undertaking that the financee will purchase that asset, which minimizes the risk associated with ownership.

Historically, the majority view in Islamic commercial jurisprudence did not consider promises legally binding. In 1988, however, in the context of deferred-payment sales by Islamic banks, the OIC's International Islamic Fiqh Academy passed a resolution paving the way for a promise to be legally binding—subject to some conditions (Islamic Development Bank 2000). Although the resolution of the Academy was in the context of credit sales, legally binding undertakings have found wide-ranging application in Islamic finance—from structuring *sukuk* to derivatives.

Application of Contracts and Promises

The Islamic prohibitions, nominate contracts, and promises are closely related features of Islamic finance. Here, we use a few examples to explain their fundamental role in shaping Islamic finance in commercial banking (the largest sector in Islamic finance), capital, *takaful*, and microfinance. These examples are also intended to advance understanding of the most fundamental debate in Islamic finance: the form versus substance debate, to which we turn later.

Commercial Banking. In its early days of conceptualization, Islamic banking was intended to work as two-tiered investment management (*mudaraba*). Individuals were supposed to invest with the bank on a profit-sharing basis, and the bank, in turn, was expected to invest in businesses on a profit-sharing basis. Contemporary practice is very different, however, from that early conceptualization.

On the liability side, Islamic commercial banks offer various types of accounts. Some of them are safekeeping accounts, without any prospect of return on the deposit, that use one of the nominate contracts (*wadia*, or safekeeping; *qard hasan*, or interest-free loan). The bank, however, may offer return in the form of a discretionary gift (*hiba*). There are also investment accounts, which may be restricted or unrestricted in their scope. These investment accounts tend to be based on a contract similar to investment management (*mudaraba*).

Banking regulators may consider the Islamic bank to have a constructive legal obligation to guarantee the capital of the investment account holders because these accounts are marketed as a substitute for conventional deposits. Regulators may also see this guarantee as a prudential commercial obligation, similar to capital adequacy, because passing losses to account holders can lead a run on the bank, causing its collapse and creating a systemic threat for the banking sector. Essentially, whether the capital guarantee is seen as a legal or a commercial obligation of the Islamic bank, investment accounts offered by Islamic banks have capital guarantees in practice (just as accounts in conventional banking do), even if, in theory, they are meant to be profit-sharing accounts, where capital is supposed to be at risk of investment outcomes.

On the asset side, Islamic commercial banks use these nominate contracts or combinations to offer various other financing arrangements. For example, a combination of a diminishing partnership and lease is often used for home financing. A bank and homebuyer jointly purchase a house and enter into a lease arrangement. The homebuyer pays rent on the share owned by the financier and gradually buys out the financier's share. By the end of the term, the homebuyer fully owns the house. In principle, this arrangement, also known as lease to buy, is entirely free of lending money on interest.

Notice here the change that can be brought about in the economic substance of the arrangement by changing a few features. If the price at which the buyer purchases a unit of the house from the financier is fixed in advance and the "rent" is based on an interest rate benchmark—not an uncommon practice in the Islamic finance industry—then the economic substance of the Shari'a-compliant home financing is similar to conventional home financing. Critics are likely to view such home financing as Islamic in legal form owing to its reliance on nominate contracts, but not in economic substance. According to such critics, rather than fixing the price per unit, it should be based on the market value of the property at the time of the purchase. Similarly, rent should be based on the rental market at the time of payment rather than an interest rate benchmark.

Capital Markets. In this section, we cover equity funds and *sukuk*.

- *Long-only equity funds.* The majority of Islamic funds are long-only equity funds that use exclusionary screening, thereby reducing the investable universe to companies that are considered acceptable.

Generally, like the early conventional ethical funds, Islamic equity funds follow exclusionary screening to avoid companies whose primary business is in conflict with Islamic jurisprudence. The companies avoided include those receiving income from alcohol, gambling, "adult entertainment," conventional banking, and insurance. The "sin" industries are not necessarily confined to those mentioned in primary sources of Islam; the list has been extended to include tobacco because it is, arguably, harmful to life. The greatest impact of exclusionary screening is usually the removal of the conventional financial and insurance sectors, which can be the largest sectors in stock exchanges of developing countries.

After the initial screening based on a company's primary business, further exclusionary screens are applied to avoid businesses with an unacceptably high level of impermissible interest income (usually 5%). Businesses with high interest-bearing debt (usually more than a third of market capitalization or total assets) are also avoided. Setting the debt threshold is a difficult issue, especially in the absence of clear guidance from the primary sources of Islam. The "one-third" threshold reportedly stems from the tradition of the Prophet Mohammad regarding inheritance; he disallowed donating more than one-third of one's wealth to a nonrelative or charity. In addition, dividend income attributable to impermissible income is to be donated to a charity, although the same is not attempted for capital gains, which remains a subject of debate.

Screening methodologies for separating permissible from impermissible income differ among Islamic index providers. The general approach, however, is the same. Because companies often do not publish detailed information about revenues from separate product lines, following specific ratios can become a complex exercise. In some cases, a company excluded by one provider might be included by another.

The screening process is generally negative, although positive alignment is also deployed in some cases (e.g., Islamic sustainability index). Unlike responsible investing, Islamic investing is not known to actively use engagement with companies as a strategy. Screening methodologies applied in Islamic investments are, in effect, subjective tolerance measures because no one company may perfectly meet Islamic criteria. Islamic screening methodologies, like many other aspects of Islamic finance, should be seen as works in progress. Most companies do not have Shari'a compliance as an objective in the first place and falling within tolerance parameters of Islamic finance is by chance rather than by design. The application of strict criteria of no interest-bearing debt and no impermissible income may reduce the investable universe to the extent that investing in listed equities would become very difficult, if not impossible.

Islamic equity funds are not without criticism. A common critique is that they lack a clear agenda for socioeconomic justice and development. Some of them facilitate private capital flight from Muslim-majority countries to Western capital markets (Henry and Wilson 2004). They are also known to invest in companies, such as those in conventional energy, that are deemed problematic in responsible investing because of environmental, social, or corporate governance (ESG) concerns. Sometimes, investments are made in companies that are otherwise shunned by some Muslims as a result of the companies' involvement in wars and conflict. In a critique of socially responsible investing, Hawken (2004) observes, "Muslim investors may be puzzled to find Halliburton on the Dow Jones Islamic Index fund" (p. 19).

Critics argue that using Shari'a arbitrage and becoming eligible for investment by an Islamic equity fund without a fundamental change in capital structure is theoretically possible. For instance, replacing a finance lease with a Shari'a-compliant equivalent can reduce a company's debt ratio without necessarily reducing its interest-bearing debt (El-Gamal 2006). Despite such criticism, Islamic equity funds are generally viewed as the most authentic form of Islamic finance because they are much closer to risk–reward sharing and further from lending money at interest than other types of products in Islamic finance. Interestingly, as of late 2013, in terms of assets under management, the largest Islamic equity fund, Amana Growth Fund, is based in the United States. According to an interview with its principal portfolio manager, the majority of its investors are non-Muslims who are attracted to the fund, arguably owing to its attractive financial performance (Barnes 2012).

According to one report, the number of Islamic mutual funds operating globally reached 786 in 2013, double the number in 2007.[14] Total fund assets under management, estimated to be below US$60 billion, are a small fraction of the general estimates of global Islamic financial assets. Although most assets are in long-only equity funds, Islamic money market funds now have more assets under management than the equity funds. A clear majority of funds are registered in Malaysia, Saudi Arabia, and Luxembourg. Achieving scale remains a challenge for Islamic funds: Only 80 funds manage US$100 million or more in assets.

■ Sukuk. Islamic investment certificates, or *sukuk* (i.e., the plural of *sakk*[15]), also translated as Islamic bonds, are often considered one of the most promising segments within Islamic finance. They receive much attention because of their fast growth and role as a much-needed liquidity management tool for Islamic banks. The Bahrain-based Islamic finance standard setter AAOIFI defines *sukuk* as "certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity."[16]

The literature suggests that *sukuk* were used in Muslim societies "as early as the Middle Ages, where papers representing financial obligations originating from trade and other commercial activities were issued" (Dubai International Financial Centre 2009). Modern *sukuk* were legitimized by the ruling of the

[14]Information in this paragraph is from Thomson Reuters and Lipper (2013).
[15]*Sukuk* is the plural, and *sakk* is the singular; however, Islamic finance literature uses *sukuk* without necessarily worrying about singular or plural use. For simplicity, we have also used *sukuk*.
[16]See www.aaoifi.com

OIC's International Islamic Fiqh Academy in 1988, which allowed any collection of assets to be represented in a written note or bond. The ruling further stated that this bond or note can be sold at a market price, provided that the composition of the group of assets represented by the security consists of a majority of tangible assets.

Sukuk have been issued by governments (e.g., Bahrain), corporations (e.g., General Electric), and other types of entities (e.g., the German state of Saxony-Anhalt, the World Bank). Moody's Investors Service, in a Special Comment on 4 September 2014, estimates that "total sovereign outstanding accounts for around 36% of the $296 billion of outstanding *sukuk* as of July 2014" (p. 1).

Interestingly, the world's first *sukuk* issue was issued not by an Islamic financial institution but by a conventional company, Shell MDS, although it was issued in Malaysia, a Muslim-majority country. A key conceptual difference between *sukuk* and bonds is that *sukuk* should represent ownership in real assets whereas conventional bondholders own debt. Thus, in principle, one should not refer to *sukuk* as "Islamic bonds," which is an oxymoron, but as "Islamic investment certificates" (Henry and Wilson 2004).

Sukuk can be structured in a variety of ways, even when using the same underlying nominate contract. For example, one can structure *sukuk* by using investment management contracts that, economically, behave much like conventional debt instruments, a collective investment fund, or an equity instrument. *Sukuk* can be structured with a single asset or a pool of tangible assets. Structures that involve a mix of tangible and financial assets in the pool of assets have also been allowed. Currently, there is no fixed minimum proportion of tangible assets in a portfolio that can be securitized through *sukuk*, although underlying views diverge.

A common structure of underlying *sukuk* is a lease (*ijara*). The originator sells an asset to a special-purpose vehicle (SPV), which is the *sukuk* issuer, and receives the initial cash flow. The SPV leases the asset back to the originator, which pays rentals to the SPV. Upon expiration of the agreed term, the originator, calling on the purchase and sale undertakings previously signed, buys back the asset at a fixed price. The rent of the asset may comprise the principal, a rate of return, and any charges incurred for maintaining the asset. The originator thus acts as a seller, lessee, obligor, and servicing agent (Dubai International Financial Centre 2009). As in the previous home financing example, this *sukuk* structure can be used to replicate a conventional bond through the following elements: lack of a true sale between the originator and SPV, use of a promise at a fixed price whereby the originator buys back the asset, and rent pegged to an interest rate benchmark. Despite its close similarity to a conventional bond, *sukuk* are considered Shari'a compliant largely because they are structured like a sale and lease and their proceeds cannot be used to finance a prohibited activity.

A key point in a *sukuk* structure is whether a true sale has taken place between the originator and the *sukuk* issuer. If there has been a true sale, assets are indeed owned by the SPV, returns are derived from the assets, and the *sukuk* holders do not have recourse to the originator in the case of a payment shortfall. These true-sale *sukuk* are known as asset-*backed sukuk*, and those without the true sale as asset-*based sukuk*. Asset-backed *sukuk* are, in essence, securitization of largely real assets, whereas asset-based *sukuk* are closer to conventional bonds. *Sukuk* are supposed to be based on real assets or a pool of real and financial assets, whereas asset-backed securities may use only financial assets, such as loans and receivables.

In late 2007, Muhammad Taqi Usmani (2007), chairman of AAOIFI's Shari'a council, issued a strong critique of some *sakk* structures. He questioned their adherence to Shari'a. He criticized the structures for using a set of legal gimmicks to turn what was supposed to be investment risk–reward sharing into a conventional bond. Much controversy followed the critique; news reports suggested that, according to the critique, 85% of *sukuk* did not comply with Shari'a.

Interestingly, the leasing *sukuk* structure was spared the criticism, even though it may be asset based and closely mimic a conventional bond. A possible technical explanation for treating leasing *sukuk* as an exception is that the net value at which the originator buys back the asset from the SPV at the end of the term is deemed its fair value.

Dusuki and Mokhtar (2010) argue, "Despite the fact that asset-backed *sukuk* are deemed closer to the spirit and principle of the *sukuk* compared to asset-based *sukuk*, to date only 11 asset-backed *sukuk* [or 2% of the concerned 560 issues] have been issued" (p. 12). There are several reasons offered to explain the predominance of asset-based *sukuk*. One such reason is that investors demand a fixed income as opposed to assuming the risk of an asset. Originators also demand financing without having to part with the asset. In addition, the legal framework for securitization is often weak in emerging markets, and a variety of taxes may be triggered in the case of a true sale (e.g., stamp duty, sales tax, capital gains tax).

An important issue pertaining to *sukuk* is the uncertainty regarding how the underlying legal structures would fare in a court of law vis-à-vis conventional bonds. Although *sukuk* have to comply with Islamic law, they are also, just as bonds are, governed by the secular (usually English) law under which they are issued. A key aspect is whether *sukuk* holders have ownership rights in the underlying asset or have assumed the credit risk of the originator. A related issue regarding enforceability is that the local courts in the countries of the Gulf Cooperation Council may not allow recourse to the *sukuk* assets pursuant to a judgment of the English courts. This enforceability concern can become acute where the local governments have an interest in the underlying assets. Analyzing case studies of *sakk* defaults, Van Wijnbergen and Zaheer (2013) argue that "in most cases the problems can be traced back to clauses and structures that made the *sukuk* more like conventional bonds" (Abstract). Amid the rapid growth in Islamic finance, dealing with defaults was probably not given sufficient attention. Aspects of insolvency in classical Islamic jurisprudence (*iflas*) are not seen as consistent with modern bankruptcy laws. Some argue that "the central difference with Western approaches to insolvency lay in the absence, in classical Islamic law, of the notion of a separate corporate personality," but there are also other differences regarding "punitive damages, hierarchies of claims and claimants, and many other matters" ("Reappraising the Islamic Financial Sector" 2011).

Takaful. Islamic insurance (*takaful*) has a special form because conventional proprietary insurance is considered inconsistent with the Islamic prohibitions of excessive *gharar* and *riba.* Proprietary insurance essentially involves trading of risk, and the investments by proprietary insurance companies include conventional interest-bearing debt securities. Another argument against conventional insurance is that it has elements of gambling because the insured are considered to be paying premiums in the expectation that the insurer will make payment when a specified event happens. Others point out that gambling is a zero-sum game in which the specified event must happen; insurance, however, is not a zero-sum game and the specified event may not happen. Also, insurance requires insurable interest in the subject matter, the policyholder is entitled to compensation only if the policyholder suffers a loss, and the amount of compensation depends on the amount of loss (Fisher 2013).

In 1985, the International Islamic Fiqh Academy passed a ruling upholding that *takaful*—the Arabic word for solidarity—through a donation (*tabarru*) contract is acceptable because *gharar* is tolerated in this contract. Instead of selling risk, *takaful* should be based on risk sharing. By avoiding *riba*-based investments, the *takaful* arrangement is, arguably, made consistent with Islamic commercial jurisprudence.

Takaful faces its own set of institutional, legal, and regulatory issues. For instance, legal systems in many countries do not accept a mutual or cooperative form of entity without shared capital. Where such a mutual entity can be set up, it may find it difficult to raise enough capital to meet regulatory requirements.

The majority of *takaful* providers are set up as hybrids of mutual and proprietary insurance, in which a for-profit shareholder-owned company operates the mutual *takaful* pool. Insurance cover is provided by the *takaful* participants to each other through the participants' *takaful* fund, and the *takaful* operator manages the underwriting and investment on behalf of the *takaful* participants.

Shari'a scholars may vary in their opinions about *takaful* in matters such as the following:

- Should shareholders of the *takaful* operator share in any underwriting surplus?
- Can the charitable endowment (*waqf*) model be used in *takaful*?

Exhibit 1 provides the distinctions between a joint stock company, a mutual insurance company, and a hybrid *takaful*.

Unlike a mutual insurance company (which bundles shareholder and policyholder rights for its members), in the hybrid *takaful*, control rights are vested with the shareholders of the operating company. In general, agency (*wakala*) contracts and investment management (*mudaraba*) contracts are used between the participants and the operator for, respectively, underwriting and investment management. The *takaful* operator earns a fee on the underwriting contributions and shares a part of the profit from investments. In the case of a deficit in underwriting, the *takaful* operator is usually required by law to extend an interest-free loan to the *takaful* fund to be recovered from future surpluses.

In practice, a hybrid *takaful* may not be fundamentally different from conventional mutual insurance. For instance, in a pure *takaful* scheme, a "solidarity group" is expected to establish the *takaful* and make all crucial decisions. In a hybrid *takaful*, the *takaful* operator, which is a for-profit company, establishes the *takaful* and makes the decisions. The donations by participants are not voluntary and altruistic but a condition for receiving compensation from the pool for specified losses suffered. The participant may also be required to pay further contributions in case of an underwriting deficit in the pool, and the shareholders' equity of the *takaful* operator is typically used to extend mandatory interest-free loans for meeting any underwriting deficits. Furthermore, *takaful* operators may cede significant portions of underwriting to conventional reinsurance companies (Archer, Karim, and Nienhaus 2009).

Exhibit 1. Joint Stock Company, Mutual Insurance Company, and *Takaful*: Allocation of Risk by Type of Operation

Setup	Underwriting Risk	Expense Risk	Operational Risk	Investment Risk
Joint stock company	Stockholders	Stockholders	Stockholders	Stockholders
Mutual insurance company	Policyholders	Policyholders	Policyholders	Policyholders
Hybrid *takaful*	Participants	Stockholders	Stockholders	Stockholders for the operator's fund and participants for the participant's funds

Source: Kassim (2012). Table has been modified from author's original.

Shari'a constraints apply to the investments of *takaful* funds, which are usually made in equities, *sukuk*, real estate, and profit-sharing investment accounts with Islamic banks. The hybrid *takaful* structure is a deviation from true blue mutuality and, therefore, creates additional complications. For instance, the capital of the *takaful* operator is supposed to stand behind the participants' risked funds for regulatory reasons, but the *takaful* operator cannot explicitly earn a price for this capital backing because to do so is considered *riba*.

According to one industry report,

> Global gross takaful contributions are estimated to reach US$11 b[illion] in 2012 (from US$9.4 b[illion] in 2011). Saudi cooperatives account for approximately 51% of the global contributions. Year-on-year growth has slowed from the 2007–11 CAGR [compound annual growth rate] of 22% to a more sustainable growth rate of 16%. (EY 2013b)

Derivatives. The use of derivatives, particularly their secondary trading, remains an area of much controversy in Islamic finance. Some reasons for needing derivatives seem obvious (e.g., to deal with foreign exchange risk). Critics find some other reasons, however, to be unconvincing—for instance, embedding interest (tied to a conventional interest rate benchmark) in credit sales, calling it profit rather than interest, and then needing to manage interest rate risk. Reasons for controversy about secondary trading include lack of underlying real assets, cash settlement, and real and perceived problems with speculation. Although trading of derivatives in the secondary market has so far been constrained in Islamic finance, over-the-counter derivatives for hedging are gaining ground.

Derivatives structures in Islamic finance are often created from combinations of synthetic credit sales and unilateral undertakings. For instance, a "profit rate swap" is created when the parties effectively swap fixed-rate and floating-rate interest payments while apparently buying and selling commodities on fixed and floating profit rates, with the "profit" element of the floating rate benchmarked to a conventional interest rate. A profit rate swap may also be structured as a series of promises whereby the parties undertake to swap relevant fixed- and floating-rate payments at a specified time in the future. Similarly, in a cross-currency swap, two commodity sale contracts are used to generate offsetting cash flows in opposite currencies with the maturities desired by the contracting parties.

A total return swap has been designed that uses a dual promise (*wa'ad*) contract, which swaps the returns of a Shari'a-compliant asset portfolio with those of a designated index or reference investment portfolio that can contain conventional non-Shari'a-compliant assets. Shari'a scholar Yusuf DeLorenzo (2007) has criticized this structure primarily on the grounds that returns from the alternative portfolio are not derived from religiously acceptable activities.

Iqbal, Kunhibava, and Dusuki (2012) argue, "While Usmani, the OIC Fiqh Academy, De Lorenzo and Kamali have not made a distinction between an option that is traded independently and an embedded option, Elgari's distinction would seem to be in line with the approval of *urbun* [a call option] by AAOIFI" (p. 17). They go on to state their support for "the view that when an option is stand-alone and can be traded independently, the premium paid for it is impermissible; however, when the option is embedded in a larger transaction, is similar to *urbun*, and a fee is paid on it, this would be permissible" (p. 17).

In March 2010, the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) released an ISDA/IIFM *Tahawwut* (i.e., hedging) Master Agreement to standardize certain derivatives transactions that are Shari'a compliant. This step is seen as the first globally standardized documentation for privately negotiated Islamic hedging products, but it is not known to have gained major traction in the market so far.

Microfinance. Given Islam's emphasis on justice and redistribution, Islamic finance is expected to have a natural affinity with initiatives to reduce poverty through microfinance. Institutionally organized microfinance in Muslim-majority countries and Islamic commercial banking were introduced around the same time. The first Islamic commercial bank, Dubai Islamic Bank, was established in 1975, and the research project that led to the establishment of Grameen Bank in Bangladesh started in 1976. Islamic commercial banking is not primarily targeted, however, at the poorer segments of society.

As in the rest of Islamic finance, Islamic microfinance also uses nominate contracts and promises to make microfinance Shari'a compliant, and trust sale (*murabaha*) is the preferred financing method (El-Zoghbi and Tarazi 2013). Obaidullah and Khan (2008) identified four models of microfinance that have been used by Islamic microfinance initiatives: the Grameen model, village banks, self-help groups, and credit unions.

Islamic microfinance is also geographically clustered. According to El-Zoghbi and Tarazi (2013), 80% of Islamic microfinance customers live in Indonesia, Bangladesh, and Sudan. The reach of Islamic microfinance is low when compared with that of conventional microfinance (currently, it is about 1% of conventional microfinance).

An example of Islamic microfinance is Akhuwat (Brotherhood) in Pakistan, which is a not-for-profit initiative launched in 2001. Akhuwat is based on the Islamic tradition of using charitable donations (*sadaqa*) and interest-free loans (*qard hasan*) to help those in need. Akhuwat has "incorporated many of the best practices and lessons learnt from conventional microfinance movements from across the globe as well."[17] Akhuwat's framework relies on the provision of

[17]See the organization's homepage: http://akhuwat.org.pk.

interest-free loans, the use of religious institutions to disburse loans, volunteers, and growth from the donations of borrowers who have managed to settle their loans. From a humble beginning, Akhuwat has emerged as a success story in extending credit to small businesses previously excluded from the conventional system. Although limited empirical research has been conducted into its social impact, Akhuwat is seen as an exceptional case of true Islamic finance, in which both the means and the ends are free of the criticisms facing the Islamic finance industry at large. Ironically, Akhuwat was started independently of the Islamic finance industry. So far, it does not use the formal trappings of the industry, such as a Shari'a supervisory board.

It is worth mentioning that microfinance itself has come under critical scrutiny. For instance, Bateman (2010) argues that microfinance can accentuate poverty traps. With the possible exception of interest-free loans, Islamic microfinance is susceptible to similar criticism.

Regulatory Issues

How the Islamic prohibitions against *riba* and excessive *gharar* are put into practice through nominate contracts and promises poses new regulatory challenges. A key challenge for Islamic finance is that it sits uncomfortably within a regulatory structure that was primarily meant for conventional finance. For this reason, Islamic financial instruments, particularly those in commercial banking, may be similar in substance to their conventional counterparts. However, some peculiarities of Islamic finance raise additional regulatory issues. Discussion in this section will be restricted to these issues.

Highlights of this section are as follows:

- Islamic finance, in general, and commercial banking, in particular, are square pegs in the round hole of the legal and regulatory framework meant for conventional finance, particularly conventional commercial banking.
- In terms of risk management, two risks specific to Islamic finance are Shari'a risk and displaced commercial risk.
- Islamic finance has no single set of globally accepted Shari'a standards.

Regulation of Islamic Finance

The regulatory literature on Islamic finance focuses on Islamic commercial banking, which is also the largest segment in Islamic finance. A secondary focus is on *takaful* given its special requirements. Collective investment schemes pursued in Islamic finance generate fewer regulatory issues because most fit within the relevant regulatory structure with relative ease.

Regulation of Islamic finance varies among countries. Malaysia has legislation concerning Islamic finance, and it has established central Shari'a boards at the central bank and securities commission and has taken a strong interest in the development of Islamic finance. In other countries, such as the United Kingdom, Shari'a-compliant banking falls under the same supervisory regime as conventional banking. The UK regulators have ensured a neutral tax regime for Islamic finance that consists of "no obstacles, but no special favours" (Ainley, Mashayekhi, Hicks, Rahman, and Ravalia 2007, p. 11).

Islamic commercial banking is, in theory, not built on interest-based monetary loans. This characteristic creates a challenge—on the asset and liability sides—for any legal and regulatory framework that was developed primarily for conventional banking that is based on interest-bearing monetary loans. This helps explain the widespread reliance in Islamic finance on *de facto* debt-based instruments that embed interest on both the liability and asset sides, despite the theoretical preference for profit-sharing arrangements.

On the liability side, Islamic investment accounts are meant to be collective investment schemes, but because they operate within the commercial banking framework, they are made to act like conventional deposits that are interest-bearing loans. Similarly, on the asset side, Islamic financing is largely based on credit sales and leases. These forms are also similar to interest-bearing debt. A common problem for Islamic banks is that they cannot hold conventional debt securities to meet prudential regulatory requirements. In January 2013, the Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision recognized this as an "insurmountable impediment" (Thomas 2009). National supervisors were advised to exercise their discretion in defining Shari'a-compliant financial products, especially *sukuk*, as eligible high-quality liquid assets to meet the liquidity requirements of Basel III. *Takaful* operations are beset with a similar dilemma. Within the general hybrid structure where mutual risk funds are contractually attached to a limited-liability company, the company operating the *takaful* funds offers capital backing to the *takaful* funds through an interest-free loan to meet the regulatory solvency requirements.

Risk Management

The two major risks unique to Islamic finance are Shari'a risk and displaced commercial risk.

Shari'a Risk. Shari'a risk can take more than one form. For instance, if financial structures marketed as Shari'a compliant are viewed as noncompliant, they may lose their viability. The 2007 critique of *sukuk* structures by Usmani (2007) reportedly affected the *sukuk* market. In another form of Shari'a risk, if a product is found to be noncompliant, it may have to be taken off the market and any profit it made channeled to a charity.

Bälz (2008) argues that because the law that often governs Islamic finance transactions tends to be the law of the land rather than Shari'a law, references to Shari'a in legal documents can be a source of legal uncertainty. In some English court cases, Shari'a has been rejected as the governing law of a contract. In the case of *Beximco Pharmaceuticals Ltd. v. Shamil Bank of Bahrain*, the contract in question stated that "subject to the principles of Glorious Sharia'a, this agreement shall be governed by and construed in accordance with the laws of England."[18] At trial, the judge, while dealing with the question of the applicable law, referred to the Law Applicable to Contractual Obligations 1980,

[18]See *Beximco Pharmaceuticals Ltd. v. Shamil Bank of Bahrain*, England and Wales Court of Appeal, Civ 19, Case No. A3/2003/1952 (2004): www.bailii.org/ew/cases/EWCA/Civ/2004/19.html.

also known as the Rome Convention, and stated that the convention made provision only for the choice of law of a country and did not provide for the choice of law of a nonnational system of such law as Shari'a law. The court held that a contract can have only one governing law and that parties to a contract can agree only to adopt the law of a country as the governing law of a contract. Therefore, according to English law, because Shari'a law is a nonnational system of law, it cannot be the governing law of a contract.

An alternative argument made to the English Court of Appeal was that, with English law being the governing law of the contract, it is possible to incorporate general Shari'a principles as terms of the contract. This argument was also rejected. Lord Justice Potter finds the attempt to incorporate by reference the "principles of Glorious Sharia'a" to be too vague to be effective. He stated,

> The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable in this case are not controversial. Such "basic rules" are neither referred to nor identified. Thus, the reference to the "principles of... Sharia" stands unqualified as a reference to the body of Sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and, therefore, meaningless. (*Beximco v. Shamil Bank* 2004)

This case demonstrates that general references to the principles of Shari'a law will not hold, at least by the English courts. The problem is exacerbated by the divergence of opinions among scholars as to the principles in question. On this issue, Lord Justice Potter made the following comment:

> Finally, so far as the "principles of... Sharia" are concerned, it was the evidence of both experts that there were indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute.(*Beximco v. Shamil Bank* 2004)

While noting that there has been a tendency to favor court litigation as a means of resolving disputes in Islamic finance, Lawrence, Morton, and Khan (2013) argue in favor of arbitration in Islamic finance transactions. They say that

> due to the diverse backgrounds of the parties involved, the specialist nature of the agreements and the potential variety of legal jurisdictions in play, there may be considerable benefits in having an authoritative common platform to resolve disputes as they arise in a manner that is guided by the Sharia within a modern commercial context.

In fact, many Middle Eastern countries are adopting the United Nations Commission on International Trade Law's model law for their arbitration law, signing the New York Convention (i.e., the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards) and establishing local arbitration centers in the region.

Displaced Commercial Risk. Although investment accounts are meant to be profit sharing, Islamic banks may not be able to pass a loss or offer a lower-than-competitive return to investment account holders because of commercial or regulatory reasons. Cases of an Islamic investment holder being passed a loss are conspicuous by their absence. The implication is that shareholders' capital bears the risk that the capital of the investment account holders was supposed to bear. This issue is known as "displaced commercial risk" in Islamic banking. Prudent regulators may, therefore, require Islamic banks to build reserves and keep certain capital to cover for displaced commercial risk.

Accounting Standards

The application of conventional accounting standards to Islamic finance runs into major issues pertaining to (1) the time value of money and (2) putting substance over form. For example, applying conventional accounting standards to *murabaha* financing results in the structure being recorded as a loan (rather than a sale) with interest (rather than profits). The AAOIFI has issued Financial Accounting Standards (or FASTs) for Islamic finance.

Shari'a Standards

Despite the Shari'a standards issued by the AAOIFI, there are significant differences in interpretations and practices not only between jurisdictions but also within jurisdictions. Differences of opinion in interpreting a point of law are inevitable and are certainly not confined to Islamic jurisprudence. These differences, however, create difficulties for the practitioners who want global Shari'a standards that can be used to create products and services that will be universally seen as Shari'a compliant (Oxford Business Group 2013). In the discussion of the absence of global Shari'a standards, the differences between Malaysia and the Gulf Cooperation Council countries are frequently highlighted. A major difference is that in Malaysia, financing based on a credit sale with immediate spot repurchase between the same parties (*bai-al-inah*) and sale of debt (*bai ul dayn*) are deemed acceptable, but in the countries of the Gulf Cooperation Council, they are generally not. Rosly and Sanusi (1999) note that most Islamic bonds issued by Malaysian companies today have been heavily structured with the use of credit sales with immediate repurchase and sale of debt; therefore, these structures are "less acceptable to some Middle-eastern investors" (p. 1).

Other differences include use of the investment management (*mudaraba*) model for underwriting in *takaful*.

Malaysia did not apply financial ratio screening (e.g., for debt levels) while identifying permissible stocks (Securities Commission Malaysia 2013 Update)—a practice that is changing and converging with international trends ("Malaysian Sharia Rules Cut 20% from Stock Pool" 2014).

Whether global Shari'a standards are feasible or even desirable is a matter of debate. A basic point is often overlooked in the discussions of the lack of global Shari'a standards: The differences regarding Shari'a pertain largely to debt and derivatives; profit-sharing arrangements in socially responsible businesses are unlikely to be deemed controversial anywhere.

Governance and Responsibility

We have covered substantial ground in Islamic finance—from laying out the context to the specifics of Islamic finance and the issues created in regulation. In this section, we discuss specific issues related to governance and ethics in Islamic finance.

Highlights of this section are as follows:

- Peculiarities of Islamic finance raise a distinct set of corporate governance issues specific to the industry.
- Shari'a governance is a sensitive area of Islamic finance, particularly owing to the conflicts of interest facing Shari'a scholars.
- Notions of corporate social responsibility, environmental sustainability, and ethics resonate well with Islamic teachings, but the practice of Islamic finance is not necessarily driven by such notions.

Shari'a Governance

Shari'a supervisory boards perform a critical function in Islamic finance. Generally, the role of the Shari'a board includes issuing religious rulings, supervision, and review. Through their religious rulings (or *fatwa*), the boards determine whether a particular product or transaction complies with Shari'a. These rulings are also informed by such sources as the Shari'a standards set by the Bahrain-based AAOIFI and the resolutions of the Jeddah-based International Islamic Fiqh Academy.

Shari'a governance is linked to the corporate governance of Islamic financial institutions. A common model is that the institution has an external Shari'a supervisory board and an internal Shari'a compliance organization. Depending on their needs, some institutions may rely on a Shari'a advisory firm and its Shari'a board on an ongoing basis or to obtain religious rulings on particular transactions. Although these religious rulings are generally disclosed, there is no central database for such rulings and their underlying reasoning also remains largely undisclosed.

According to Shari'a governance standard by the standard setter AAOIFI, members of Shari'a supervisory boards are to be appointed by shareholders at each institution's annual meeting; each board should have at least three members who are experts in Islamic commercial jurisprudence, although the board may include one member with expertise in Islamic finance rather than jurisprudence. The standard setter IFSB has also provided guiding principles regarding Shari'a supervisory boards; these principles cover the board members' competence, independence, confidentiality, and consistency (IFSB 2009).

The three main approaches to regulating the function of Shari'a advisory services in Islamic finance are as follows: (1) specific and dedicated legislation (Malaysia, Brunei, and the UAE), (2) specific provisions about Shari'a advisers in general legislation (Indonesia, Kuwait, the United Kingdom, and Bahrain), and (3) guidelines and circulars (e.g., Pakistan and Singapore).[19] Hasan (2012) notes significant differences in the general approaches to Shari'a governance. These differences pertain to, among other things, the regulatory framework for Shari'a governance, the roles and functions of the Shari'a board, and the attributes of the Shari'a board in terms of competence, independence, transparency, and confidentiality. He claims that the disclosure in various aspects of Shari'a governance is "still at a very minimal and weak level" (p. 215).

An important controversial issue in Shari'a governance is conflict of interest. This has several aspects. For instance, a Shari'a scholar in possession of confidential information may be on the Shari'a supervisory board of multiple institutions, or a Shari'a scholar may assume both supervisory and advisory or audit responsibilities for the same client. The most obvious conflict of interest, however, is for a Shari'a scholar to be paid by a client financial institution that is seeking his opinion. In this case, the opinion of the Shari'a scholar can be influenced by his commercial interest. In the worst case, the religious ruling can simply appear to be purchased.

Neither the Kuala Lumpur–based IFSB nor the Bahrain-based AAOIFI has directly addressed this obvious conflict of interest in Shari'a governance. Others, however, have addressed it candidly. Kahf (2001) opines that the alliance of wealth and Shari'a scholarship has led to changes in the lifestyles and opinions of these scholars: "Many of them are now accused of being bankers' window dressing and of over-stretching the rules of Shari'a to provide easy *fatwas* [religious rulings] to the new breed of bankers" (p. 15).

Issues of independence are not just confined to Shari'a scholars affiliated with Islamic financial institutions. Scholars on central boards set up by central banks or securities commissions may be subject to similar conflicts of interest—between protecting their careers from the politically powerful and giving independent opinions. The report "The Small World of Islamic Finance: Shari'a Scholars—A Network Analytic Perspective, Version 6.0" (Unal 2011) shows that the top 20 Shari'a scholars hold 14–85 positions in Islamic financial institutions. The report raises a number of governance-related questions. One question relates to the simultaneous representation of the same Shari'a scholars in financial institutions, on national Shari'a boards, and in international standard-setting organizations, which undermines checks and balances.

[19] See Hassan, Abdullah, Hassan, Ibrahim, Sawari, Aziz, and Triyanta (2013).

Scholars responding critically to the report argue that, although the current arrangement is not optimal, it reflects the paucity of scholars with the necessary skills (see, for example, Siddiqui 2010).

Malaysia limits the number of Shari'a boards in Malaysia on which a Shari'a scholar can serve—namely, one for banking and one for *takaful*. That limit does not apply, however, to boards outside Malaysia. Also, in Malaysia, under the Islamic Financial Services Act 2013, scholars may be jailed for up to eight years or fined as much as 25 million ringgit (US$7.6 million) if they fail to comply with the central bank rules. This act is regarded as the first case in which Shari'a scholars have been expressly made accountable ("Malaysia Exposes Shariah Scholars to Jail for Breaches" 2013).

In defense of Shari'a scholars, an analogy is often drawn between them and financial auditors. The crux of the argument is that the financial auditor faces a similar conflict of interest but that conflict does not compromise the credibility of the audited financial statements. Therefore, conflicts of interest with reference to Shari'a scholars should not cast doubt on the credibility of Shari'a compliance.[20] Financial institutions undergo audits whether they are Islamic or not. A financial auditor has a public interest role, and this role is an established position. Shari'a scholars also obviously have a public interest role. Some checks and balances are common to auditors and Shari'a scholars. Both may be selected on the basis of a vote by shareholders rather than simply appointment by the management. Some checks and balances, however, apply to auditors but not to Shari'a scholars. For instance, auditing is an internationally and domestically regulated profession. In addition, auditors work according to standards with less room for discretion, arguably, than do Shari'a scholars.

Despite these checks and balances, financial auditors are paid by the companies they audit, and there is continuing debate on the independence of external financial audit. Some have suggested that auditors should be paid by an independent third party, such as a stock exchange (Romero 2010). In a commentary on current issues in auditing, it is reported that the chairman of the US-based Public Company Accounting Oversight Board (PCAOB)

> believes that the current arrangement, where the auditor is paid by the auditee, and long associations exist between auditors and clients, particularly large

[20]See Davies and Sleiman (2012). The article quotes Shari'a scholar Sheikh Hussein as follows: "What's wrong with getting paid for issuing a fatwa or reviewing the sharia compliancy of a financial instrument?…We're just like auditors, lawyers. Each one of us has years and years of experience in sharia law. We do our job and get paid for it. Nobody is allowed to question our honor, integrity and truthfulness."

> clients, are issues that must be addressed to fulfill the mission of the PCAOB. (Roush, Church, Jenkins, McCracken, and Stanley 2011, p. C16)[21]

Auditors' conflicts of interest have hurt stakeholders in several cases—from Enron and Tyco International to Adelphia Communications Corporation, Peregrine Systems, and WorldCom (Moore, Tetlock, Tanlu, and Bazerman 2006).

Media reports have shown that the perception of a conflict of interest in Shari'a governance affects the credibility of the Islamic finance industry. A news item from the BBC reports the following statement by an unidentified investment banker based in Dubai:

> We create the same type of products that we do for the conventional markets. We then phone up a Sharia scholar for a Fatwa [religious ruling]...if he doesn't give it to us, we phone up another scholar, offer him a sum of money for his services and ask him for a Fatwa. We do this until we get Sharia compliance. Then we are free to distribute the product as Islamic. (Foster 2009)

In 2013, Shari'a scholars took a step toward self-regulation by establishing an association, a British-registered charity, that, among other things, is expected to establish a code of conduct and continuing professional development requirements (Vizcaino 2013).

Corporate Governance

In Islamic banking, corporate governance issues arise mainly in relation to investment accounts. The holders of these accounts, unlike the shareholders of the bank, lack any control rights, especially voting rights to appoint the board of directors, Shari'a supervisory board, or auditors. The restricted investment accounts are similar to collective investment schemes, which raise corporate governance issues pertaining mainly to the right to information of the account holders. Unlike conventional collective investment schemes, restricted investment accounts are not separate legal entities. The disclosure requirements that apply to collective investment schemes to facilitate monitoring by investors do not apply to these restricted investment accounts.

The case of unrestricted investment accounts is more complicated than that of restricted investment accounts because of the commingling of their funds with shareholder funds, which creates potential conflicts of interest between the account holders and shareholders. The shareholders may have a greater appetite for risk than the account holders, who are often retail savers seeking

[21]The PCAOB is a US-based not-for-profit corporation "established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports" (from the PCAOB website: http://pcaobus.org).

modest returns with capital protection. A bank may allocate the funds to higher risk investments than may be suitable for the unrestricted account holders. The allocation of profits between the investment account holders and the shareholders can also be manipulated by the management.

The use of a "profit equalization reserve" and "investment risk reserve" by Islamic banks to, respectively, smooth returns and cover potential losses attributable to unrestricted investment account holders generates separate corporate governance challenges. The account holders do not typically have a say in the creation and use of these reserves. Moreover, without adequate disclosure, these reserves may mislead investors about the performance of investments.

Because both the restricted and unrestricted investment accounts have no control rights, if these account holders are unhappy with the bank, the main recourse available to them is to vote with their feet and, subject to contractual restrictions (e.g., notice periods), move to another bank. Competition between banks may not, however, be an adequate safeguard for protecting the interests of investment account holders because of the cost and hassle involved in switching. Also, account holders can discover poor performance only *ex post*.

Whether the investment account holders want control rights and would be able to use them effectively to protect their rights is doubtful. Thus, one suggestion to address this issue is to establish a governance committee of the bank's board of directors. It would comprise a nonexecutive director who is member of the audit committee, a Shari'a scholar who is a member of the bank's Shari'a supervisory board, and another able nonexecutive director to protect the interests of the investment account holders. The effectiveness of such committees, however, is open to question, and the banking supervisor would have to play an active role in ensuring that this committee, if created, would be able to do its job (Archer and Karim 2013).

In *takaful* undertakings, which are usually a hybrid between mutual and a proprietary insurance, the principal corporate governance challenge is that the *takaful* participants do not possess governance rights. These rights are exercised by shareholders of the *takaful* operator, and in case of a conflict of interest between shareholders and policyholders, the operator may favor the shareholders with control rights. The situation is different from that of mutual insurance companies, where policyholders have most of the stakeholder rights possessed by shareholders of proprietary companies (Archer, Karim, and Nienhaus 2009).

Like the investment account holders in an Islamic bank, the policyholders in *takaful* have the option of voting with their feet. Again, however, competition is unlikely to be an adequate safeguard. Critical information, especially about how claims are handled, may be discovered only several years after account holders have paid their contributions. Moreover, in the case of life insurance products, the cost of switching can be significant. As for dealing with the governance challenges of Islamic investment accounts, a suggestion to address the corporate governance issues in *takaful* is to establish a committee of the board (comprising, for example, an actuary, a Shari'a scholar, and a nonexecutive director) that would be supervised by the insurance regulator to protect policyholders' interests.

With regard to corporate governance, there are limited structural differences characterize Islamic and conventional collective schemes. The principal difference is that Islamic schemes need to have an additional arrangement for Shari'a governance.

Islamic Finance and Corporate Social Responsibility

The ethical principles underpinning Islamic finance clearly overlap with those underpinning corporate social responsibility (CSR). An OWW Consulting report (Williams and Zinkin 2010) argues that

> with the possible exception of Islam's focus on personal responsibility and the nonrecognition of the corporation as a legal person, which could undermine the concept of corporate responsibility, there is no divergence between the tenets of the religion and the principles of the UN Global Compact [the widely recognized framework for CSR]. Indeed, Islam often goes further and has the advantage of clearer codification of ethical standards as well as a set of explicit enforcement mechanisms. (Abstract)

Beyond the core prohibitions, much of what may be considered ethical in Islamic finance is covered in the standard titled "Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions" set forth by the Bahrain-based AAOIFI. The standard states that it is based on such ideas as man being a vicegerent of God. **Exhibit 2** provides a top-line view of the standard covering the mandatory and recommended conduct.

Exhibit 2. The AAOIFI Standard on CSR

Mandatory Conduct	Recommended Conduct
Client screening (e.g., client's business should not be against Islamic teachings or core CSR aspects of this standard)	*Qard hassan* (interest-free loan)
Responsible dealings with clients (e.g., avoiding imposing onerous terms, encouraging inappropriate consumption)	Reduction of adverse impact on the environment (e.g., waste management, renewable energy)
Earnings and expenditure prohibited by Shari'a (e.g., identification, disposal)	Social-, development-, and environment-based investment quotas
Employee welfare (e.g., equal opportunity)	*Par excellence* customer service
Zakah (an obligatory religious contribution)	Micro- and small businesses; social savings and investments
	Charitable activities
	Waqf (Islamic endowment) management

A report based on surveying AAOIFI's CSR standard in 2009–2010 finds that "overall, the results suggest that IFIs [Islamic financial institutions] do have a good start on most aspects of social responsibility, contrary to criticisms leveled at the industry" ("Social Responsibility Trends at Islamic Financial Institutions" 2010, p. 4). Another survey-based study finds, however, that IFIs fall short of "the ethical and social objectives implied by Shari'a."[22] Furthermore, CSR is "not of major concern for most Islamic banks." The literature does not provide a clear conclusion on performance of Islamic banks on CSR.

At a more fundamental level, what is "ethical" is typically not clearly explained in Islamic financial practice. Wilson (2002) argues that "Islamic banks often describe themselves as being providers of ethical financial services, but they do not spell out explicitly what is meant by this or its significance" (Abstract) and "although Islamic banks continue to be heavily involved in trade finance through *murabahah* (credit sales) and other Islamic financing instruments, they seldom refer to fair trading practices" (p. 11).

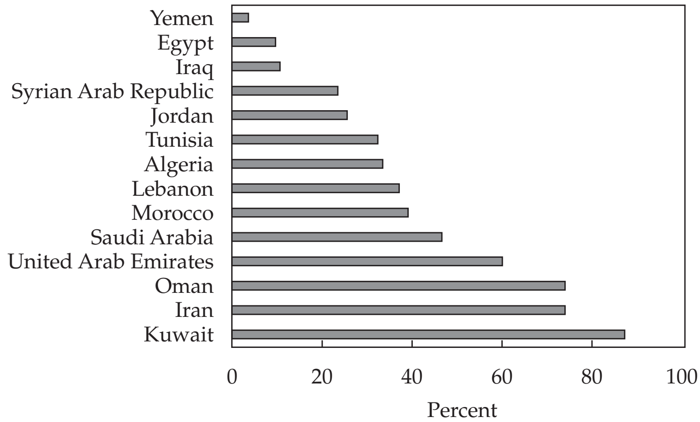
Regarding doing good and avoiding harm to society and the environment, noted economist Milton Friedman argues that the job of a company's management is to maximize profit for the shareholders (see, for example, Friedman 1970). By implication, profitable business leads to a prosperous society, and if shareholders want to do something charitable, they can do so in their private lives. This argument is invoked in Islamic finance to make the point that the job of Islamic financial institutions is to make money for the shareholders in a Shari'a-compliant manner rather than engage in social causes (see, for instance, "Islamic Financial Intermediation" 2012).

A counterargument is that, to justify the "Islamic" label, financial institutions need to go beyond simply changing the form of financing and be concerned with social welfare. For example, Islamic banking should focus on expanding access to finance, and Islamic project financing should push for fair treatment of construction workers and for reducing inefficiencies in energy, waste, water, and carbon emissions. In short, Islamic finance is expected to be like what is being referred to as "impact investing," making a profit while committing to making a positive difference and minimizing harm.

Access to Finance. Although improving access to finance is not explicitly covered in the AAOIFI's standard on CSR, it is a core aspect of CSR that can be reasonably expected from Islamic finance. Large parts of the Muslim world are underserved by formal banking institutions, as shown by survey evidence compiled by the World Bank. **Figure 1** shows that in 2012 in the Middle East and North Africa, for example, a mere 18% of adults had an account with a formal financial institution—the lowest average of all other developing regions. In Egypt, Yemen, and Iraq, the percentage was less than 10%. Financial access was

[22]This and the remaining quotations in this paragraph are from Aribi and Arun (2012).

Figure 1. Account at a Formal Financial Institution, 2012



Note: Individuals surveyed were aged 15 and over.
Source: Based on data from the World Bank's Global Findex Database.

particularly inadequate for people in the bottom 40% of income distribution, and only 5% of the surveyed adults had received a loan from a financial institution.[23]

Islamic finance has an urban bias and focuses on what the bankers call "the bankable" (see, e.g., customer profiles in Khan and Khanna 2010). In rural settings, where credit market imperfections are rife and informal finance is typically controlled by money lenders, Islamic finance is usually absent. In Pakistan, for example, 86% of the rural population remains unbanked,[24] while Islamic banking remains concentrated in cities.

Sustainable and Responsible Investing. Both Islamic finance and ethical finance in the conventional domain are concerned with the *purpose* of financing and with avoiding harm and doing good. However, Islamic finance, given its insistence on avoiding *riba* and excessive *gharar,* is also concerned with the structure of financing, which does not figure as an ethical concern in socially responsible investing (SRI).

The SRI movement is rooted in investment approaches based on Christian beliefs. The idea of custodianship or stewardship (much like the idea of vicegerency in Islam) was central to 18th-century philosophers, such as John Wesley. They believed that investors should not act as owners but as stewards or custodians of property and that wealth should not be created while harming one's neighbor. To avoid investments that are inconsistent with the faith, the principal method used is exclusionary screening—that is, avoiding investments that are inconsistent with values of the investors. Some of the earliest funds that

[23]Only 9% of adults are in the bottom 40% of the income range.
[24]This is an estimate of the State Bank of Pakistan.

captured this spirit are the Pioneer Fund (launched in 1928 by the US Federal Council of Churches) and the Pax World Fund (launched in 1971).[25]

In the secular space, the ethical standards cater to the needs of specific constituencies. Some people are sensitive to certain global norms, such as reduced carbon emissions; others may worry about sale of controversial weapons. Financial institutions can address those concerns in their financing and investment products through different methods, such as exclusionary screening, best-in-class investing, and active ownership.

In Islamic finance, the ethical framework is guided by Islamic teachings, in which the primary sources remain unchanged even though human understanding of divine guidance evolves over time. Thus, ethical finance in the secular domain can be more selective in its approach than can Islamic finance. For instance, an Islamic equity fund will typically screen out all sin industries (from alcohol to conventional banking) but also avoid highly leveraged companies and donate tainted dividend income to charity. A conventional fund might describe itself as ethical by simply screening out any one sector (e.g., tobacco) or, for that matter, none at all. Thus, at least in theory, Islamic finance seems to place greater ethical constraints on financing than does secular ethical finance (Hayat 2010).

Collaboration between Islamic finance and SRI remains limited, however. Whether considering industry events, reports, or educational qualifications, SRI and Islamic finance traverse in separate domains. Occasionally, a financial product will combine some traditional Islamic and modern environmental, social, and governance (ESG) criteria. A prominent example is the Dow Jones Islamic Market Sustainability Index (introduced in 2006) or a "green" *sukuk*. Such products remain an exception, however.

Ecology. A peripheral area for Islamic finance, but one with great significance for contemporary CSR and SRI, is ecology. Environmental concerns have received scant attention in Islamic finance. The prevailing criteria for assessing whether a financial arrangement is permissible under Islamic finance is largely concerned with nominate contracts and identification of traditional sin activities. Although ecological concerns do not figure prominently in Islamic financial practice, the same could not be said for Islam.

Key references on Islam and ecology seek inspiration from the Prophet Mohammad's tradition, which reportedly accords great respect to the maintenance of plants and trees, land cultivation and irrigation, crops, livestock, grazing, water distribution, water sources, wells and rivers, and water rights. The literature on Islam and ecology frequently refers to two related Islamic notions—namely, land distribution and land consecration (see, e.g., Haq 2001). Recent environmental concerns, such as carbon emissions, have not, however, attracted specific rulings from contemporary scholars.

[25]For more on the ideas discussed in this paragraph, see Hobeika and Husson-Traore (2009).

El Diwany (2003) makes a direct connection between lending money at interest and ecological degradation. He claims that charging interest and growth of debt through credit creation are important causes of ecological degradation because nations are pushed to overexploit nature to service their interest-bearing debt. Dutton (2003) also points to usury and credit creation as forces inimical to sustainable development. Credit creation, in this view, artificially spurs large projects with large financing requirements, which lead to further exploitation of finite natural resources.

Even with profit-sharing modes, the question remains whether profit sharing is sufficient to "avoid harm and do good." For instance, one can establish a legitimate equity-financed business, but much depends on how the business deals with ESG issues—air and water pollution, managing relationships with the labor force and communities, or ensuring independence and diversity on the board. So far, the focus in determining what is licit in Islamic finance has been on certain prohibited activities and legal contracts rather than possible impact on society and the environment.

In practice, environmental concerns are peripheral to Islamic finance. The AAOIFI standard on CSR also relegates environmental issues (e.g., reduction of an adverse impact on the environment) into voluntary conduct, whereas issues directly related to society (e.g., employee welfare) are part of mandatory conduct. Practices, however, seems to lag even the CSR standard suggested by the AAOIFI. The Global Islamic Finance Report 2010 (BMB Islamic 2010) notes that none of the Islamic banks from the Gulf Cooperation Council countries have adopted the Equator Principles for managing environmental and social issues in development project finance.[26]

[26]The Equator Principles are defined at www.equator-principles.com.

Political Economy of Islamic Finance

Although the voluminous literature on Islamic economics and finance pays only passing attention to the political economy, we try to provide here a selection on the interface between the two. As in the other sections, rather than being comprehensive, we aim to cover the most salient themes—institutional incentives and the rule of law—and also provide a brief overview of various country experiences.

Highlights of this section are as follows:

- Although Muslim societies have, in general, not restricted *riba*-tainted conventional finance, some of them have gone to great lengths to restrict trade to avoid the emergence of economic power that is independent of state patronage.
- Countries have followed quite different paths to Islamic finance with varying levels of support, or even opposition, from the government.
- The practice of Islamic finance by private institutions avoids direct political association; it is to a large extent independent of what is, at times, described as "political Islam."

Institutional Incentive Structure for Production

Islamic finance—both its modern conception and earlier experience—is mediated by the underlying institutional structure that governs production and trade. The story of Islamic finance, in the words of Warde (2010), "cannot be captured without a full understanding of religion and finance, but also of history, politics, economics, business, and culture" (p. 3). Since the Ottoman era, the relationship between the state and productive classes has been strained in large parts of the Middle East. The merchants lay at the lower rung of the hierarchy of power and privilege, with sultans, scholars, and bureaucrats monopolizing economic privileges (Hourani 2005). Trade and crafts were disadvantaged. Exports faced heavier duties than imports, and when compared with their European counterparts, guilds enjoyed less autonomy from state intervention (Malik 2012).

Unlike European rulers, the Ottoman sultans did not need to rule with the consent of the merchant classes (Pamuk 2012). They were more fiscally dependent on land than on private merchandise. Even when forced to increase economic flexibility in the face of declining military and economic power, Ottoman rulers were more predisposed to grant trade and financial concessions to European merchants and banks. This attitude was politically expedient: Economic power was then perfectly insulated from the political domain. Malik and Awadallah (2013) explain that for much of recent Arab history, merchants have been more "feared than favoured" (p. 302). Rulers have been alarmed at the prospect of a rising class that could draw on independent sources of income. Merchants were tolerated as long as they were an appendage of the ruling circle.

Another barrier has been structures for control that militate against the emergence of independent social classes. These control structures are rooted in specific forms of military organization under Islamic rule that depended on foreign military slaves who were initially allowed neither to marry in society nor to own property. The resulting insulated military structures allowed rulers to concentrate power, reinforcing personalized rule and weakening checks and balances (Blaydes and Chaney 2013).

This historical legacy casts a long shadow on Arab economies, where heavy-handed state intervention remains the order of the day. Of all the global regions, the Middle East and North Africa have the most pervasive nontariff barriers, defined by a raft of arbitrary regulations and controls that restrict economic opportunity to a closed circle of insiders. New economic opportunities are often monopolized by crony capitalists. As a result, the economics of concessions trumps the economics of competition in the Middle East, creating a "pyramid of privilege," defined by a few well-connected companies at the top with a large base of small companies. In short, the business environment in most Arab states is characterized by tremendous inequality of access, which effectively bars small companies from becoming medium or large. Small companies are often forced to operate in the informal sector.

In the resource-rich countries of the Gulf, where the private sector is arguably stronger, the boundaries between the public and private are often blurred. This feature is characteristic of the *rentier* states—that is, those that derive their income primarily from oil and aid. Several decades ago, the discovery of oil in the Gulf kingdoms shifted the ruler–merchant relationship firmly in favor of ruling families by reducing their dependence on merchants (Crystal 1995). With high barriers against regional trade (intra-Arab trade constitutes only 10% of total trade), merchants are more dependent on the state for economic access. Trade restrictions have fragmented local and regional markets, undermining economic prosperity and preventing merchants from becoming a powerful constituency for economic and political reform.

Islamic finance has to operate in this brittle political economy. Finance is unlikely to be an enabling factor in a milieu where the productive domain is held captive by insiders through barriers to entry and mobility. Such decoupling of the institutional regimes governing finance and production is consistent with neither Qur'anic injunctions nor modern political economy. Significantly, the Qur'an emphasizes, in the same verse, the prohibition of *riba* and the permissibility of trade (2:275). Ironically, even as some Muslim societies are aspiring to align their financial systems with Islamic principles, their economies remain chained by protective barriers to production. Effectively, these societies need to worry not about *riba* alone but also about unnecessary trade barriers.

Clearly, this discussion is most pertinent to Arab economies with high levels of trade protection. Many majority-Muslim nations in Southeast Asia—for example, Malaysia and Indonesia—have produced different growth patterns because the incentives for trade and production are more favorable in these countries.

Rule of Law

A legal system that facilitates business transactions, enforces contracts, and acts as a neutral third party is an institutional requirement for Islamic finance. Like other developing countries, Muslim societies confront several legal challenges that can influence both the absorption and efficacy of Islamic finance. Many international Islamic finance transactions are subject to English law as the governing law, which provides investors with the desired legal certainty.

Some key dimensions worth discussing regarding the rule of law are independence of the judiciary, efficiency, access, equity, enforcement, and property rights.

Independence. The judiciary in many Muslim societies (especially those with closed political systems) has limited autonomy in relation to the executive or the political domain. Rulers have significant discretion in hiring and firing judges and face few constraints on the arbitrary use of power.

Efficiency. In many populous Muslim societies, court delays compromise the efficiency of judicial systems. Shortage of judges, burdensome clerical functions, the unrestricted right to appeal, and requirements for frequent court appearances result in a huge backlog of cases. This backlog increases costs and may result in the exit of business parties from the legal system. In Egypt, resolution of business disputes is at a disadvantage relative to criminal convictions, which are faster and more efficient. Judges have more experience in criminal law than in business procedures. Interested parties are thus motivated to shift borrowing-related disputes to the criminal jurisdiction (Brown 1997).

Access. A slow and inefficient judicial system raises costs and reduces the access for those who are less well off. In many Arab countries, a progressive fee structure causes the cost to rise the longer and more complicated the court structure is. Even the winning party has to pay and seek further action to recoup costs. Appeals are relatively costless; the losing party does not bear all the costs of the appeal process. As a consequence, in Egypt, 80% of cases are appealed after the first hearing (El Dean 2002). The result is that many wealthy and powerful people exploit creative ways to bypass the system. In

North Africa, established businesses, especially foreign investors, increasingly rely on out-of-court arbitration. Given their unfamiliarity with the language and procedures of the courts in North African countries, international businesses opt for additional arbitration clauses that allow them to choose separate court procedures and law governing dispute resolution. Such "exit options" from the system disempower the constituencies that could have pushed for legal reform.

Equity. The rich can bypass the system through corruption or out-of-court settlement, so the cost of an inefficient judicial system weighs heavily on the poor. In North Africa, small businesses are more legally disadvantaged in terms of dispute resolution; their operations are also governed by an archaic legal regime that penalizes risk-taking ventures. The bankruptcy code in Egypt is famed for its distortionary effect: When a business goes bankrupt, the owner can be put in jail, barred from holding a public office, and still be liable to pay the debt. By raising the cost of business failure, such archaic laws deter small companies from experimentation, which is the bedrock of productivity and innovation. Tunisia faces the opposite challenge, in that it lacks even the most basic bankruptcy law.

Enforcement. The disjunction between the *de jure* and *de facto* means that, even when laws exist on paper, they may not be credibly enforced, which makes economic exchanges unpredictable. Firm-level surveys from the Middle East found wide variation in firms' responses to questions about the correspondence between laws and practices.

Property Rights. In many Muslim societies, property rights are either not well established or inadequately enforced. In Egypt, land is predominantly owned by the state. Lack of clarity on titles of land ownership leaves land as "dead" capital. Pakistan, in contrast, suffers from high levels of land inequality, which deprives the poor of the ability to use land as collateral for bank financing.

These issues highlight the challenge of promoting a moral economy and Islamic finance—particularly profit-sharing arrangements—where the rule of law is either absent or weak.

Lessons from Country Experiences

The political economy in individual countries has also shaped the development of Islamic finance. A look at the experience of countries, therefore, can shed light on the interface between politics and finance. Politics has been a sensitive issue, however, for the Islamic finance industry. Unsurprisingly, large parts of the literature on Islamic finance lack any reference to politics. In some countries, the rise of Islamic finance is tied to ethnic politics or ideological orientation. In others, the push for Islamic finance emanates from surpluses generated from an oil-based economic structure.

Consider Malaysia, a country at the forefront of modern Islamic finance. It is generally regarded as the most advanced and pragmatic center for Islamic finance, a country where the state has strongly favored the development of an Islamic finance industry. Unlike Pakistan and Iran, which tried to Islamize the entire financial system, Malaysia is experimenting with Islamic finance through the dual banking model, where conventional and Islamic finance coexist. Although Malaysia's Tabung Haji is considered one of the earliest experiments in Islamic finance, it was not until 1983 that the parliament passed the Islamic Banking Act that created Bank Islam, a full-fledged commercial bank controlled by the government.[27] In 2013, Islamic banking assets totaled 24.1% of banking assets, according to the Bank Negara Malaysia, the central bank of Malaysia.

The roots of state-propelled developments in Islamic finance are often traced to the government's agenda to facilitate the distribution of wealth in favor of the Muslim Malay population, which is 65% of the total population but lags behind the ethnic Chinese in business and commerce. Warde (2010) describes Malaysia as "a nation in a hurry" (p. 125). The speed helps to explain why Islamic finance in Malaysia is sometimes criticized for going too far and too fast in copying conventional finance and compromising the authenticity of Islamic finance, which seems hard to reverse. The Shari'a boards established by Malaysia's central bank and securities commission are perceived to have approved practices (e.g., sale with immediate repurchase, sale of debt) that critics denounce as legal stratagems to circumvent Islamic prohibitions of *riba* and *gharar*. By law, rulings of the Shariah Advisory Council of Bank Negara Malaysia prevail over any contradictory ruling. The court and arbitrator are also required to refer to these rulings for any proceedings relating to Islamic financial business.

In Islamic finance, Malaysia is in competition with the Gulf Cooperation Council (GCC) countries, especially Dubai. The world's first Islamic commercial bank was established in Dubai in 1975. In early 2013, Dubai's ruler, Sheikh Mohammed, announced plans to turn Dubai into the capital of Islamic economies, which indicated a new era of strong state backing for Islamic finance. Both Islamic and conventional finance have supported real estate ventures in Dubai and the UAE, an area of priority for the ruling elite. Islamic finance, like conventional finance, is criticized for contributing to the property bubble running up to the financial crisis of 2007–2008.

[27]Tabung Haji, established in 1963, is known as the first Islamic financial institution in Malaysia. Its purpose is to allow those who wish to make the pilgrimage to save for it. See www.tabunghaji.gov.my/web/guest/latarbelakang3.

An ethical concern across all the GCC countries is the reported harsh treatment of migrant workers from poor countries. Many of these workers work in the construction sector and are seen as deprived of essential rights. Although ethics and justice are routinely mentioned in Islamic finance events held in the region, participants carefully avoid mention of the treatment of these construction workers. Visser (2012) notes that Islamic banks "do not hesitate to finance huge building projects in Bahrain, Qatar and Dubai, where conditions for the workers are reported to be appalling" (p. 33).

The Iranian experience, by contrast, is ideologically rooted. Iran's legislation on usury-free banking was enacted only four years after Iran became an Islamic republic in 1979. As Wilson (2012) notes, "enacting ambitious Islamic banking legislation to transform a country's entire financial system may have less impact than those who had been ideologically inspired to achieve this goal had hoped" (p. 101). Despite this legislation, however, the Central Bank of the Islamic Republic of Iran conducts monetary policy largely in the same manner as any other conventional central bank. Industry reports on Islamic finance classify Iran as the country with the largest share of global Islamic finance assets (surpassing even Malaysia). Persistent sanctions against Iran, however, have reduced the integration of its banking sector with the global economy. Ironically, although Iran has the largest share of Islamic banking assets, Iranian scholars are noticeably absent from both the Islamic finance literature and industry events. The hostility between Iran and its Arab neighbors offers a partial reason.

The Pakistan case bears similarities to that of Iran. Many pioneers of Islamic finance have come from Pakistan, and the country has, on various occasions, unsuccessfully tried to Islamize its entire banking system. Warde (2010) notes, "the Pakistani experiment in Islamic banking is nothing short of contradictory" (p. 114). Pakistan's founding father, Mohammad Ali Jinnah (1948), ardently spoke in favor of the Islamic system of banking at the inauguration ceremony of the State Bank of Pakistan in 1948, making him, perhaps, the first head of state to do so. He reportedly set up a research center to explore an Islamic model of banking. It was later closed because of official neglect.

The state-sponsored move toward Islamic banking was undertaken much later, in the 1980s, under the military rule of General Zia-ul-Haq. He used Islamization as a tool for political legitimization. Apart from seeking religious legitimacy for dictatorial rule, Islamization also deflected attention away from a core issue—the need for redistributive reform. For example, Zia-ul-Haq's Islamization did little to change the elitist nature of the economy; in fact, some argue that it put essential agrarian reforms on the back burner. Zia-ul-Haq's Islamization changed only the banking nomenclature without altering the underlying substance. Aside from the historic judgments of Pakistan's highest court against *riba*, Pakistan has, like many other countries, followed a dual system in which Islamic finance and conventional finance coexist. After experiencing rapid growth, Islamic financial assets accounted for only 9% of total banking assets as of the end of June 2013.

Unlike Malaysia and the UAE, where the state has actively promoted Islamic finance, Saudi Arabia, the birthplace of Islam, has embraced Islamic finance only reluctantly, although the kingdom did establish the Islamic Development Bank during the 1970s. Its reluctance to introduce Islamic banking has been attributed partly to apprehensions that doing so might portray the existing banking system as un-Islamic. This outcome would reflect adversely on the ruling class, which has stakes in the prevailing banking system. The term "Islamic bank" has, therefore, not been officially used in the kingdom to date. (Ironically, this practice in religiously conservative Saudi Arabia bears a resemblance to the situation in secular Turkey, where Islamic banking is referred to as "participation banking" as a result of the sensitivities of the secular segment of the population.)

The Saudi Arabian Monetary Agency, the country's central bank, and capital market regulator do not have any specific regulations for Islamic finance. The resourceful Saudis who wished to establish Islamic banks in the kingdom—notably, Prince Mohammed bin Faisal and Sheikh Saleh Kamel—had to turn their attention to building an Islamic financial sector overseas.

Still, demand for Islamic finance at the retail level is high. The Saudi authorities were reluctant in the 1980s to grant Al Rajhi Bank, then currency exchange and remittances services provider, a license as an Islamic bank. But Al Rajhi eventually became the largest stock market-listed Islamic bank in the world, even though it does not carry the title of "Islamic bank." A report (UK Islamic Finance Secretariat 2013) estimates the market share of Islamic banking in Saudi Arabia in 2011 at 35%.

The countries mentioned so far have Muslim-majority populations. A leading example of Islamic finance among countries that do not have a Muslim-majority population is the United Kingdom. Of late, Islamic finance has received considerable official patronage in the United Kingdom. It is home to the only Islamic retail bank in Europe and four other Shari'a-compliant banks. Its ties with the Middle East and presence of a significant Muslim population have helped UK ambitions of becoming the European center for Islamic finance. According to various government pronouncements, the policy objective is mainly aimed at turning London into a hub for inward investments in Islamic finance. In October 2013, the United Kingdom became the first country outside the Muslim world to hold the World Islamic Economic Forum, where the British prime minister expressed the desire to convert London into one of the great capitals of Islamic finance, standing alongside Dubai and

Kuala Lumpur. Critical observers view such British Islamic finance ambitions as largely targeted toward recycling petrodollars from oil-rich countries in the Middle East.

A number of resource-rich Muslim-majority countries have set up sovereign wealth funds that engage in overseas investments. Examples include Saudi Arabia, the UAE, Qatar, Kuwait, and Malaysia. Curiously, these new investment vehicles have not typically shown much interest in Islamic finance. Only Malaysia's Khazanah National Berhad has issued a *sukuk* (Islamic investment certificates) to raise funds, but even it is hesitant to use Islamic financial instruments on the asset side. While discussing the relevance of these funds to Islamic and social finance, Ali and Al-Aswad (2012) observed that "the advancement of Islamic Finance among [these] SWFs has been anemic to date" (p. 8).

Islamic finance has a presence in many other countries. We limit ourselves to the following observations from the literature: First, the initial push for Islamic economics and finance can be traced to independence of Muslim-majority countries from colonial rule after World War II. Second, the prevailing financial and legal systems in Muslim societies are in conflict with Islamic teachings based on mainstream interpretations of *riba* and excessive *gharar*. Third, official interest in Islamic finance varies significantly, but no government has adopted a path that offers a genuine, even if piecemeal, alternative to conventional finance. Fourth, no collective effort has been made in favor of Islamic finance by Muslim-majority countries through such platforms as the OIC or the Arab League. Fifth, the domination of conventional finance in Muslim-majority countries is unlikely to be challenged by Islamic finance in the foreseeable future.

Form vs. Substance

Having explained the context, the specifics, and the political economy of Islamic finance, now we are ready to turn to one of the most important debates facing the industry and a recurring theme in the literature on Islamic finance: the "form versus substance" debate. A frequent criticism is that Islamic finance, at least the manner in which it is currently practiced, is a legalistic phenomenon. The "Islamic" in Islamic finance is Islamic in legal form only and conventional in economic substance.

Highlights of this section are as follows:

- The form versus substance debate signifies the gap between the theory and practice of Islamic finance and the legalistic nature of the field.
- Although conventional interest-bearing loans are described as un-Islamic and unjust, they are mimicked in Islamic finance, which eliminates any substantive difference between the two.
- Critics denounce Islamic finance, in general, and Islamic commercial banking, in particular, for taking unfair advantage of the religious sensitivities of Muslims and offering them conventional financial services essentially marketed as Shari'a compliant.

Legal Form vs. Economic Substance

The debate over "form versus substance" concerns both the means and ends of Islamic finance. Clearly, "Islamic finance" can mean very different things to different people. The multiple interpretations include "business as usual but Shari'a compliant;" "ethical, social, and development finance;" and "political Islamism in finance." This is a broad spectrum covering both idealism and legalism.

In for-profit financial institutions that wish to compete with conventional financial institutions and each other, the focus has primarily been on legalistic compliance. This has led critics to argue that, by putting form over substance, the industry is squandering the potential to create economic and social value through Islamic ethics.

Murabaha Financing

The form versus substance debate can also be explained by analyzing the contemporary trust sale or *murabaha* financing. Estimates suggest that more than 70% of Islamic finance is based on *murabaha*. The dominance of *murabaha* in Islamic finance is so conspicuous that it has been termed the "*murabaha* syndrome" (Yousef 2004). Using credit sales of goods, the financier buys a good (instead of lending money at interest) and sells it to the customer on installment credit. This makes the transaction Shari'a compliant while securing a fixed return. As explained earlier, from the perspective of Islamic commercial jurisprudence, however, there must be clear evidence that legal title and possession of the asset (whether actual or constructive) are transferred to the financier before the financier sells it on to the customer. By owning the asset, even if for a split second, the financier is seen as assuming the risk associated with ownership of an asset.

The legitimacy of contemporary *murabaha* has come under growing scrutiny. Typically, the financier buys the goods only if the financier has obtained an undertaking that the client will purchase them from the financier and the client agrees to act as an agent for buying the goods. The purchase and sale are processed as quickly as possible so that the length of time the goods are owned by the financier is minimized to hours, if not minutes or seconds. The trade takes place only if credit is involved; the markup is benchmarked to a conventional interest rate benchmark, such as LIBOR; and the amount payable to the bank rises with the length of the period for which credit is extended.

The context of contemporary *murabaha* is also different from that of classical *murabaha*. It is not necessarily a sale based on trust because the client is not relying on the expertise or trustworthiness of the seller (financier). Taken together, these elements make a deferred sale in Islamic finance similar in substance to a conventional loan. These credit sales carry mainly credit risk and interest rate risk, not the risk associated with ownership of an asset or a business enterprise.

Proponents of credit sales contracts, on the one hand, argue that they are, per Islamic commercial jurisprudence, trading for profit rather than lending money at interest. Some salient arguments run as follows:

- It is a contract of sale as opposed to a contract of loan.
- The financier assumes the risk of ownership of an asset even if it is for a split second.
- An asset must be involved, whereas conventional interest-bearing loans have no such requirement.
- Financing cannot be rolled over to a later period.
- The total price payable is fixed up front.
- Any penalties for late payments from the debtor are given away to charities.

The critics, on the other hand, describe credit sales as simply an inefficient method of lending money at interest—inefficient because the process involves needless and complex legal paperwork to make the structure Shari'a compliant. The business of the financiers, the argument goes, is not to trade goods but to engage in financial intermediation. Besides, any benign feature added in, such as donating penalties for late payments to charities, can also be built into the terms and conditions of a conventional loan. The critics invoke the observation by classical Shari'a scholar Ibn Qayyim (died 1350), a disciple of the theologian Ibn Taymiyyah (died 1328): "What matters in contracts is substance, not words and structure" (Al-Haddad and El Diwany 2006, p. 3).

El Diwany (2003) has likened *murabaha* financing to *contractum trinius*, a bundling of three contracts into one during the medieval era. The purpose of the bundled contract was to circumvent the prohibition against interest imposed by the Christian Church by converting a profit-sharing investment into an interest-bearing loan. In simple terms, together with investing, say £100, the financier would sell the right to profits to the client for £15 and also buy from him insurance against any losses for £10, netting the financier a contractually required return of £5 without subjecting his capital to business risk (El Diwany 2003).

Some Shari'a scholars who legitimized *murabaha* have also qualified their support for it. For instance, Usmani (2002) has argued that *murabaha* should be taken as a transitory step toward an ideal Islamic system in which financing will rely largely on investment contracts.

Monetization

A combination of credit and spot sales can produce the highly controversial monetization, or *tawarruq*, also referred to as "commodity *murabaha*." As explained previously, in monetization, the financier sells a good on credit to the client, who then sells it again at the spot price to another party. Economically, this credit and spot trading produces an interest-bearing monetary loan between the financier and the financee. Like the deferred-payment sale, the use of monetization in Islamic finance is different from the classical notion of monetization. In its modern incarnation, monetization (frequently referred to as "organized *tawarruq*" or "banking *tawarruq*") entails a structured process of paper trading that instantly generates what is essentially an interest-bearing monetary loan.

Usmani ("Verdicts on At-Tawarruq and Its Banking Applications") accepts that this structure is a "legal trick" to get cash; it cannot represent the economic order aimed at by Islam. Organized monetization was also denounced by a 2009 ruling from the OIC's International Islamic Fiqh Academy, which dismissed it as a "trick" to get cash now for more cash later. This ruling was widely viewed as a major blow to the Islamic finance industry. The industry, however, continues to make use of monetization.

The debate on monetization is polarized. On the one hand, Khan (2009) believes that monetization "needs to go." According to Khan, a majority of

Islamic banks regularly conduct a large volume of such transactions for their treasury operations, which they justify on the basis of the doctrine of necessity. In his view, the best solution is a phased return to a 100% cash reserve ratio and a shift in focus to genuine investment-based and profit-and-loss-sharing products. Khan accepts that "such a move represents a paradigm shift that challenges the very basis of the existing banking structure" (p. 20). On the other hand, Hasan (2009) believes that monetization "needs to stay." He argues that Islamic banking has two options: either "to tell the client that we cannot assist him and he has to go to conventional banks" (p. 17) or to provide him with "a proper Tawarruq transaction" (p. 17) that gives him cash in hand. Hasan adds that until Islamic banking has "a better structure or law and practice" (p. 17), it needs to use monetization. He does not discuss, however, what that better way may be.

Kahf (2004) argues that "regardless of whether it is permissible or not and regardless of what conditions the Shari'ah compatibility may impose on it" (p. 6–7), monetization is against even a liberal interpretation of Islamic finance theory because it provides cash financing independent of any transaction in the real economy.

The contracts of profit sharing via investment (*mudaraba* and *musharaka*) are also sometimes converted into fixed-income contracts through legal devices. This practice was an important reason behind the controversy surrounding the Islamic authenticity of *sukuk* in 2007–2008. Partly as a result of the use of such legal devices, Islamic finance is sometimes viewed as simply adding complexity and intermediaries to conventional financing without necessarily delivering incremental economic or social value.

Preponderance of Debt

In economic terms, Islamic finance relies primarily on debt financing rather than equity financing. This practice runs counter to the logic of an Islamic financial system that is supposed to rely largely on profit-sharing modes of financing.

Several explanations have been offered for the reliance on debt. One pertains to the monetary system: Much of Islamic finance depends on commercial banking within the prevalent fractional-reserve banking system. It is subject to the same legal and regulatory frameworks as conventional banking. It is also subject to a tax system that favors debt over equity; for example, interest payments are tax deductible whereas dividend payments are not.

Another explanation has to do with informational imperfections and the rule of law. Analyzing the predominance of debt in Islamic finance, Aggarwal and Yousef (2000) argue that "economies characterized by agency problems will be biased toward debt financing. As these problems become more severe, debt will become the dominant instrument of finance" (p. 95). In their view, the "use of debt like instruments is a rational endogenous response on the part of Islamic banks to the contracting environments in which they operate" (p. 95).

There are also other reasons offered to explain the predominance of debt in Islamic finance. Islamic banks are largely run by bankers trained and experienced in conventional banking. Although a major criticism of conventional banks is that they promote debt by encouraging consumption of unnecessary goods, banks in the GCC, as Wilson (2009) notes, effectively "behaved in exactly the same way as conventional banks...major Islamic banks in the GCC are unapologetic; their business strategy is to focus on consumer rather than development finance" (p. 16).

Court Cases

In Islamic finance, transactions have to comply with Shari'a as well as the law of the land. Financial cases that have gone to court in the United Kingdom and Malaysia have shed light on the form versus substance debate. In the UK court case of *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd and Others*, the defendants who had defaulted on payment argued rather scandalously that the legal agreements they had entered into were not enforceable because they had to be valid in accordance with the principles of Shari'a and in accordance with English law and the agreements did not, in fact, comply with Shari'a because they were disguised interest-bearing loans.

In another UK court case, *Investment Dar Co KSCC v. Blom Developments Bank Sal* (2009), the defendant that had defaulted on payments argued that the agency (*wakala*) agreement underlying the transaction, which was approved by its own Shari'a board, did not comply with Shari'a and was, therefore, void because it was against the constitutional documents of Investment Dar.[28]

In Malaysia in 2008, in a collective judgment for 11 separate cases involving Bank Islam Malaysia Berhad and Arab Malaysian Finance Berhad, the judge ruled that the banks cannot claim the full sale price of the property in the event of default by the borrower. The key point was that a default in a deferred-payment sale, which is known in Malaysia as *Bai Bithaman Ajil* (BBA), using Islamic finance was far more burdensome than in a conventional mortgage. The reason given was that when financing is given the legal form of a sale using BBA, the bank can claim a return even for the post-default period for which financing was not extended. With a default in a conventional mortgage, the financier cannot lay claim to remaining interest payments that would have been made if the default had not happened.

These court cases followed different paths. In some instances, the case was withdrawn; in others, the appeal courts overturned the judgment by the lower

[28]This case may be found at http://learn.westlawbusiness.com/PDFs/Investment_Dar_Co_KSCC_v_Blom_Developments.pdf.

courts. They indicate that, in the eyes of the informed observer, despite changing the legal form of lending money at interest into that of a sale or a lease to achieve Shari'a compliance, the practice is likely to be viewed as lending money at interest in substance.

Defense of the Industry

Defenders of current practices in the Islamic finance industry point to difficulties associated with genuine risk–reward sharing in equity-like profit-sharing structures and arrangements based on genuine ownership of real assets. These difficulties include information asymmetry between financier and management of the entity being financed, legal and regulatory obstacles to financiers (particularly, banks assuming risks of equity financing), and the general lack of an enabling environment that fosters trust and enforces contracts (as explained in the political economy section).

According to defenders of the current practice, large borrowers, such as industrialists, are not interested in sharing profits when raising debt is easier and cheaper. Similarly, individual depositors or institutional investors are not interested in sharing profits and risking losses; they prefer capital protection. Therefore, to enable risk–reward sharing, first, the wider economy must first be changed in favor of profit sharing; then, Islamic finance will change accordingly.

As the CEO of an Islamic bank puts it, when Islamic finance is obliged to follow rules written for conventional finance, it is "trying to play football on a rugby field."[29] Offering an insider's account of Islamic finance practice, Irfan (2014) suggests something very similar: "Without conventional banks to offer macroeconomic hedges and inter-bank funding, the Islamic institutions struggle to survive. Credit traders at powerful conventional institutions who transact with Islamic institutions want to see risk packaged in a certain way. Their credit committees don't believe in the cult of equity, only debt." Other observers have noted that purists in Islamic finance are chasing a utopia in a deeply dystopian world ("Islamic Finance and Shari'a Compliance" 2013).

The defenders of the industry point out that *halal* (licit) and *haram* (illicit) meat are the same in their substance; the main difference between the two relates to the *process* of slaughter. In other words, with a different process, the prohibited becomes permissible even if the underlying economic substance is the same. Conventional interest-bearing loans can thus become permissible with changes in contractual form. It is the process, not the outcome, which really matters. Justifying their emphasis on contract mechanics, proponents argue that in Islam, sexual relationship between a man and woman is made permissible because of the contract of marriage.

[29]Rafe Haneef, CEO of HSBC Amanah in Malaysia, quoted in "Islamic Banks Urged to Broaden Appeal" (2013).

Defending the use of conventional interest benchmarks (e.g., LIBOR) in the pricing or benchmarking of loans, proponents argue that reference rates do not turn the permissible into the impermissible. Therefore, using conventional interest benchmarks in pricing does not turn Islamic financial transactions into conventional financial transactions. For instance, someone selling soft drinks may benchmark the rate of return a competitor is generating through the sale of alcoholic drinks. Such benchmarking of a rate of return does not turn the business of selling soft drinks into that of selling alcoholic drinks (Usmani 2002).

Another defense is the doctrine of necessity. The argument is that the prevailing economic environment and the nascent stage of the Islamic finance field necessitate the relaxation of the rules of Islamic finance. Once Islamic finance has grown sufficiently in size, it can be geared toward genuine risk–reward sharing between contracting parties, rather than merely mimicking interest-based products (Haneef 2009).

Defenders have also suggested that Islamic financial practices should be judged by their intention. They argue that their intentions are good even if the methods are imperfect. They take the view that God will judge humans based on their intentions, and the industry practices should be given the benefit of the doubt. They also argue that even if the substance of Islamic finance tends to be similar to that of conventional finance in the use of interest-based debt, many practices in conventional finance are still not allowed in Islamic finance, such as outright trading of derivatives.

Response of Critics

Some critics who tend to accept the food analogies take the view that junk food can be licit but also harmful to health. Similarly, debt, even if Shari'a compliant, can be economically harmful, like its conventional equivalent. Others argue that the job of financial markets is to deal with risk and capital and that financial services, by their nature, are not amenable to analogies to food or marriage. The underlying in the analogies of food and marriage are permissible and depend on due process. This situation is different from having underlying acts that are prohibited regardless of the process. For instance, committing incest and eating swine are prohibited in Islam. Use of an Islamic contract of marriage or Islamic way of slaughter does not make committing incest or eating swine permissible.

Marketing of *haram* products as *halal* in its most blatant form is not without its modern-day precedent. In some cases, food sold as *halal* has been found to contain pork.[30] Critics seem to suggest that Islamic finance could be doing the same—that is, marketing the prohibited as Islamic for private profit. In a

[30]See, for instance, the BBC reports "Study Reveals 'Shocking' Kebabs" (2009); "South African Muslims Furious at 'Halal Pork' Scandal" (2011); and "Leicester Schools Halal Lamb Burger Contained Up to 50% Pork" (2013).

critical article, Bhatti (2010), a former employee of the Islamic Bank of Britain, argues that the industry has been able to attract only a tiny fraction of British Muslims largely because of its flawed marketing and because "the flowering of Britain's Islamic banking movement had little to do with the Koran and much more to do with capital gains."

Critics also suggest that the legalistic compliance used by the industry tends to be different from the marketing materials meant for Shari'a-sensitive Muslims. The marketing message offers a rich portrayal of religious symbolism, with references to *riba*, ethics, and values. The materials remain silent, however, about the fact that monetization, which could be a tool used by the financial institution, is considered by the OIC's International Islamic Fiqh Academy to be a legal stratagem. The materials also say little about whether and to what extent the institutions will take into account any social considerations when selecting their investments. Thus, according to the critics, these institutions may use Islamic messaging to take advantage of ignorance and religious sensitivities of individuals in collecting funds from them but may disown the socioeconomic expectations triggered by the same messaging in pursuit of private profit. For instance, Islamic finance has been used for building skyscrapers (such as the Shard in London) through controversial financial structures (e.g., monetization), where neither the means nor the ends fit with what people, Muslims or non-Muslims, might be expecting from "Islamic" finance (Hart and Childs 2011).

Critics dismiss commonly used techniques to turn conventional financing arrangements into Islamic financing as legal stratagems that violate the spirit while conforming with the letter of Islamic law on technical grounds. They point out that the Qur'an states that those who disobeyed God's prohibition of fishing on the Sabbath by using a stratagem were punished by God (7:163).

Critics also dispute the idea that synthetic credit sales and leases will one day lead to genuine profit-sharing arrangements once the Islamic finance industry gains in size. They point out that these synthetic arrangements have been rife in Islamic finance for decades but have not led to profit sharing over time. In fact, by becoming the dominant mode of financing, they may have paved the way for increased use of even more controversial arrangements, such as monetization.

Critics see the Islamic finance industry as using the doctrine of necessity for private profit rather than public good. They also consider that there is no end in sight to the use of the doctrine of necessity. An excessive emphasis on process, regardless of the associated outcomes, runs counter to the spirit of the objectives of Shari'a, which tend to be concerned with public welfare. Critics argue that it is only a matter of time before the Islamic label is placed on more and more financial structures, no matter how exotic. Thirty years ago, few could have expected that Islamic finance would one day offer the many conventional look-alike products that it is offering today. Through the use of synthetic sales, promises, and options, any conventional structure can be replicated in Islamic finance through financial engineering.

Critics dismiss the idea that the intentions of those running the industry are good and deserve the benefit of doubt. They argue that the intentions of an individual in a one-off act can be hard to judge but little doubt is left about the intentions of organized finance for private profit. In a hard-hitting point in the debate about form over substance, El-Gamal (2007a) quotes classical Shari'a scholar Ibn Qayyim in the following words:

> It is impossible for the Law of the Wisest of the wise [God] that He would forbid a harmful dealing [*riba*, or usury], curse its perpetrators and warn them of a war from God and his Messenger, and then to allow a ruse to result in the same effect with the same harm and added transaction costs in constructing the ruse to deceive God and his Messenger.

For the Non-Muslim

In terms of the value proposition of Islamic finance for the non-Muslim, one advantage is that it has to be based on moral and economic substance rather than Shari'a compliance. Little has been written on this subject. Addressing this issue directly, Nienhaus (2013) argues that Islamic finance has limited, if any, incremental moral or economic value to offer when compared with conventional *responsible* finance (that takes into consideration ESG issues). The reasons are that the ethical appeal of Islamic finance is largely confined to exclusionary screening and that its economic substance mimics that of conventional finance. He points out that the responsible investing industry is much larger than that of Islamic finance. In addition, he points out that not only non-Muslims but also the majority of Muslims tend to use conventional finance, even when Islamic finance is available to them.

Krasicka and Nowak (2012) address the question of what attracts conventional investors to Islamic financial instruments in Malaysia. To answer this question, they compare Islamic and conventional financial instruments and banks from the perspective of non-Muslim investors. They suggest that "Islamic and conventional bond and equity prices are driven by common factors… [and] Islamic banks have responded to economic and financial shocks in the same way as conventional banks… [and] the gap between Islamic and conventional financial practices is shrinking" (Abstract).

Similar Debate in SRI

The form versus substance debate is not unique to Islamic finance. Similar debates about ends, means, and intentions are found in discussions about sustainable and responsible investing. Hawken (2004) finds that "the cumulative investment portfolio of the combined SRI mutual funds is virtually no different than the combined portfolio of conventional mutual funds" (p. 16). If every company could be deemed acceptable for investment by using one method or the other, the expected ethical difference between SRI and mainstream mutual funds would be blurred. In its "Guide to Climate Change Investment," Holden & Partners (2007) reached a similar conclusion: "SRI and ethical funds perform as well (if not slightly better) than their mainstream counterparts because in most cases they are in fact mainstream." Others have criticized the lists of best-performing companies based on sustainability criteria (Gunther 2010; Siegel 2010). In November 2013, community-based nongovernmental organizations described the Johannesburg Stock Exchange's SRI Index as "nothing more than greenwash" (Crotty 2013).

Some observers have pointed out that institutional investors frequently sign on to the Principles for Responsible Investment for public relations reasons without regard for the ESG considerations of the principles (Kelleher 2011). SRI is also at times hit by ethical scandals. For example, in 2013, the chairman of the Co-Operative Bank, the leading bank in ethical banking in the United Kingdom, was reportedly filmed buying illegal drugs, which caused tremendous embarrassment for the Co-Operative Banking Group, which was also experiencing financial difficulties ("Co-Op Probe after Drug Allegations against Ex-Boss" 2013). Another example in 2013 was the Vatican Bank, which was hit by a scandal concerning fraud and money laundering (Sanderson 2013).

Expectations Gap

The preceding discussions underscore the gap between the expectations and reality of Islamic finance. Adding the label "Islamic" to finance triggers many expectations, such as risk sharing, the avoidance of interest-based loans, and the avoidance of harm and pursuit of good for society and the environment. In practice, other than refusing to finance so-called sin industries, these expectations have been hard to meet. For instance, despite the expectation of profit sharing, most financing in the Islamic financial sector is debt based. When Islamic banks engage in large-scale placements of funds with conventional financial institutions, even avoidance of sin industries becomes questionable because conventional banks and investment firms may not subscribe to the Islamic exclusionary screening.

Visser (2012) argues that "the ideals of brotherhood touted by proponents of Islamic finance appear hard to put into practice" (p. 32). He laments the limited role of the social welfare tax (*zakah*) and interest-free loans (*qard hasan*) in Islamic banks' activities.

Many of the world's leading financial institutions, such as Goldman Sachs, have participated in Islamic finance. At times, Shari'a scholars are quoted welcoming such institutions to Islamic finance (Khan 2012). But Goldman Sachs has made headlines for falling short of ethical behavior. Moreover, the participation of such institutions sometimes reinforces the apprehension that by putting form over substance, Islamic finance might have become part of the same financial system that its literature portrays as unjust.

Some Islamic financial institutions have also been accused of misconduct. Take, for example, the three cases discussed in the subsection "Court Cases." Many more cases could be cited: the Ponzi schemes in Egypt in the 1980s, the collapse of the Islamic Bank of South Africa in 1997, the collapse of Ihlas Finance House in Turkey in 2001, the reported case of mismanagement and poor internal controls in Bank Islam in Malaysia in 2005, the reported fraud involving employees of Dubai Islamic Bank in the UAE in 2009, the alleged secretive payments made in gold and silver to Shari'a scholars in the controversial failure of UM Financial in Canada in 2011, and the allegation by a consumer association in Malaysia in 2013 that Islamic banks are charging excessive rates of interest on personal loans.

Such reports put a sobering spotlight on Islamic finance. As Grais and Pellegrini (2006) have observed:

> The history of Islamic finance shows that cases of CG [corporate governance] failures have features in common with conventional banking scandals, such as collusion of the board with management, external and internal audit failure, neglect of minority shareholders' interests, imprudent lending, and excessive risk taking by management. (p. 6)

Although ethical failure is unacceptable in both conventional and Islamic finance, it raises more objections in the Islamic finance industry because of greater expectations from and rhetoric on ethics in "Islamic" finance.

Another recurring theme is that Islamic finance has not yet vigorously responded, as it is expected to do, to situations of abject poverty and underdevelopment. For this reason, Islamic finance is sometimes characterized as "rich man's finance" and considered not aligned with the spirit of Islamic moral teachings about the economy. Partly as a result of this expectations gap, conservative Muslims, who are sympathetic to Islamic finance, have also publicly questioned industry practices. In an op-ed, Muhammad Zubair Mughal (2013), CEO of AlHuda Center of Islamic Banking & Economics, asks why Islamic microfinance occupies less than 1% of the total share of Islamic finance and whether "commercialism has captured" Islamic finance institutions to an extent that "business with and financing to the poor have slipped from their agenda."

The theoretical ambition of Islamic finance is to benefit all mankind and not be confined to Muslims. In practice, the industry is finding it challenging to even convince conservative Muslims of its appeal.

Legal Minimum vs. Higher Objectives

From the ongoing debate about form and substance in Islamic finance, one is likely to reach the conclusion that Islamic finance is unlikely to result in incremental value if it merely mimics conventional finance through technical legal compliance.

Not only the critics of the Islamic finance industry but also Shari'a scholars with long associations with the industry have at times discussed the need to move beyond a compliance regime to a real financial alternative that serves the objectives of Shari'a. DeLorenzo (2007) expresses the opinion that although Shari'a supervisory boards of Islamic financial institutions have typically "focused almost exclusively on the rules for transacting in compliance with Shariah, it is now time for them to focus as well on the higher purposes of Islamic law or the *maqasid al-Shari'ah*" (p. 1).

Usmani (2007) has voiced similar views:

> If we consider the matter from the perspective of the higher purposes of Islamic law or the objectives of Islamic economics, then Sukuk in which are to be found nearly all of the characteristics of conventional bonds are inimical in every way to these higher purposes and objectives. The noble objective for which riba was prohibited is the equitable distribution among partners of revenues from commercial and industrial enterprises. (p. 13)

Dusuki (2009) argues,

> The overemphasis on form over substance may lead to abuse of Shari'ah principles in justifying certain contracts that are, in fact, contradictory to one or more Shari'ah texts and that ultimately undermine the higher objectives of the Shari'ah.... The substance of a contract, which has greater implications for the realisation of Maqasid al-Shari'ah [objective of Shari'a] should be equally looked into. (Abstract)

A 2012 BBC report (Pak 2012) noted,

> According to the executive director of the [Kuala Lumpur–based] International Shariah Research Academy for Islamic finance, Mohamad Akram Laldin, 80% of Islamic financial products are merely Islamised versions of conventional ones. "In terms of compliance, it is compliant. But is it the best option? If you ask me, not necessarily," he says.

These views indicate an urge to align Islamic finance with the objectives of Shari'a. In Islamic imagination, this alignment is expressed as a shift from *halal* (licit) to *tayyib* (wholesome).[31] Shifting the focus of Islamic finance from legal compliance to genuine risk–reward sharing in the real economy with an eye on wider economic and social welfare is a challenge. Why and how to manage this change in commercial institutions will probably be the subject of many future publications.

[31]At times, these impressions are also expressed as moving from Shari'a compliant to Shari'a based, although there is no one meaning of "Shari'a based."

Empirical Studies and Concluding Thoughts

We aim to provide in this section a brief review of the empirical findings on the performance of Islamic finance. We will also discuss alternative models of Islamic finance and highlight key gaps in the literature. Finally, we will offer our concluding impressions.

Highlights of this section are as follows:

- Comparative empirical studies of Islamic finance are complicated by the similarities in the underlying substance of conventional and Islamic finance (especially in Islamic commercial banking).
- Those who consider Islamic finance a success tend to focus on growth and profitability; those who consider it a failure typically question its Islamic authenticity and social and economic value.
- Because of a realization that the theory of Islamic finance may not be a good fit for the current monetary system, the literature contains discussions of alternative monetary systems that might be better suited to Islamic finance.

Empirical Studies

Most empirical studies in Islamic finance focus on commercial banking and equity funds. Few empirical studies exist on *takaful*. Comparative evaluations of Islamic and conventional finance, particularly the ones involving commercial banking, face the fundamental constraint that both offer financing that is similar in substance.

Using a large dataset for 1995–2007, Beck, Demirgüç-Kunt, and Merrouche (2010), while comparing conventional and Islamic banks and controlling for other bank and country characteristics, find few significant differences in business orientation, efficiency, asset quality, or stability. The study suggests that higher capitalization and higher liquidity reserves of Islamic banks explain the relatively better performance of Islamic banks during the recent crisis. The authors mention that, in reality, "many Islamic banks offer financial products that, while being Sharia-compliant, resemble conventional banking products" (p. 7).

In a similar vein, Bader, Mohamad, Ariff, and Hassan (2008) use data for 21 countries during the period 1990–2005 to compare costs, revenues, and profit efficiency of the two banking systems. Like the Beck et al. (2010) study, the results suggest no significant differences between the overall efficiency of conventional and Islamic banks. Using data for eight countries for the period 2007–2009, Hasan and Dridi (2010) suggest a differential impact of the global financial crisis on Islamic banks and conventional banks. Factors related to the business model of Islamic banks helped limit adverse effects on profitability in 2008, but weaknesses in risk management practices led to a larger decline in profitability in 2009.

Weill (2011) explores whether Islamic banks have greater market power than conventional banks because they might benefit from a captive client base. The findings suggest that "Islamic banks do not have greater market power than conventional banks" (Abstract), attributing the competitive behavior of Islamic banks to differences in norms and incentives. Using a sample of more than 65,000 adults from 64 economies, Demirgüç-Kunt, Klapper, and Randall (2013), find that "Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution after controlling for other individual- and country-level characteristics" but there is "no evidence that Muslims are less likely than non-Muslims to report formal or informal borrowing" (Abstract). In fact, both Muslims and non-Muslims tend to cite cost, distance, and documentation as barriers to account ownership.

Hassan and Girard (2010) examine the relative performance of seven indices chosen from the Dow Jones Islamic Market Index family and discover no substantive difference in performance from their conventional counterparts. The authors find similar risk–reward ratios and diversification benefits for Islamic and conventional indices. Walkshäusl and Lobe (2012) compare the financial performance of risk-adjusted Islamic indices with that of conventional indices for the period 2002–2012. The result suggests a geographical nuance: Islamic indices generally outperform in developed markets but underperform in emerging markets. However, the degree of underperformance is not material.

In a comparative study of *takaful* and conventional insurance providers in Malaysia, Abdou, Ali, and Lister (2014) find that conventional insurers demonstrate a performance superior to that of *takaful* companies in terms of profitability and risk measurement. However, *takaful* outperforms conventional insurance "in respect of premium to surplus ratio" (Abstract).

There is also limited direct evidence to support the claim that Islamic finance has widened access to financial institutions. In fact, some studies present evidence to the contrary. Khan and Khanna (2010) uses a dataset from Pakistan to demonstrate that Islamic banking customers are generally older and better educated, have traveled to more countries, and maintain higher average balances than comparative customers in conventional banking. Taken together, the sparse evidence suggests limited added value from Islamic finance when compared with conventional finance. Although the empirical findings show that Islamic finance can be profitable, they also suggest that Islamic banking is offering the same type of products to customers who may already be well served by conventional finance.

Search for Alternative Monetary Systems

A latent debate in the literature on Islamic finance concerns the roles of money, credit creation, and monetary policy. One side takes the view that the prevailing monetary system is ill suited to host Islamic finance based on genuine risk–reward sharing and the preference of equity over debt. While explaining the position of Muslim philosopher Al-Ghazali (died 1111) on money, Usmani ("Present Financial Crisis Causes and Remedies From Islamic Perspective") states that money should be a medium of exchange and that making money from money by charging interest is injustice.

Fiat money, notes Ferguson (2008), has no intrinsic value. It cannot be redeemed for such metals as gold. Essentially, money represents a trust that it holds value and can be accepted as money when exchanging it for goods and services. Once a presumed value has been ascribed to money, it can easily be traded. Delinking money from tangible assets facilitates widespread credit creation. In this context, a return to using gold as a currency or as a reserve echoes in discussions of the monetary system in Islamic finance. In Malaysia, the former prime minister, Mahathir Mohamad, is also known to have favored using a gold reserve system.

Some have advocated a return to the currency used during the time of the Prophet Mohammad: the gold dinar or silver dirham.[32] Advocates for a return to a gold dinar as well as a silver dirham argue that fiat currency causes inflation, devaluation, currency volatility, and an avenue for the charging of interest (Vadillo 2013). El Diwany (2003) argues that an Islamic bank should provide only depository services without any interest-based lending. Financing activities should take place through genuine risk-sharing arrangements in asset management. El Diwany calls for a return to the use of gold as currency whereby the supply of money would be determined neither by the private sector nor governments. The idea that private banks should not create money (a key point made by El Diwany since the late 1990s) has gained some reception in mainstream economics following the financial crisis of 2007–2008. For instance, prominent economist Martin Wolf has argued for stripping private banks of their power

[32]Some have gone so far as to assert that transacting with fiat money is prohibited in Islam. Their argument tends to rely on an incident related in the Muwatta of Malik ibn Anas (died 795 AD), an influential Shari'a scholar from Medina. In that incident, buying and selling of receipts before taking delivery of goods was deemed engaging in prohibited *riba*. Unlike the receipts, which are similar to fiat money, the gold dinar has an intrinsic value. Only tangible goods can be exchanged with each other; anything that is essentially a debt, such as an I.O.U., cannot be used as a means of exchange (Vadillo 2006).

to create money though, unlike Diwani, Wolf wants the central banks to create money.[33] By contrast, Cizakca (2010) argues that anything the public regards as currency is currency (including fiat money). Even with paper currency, 0% interest is possible and inflation can occur with a commodity currency as it can with paper currency. Yaacob (2012) reviews the infrastructure that would be required for the successful implementation of the gold dinar and concludes that the widespread issuance of the gold dinar is not feasible in light of the current political, economic, and physical framework.

With experience accumulated over four decades, some have argued that the Islamic financial sector might have been better aligned with the objectives of Shari'a through risk–reward sharing had it followed narrow banking complemented by asset management ("Reappraising the Islamic Financial Sector" 2011).

El-Gamal (2007b) advocates a mutual structure, which he believes fits better with Shari'a than the current structures being used in Islamic finance. He argues that

> mutuality in intermediation of credit and risk can assist significantly in implementing the substance of Shari'a as well as its forms, including the financial empowerment of Islamic financial customers (be they Muslims or otherwise) to face the challenging domination of Islamic finance by international financial behemoths.

Some other writers concur that mutuals and cooperatives better suit the spirit of ethical finance (see, for example, Housby 2013).

The idea of limited-purpose banking, as developed by the economist Laurence Kotlikoff (2010), has also raised interest in Islamic finance circles. As implied by its name, limited-purpose banking limits the role of banks to financial intermediation. With this limited role, banks are unable to expand the money supply and the government has full control of the money supply (M1). Financing is provided mainly by mutual funds, and unlimited liability applies to financial institutions that cannot work as mutual funds (e.g., hedge funds). By promoting genuine risk–reward sharing in the real economy, such a back-to-basics financial system is better aligned than the current system with Islamic financial principles. Another proposal for reforming the monetary system and stripping private banks of the power to create money has been put forth by Jackson and Dyson (2012). Interestingly, one of the elements of this proposal is use of risk–reward sharing "investment accounts" by banks, similar to those conceptualized in Islamic banking.

[33]Martin Wolf, "Strip Private Banks of Their Power to Create Money," *Financial Times* (24 April 2014): www.ft.com/intl/cms/s/0/7f000b18-ca44-11e3-bb92-00144feabdc0.html#axzz3FGRBEx8O.

Gaps in the Literature

Although the body of knowledge in Islamic finance is rapidly expanding, some topics remain underexplored. Worth emphasizing is the absence of assessments of the social impact of Islamic finance. Impact studies have become increasingly common in other areas, especially in microfinance and impact investing in general. However, little effort has been devoted along the same lines to Islamic finance. Does it offer incremental economic and social value that meets the objectives of Islam?

A key dimension that is underexplored is the political economy of Islamic finance. Scant literature on the subject can be found other than two studies: Warde's *Islamic Finance in the Global Economy* (2010) and *The Politics of Islamic Finance*, a collection of essays edited by Henry and Wilson (2004). Ecology and Islamic finance is another underexplored theme. The key title in this area is *Islam and Ecology: A Bestowed Trust* (edited by Foltz, Denny, and Baharuddin 2003). Some essays in the collection explore the relationship between finance and ecology in the context of Islam, but there is room for more serious work on this issue.

Another area with relatively weak content is the analysis of customers and sources of growth of Islamic finance. Few studies paint a profile of Islamic finance customers and explore how they are different from customers of conventional finance. Is Islamic finance serving a similar or different set of customers? Similarly, despite frequent references to the growth of Islamic finance, little serious analysis has been made of the sources of this growth. When it comes to explaining the reasons for cynicism about Islamic finance among Muslims, there are only intuitive claims. But without more studies, it is difficult to get a clear understanding of this important subject. Why is there a limited take-up of Islamic finance in many Muslim societies?

Islamic Finance: Success or Failure?

The starting point in Islamic finance is the belief in God and thereby His guidance on economic and financial matters. What precisely is the guidance and how to operationalize it are subject to interpretation and debate. Moreover, to what extent Muslims are willing and able to follow His guidance in their lives is hard to measure. There is, inevitably, a long way with many twists and turns between this starting point of belief in Divine guidance and the ending point of having financial services in the real world that are consistent with it.

The success of Islamic finance is often measured in quantitative terms, in terms of its higher-than-expected growth. Its shortcomings, however, are attributed to the lack of differentiated substance from conventional finance and uncertain socioeconomic value addition. Such assessments notwithstanding, a distinction should be made between the principles and practices of

Islamic finance. Even if Islamic financial practices are routinely critiqued, its principles strike a sympathetic chord with those hoping for reform of the modern financial system.

Scholarly assessments of Islamic finance are often severe. Noted critic Timur Kuran claims that "Islamic banking, in its current form, will go down in history as a mighty deceit based on an operational principle that is simply unfeasible" (Barnes 2013). El-Gamal (2007b) considers modern Islamic finance to be "rent seeking Shari'a arbitrage" (p. 3). Asutay (2008) is more concerned with the "social failure" of Islamic finance. He argues that Islamic finance does not share the aspirations or the foundational claims of Islamic moral economy. El Diwany (2006) is also critical of contemporary Islamic finance practices and argues that "if Islamic banking adopts a genuinely Islamic paradigm it can offer a solution to a world hungry for alternatives. If it does not, it will enjoy a brief life as a get rich quick bandwagon and then disappear into the relics of financial history."[34]

Although regarded as sympathetic to its ideas, Nienhaus (2013) opines that "Islamic finance as it is practiced today is not so well received by the average Muslim" but sees potential for it in some areas, such as in expanding access to finance. Warde (2010) believes that "Islamic finance is still in its early stages of development and is still beset by tensions and problems" (p. 251–252).

Practitioner and journalistic assessments are more sanguine. Oliver Agha (2012), a practicing lawyer, argues that blaming Islamic finance for the credibility challenges associated with its adherents is not fair. He believes that if Islamic finance is to be genuinely implemented, however, it must return to its spiritual roots. Islamic finance, according to journalist and political analyst Loretta Napoleoni (2008), "represents the sole global economic force that conceptually challenges rogue economics" (p. 241), and it does not allow investment in pornography, prostitution, narcotics, tobacco, or gambling—areas that have flourished in globalization and a free market economy. Camilla Hall, a correspondent for the *Financial Times*, appreciates Islamic finance's quantitative success. She argues that "no one could have foreseen that sharia-compliant banking could grow into the US$1.1tn global industry that it has become today" (Hall 2012).

If the practice of Islamic finance is received with skepticism, its underlying principles often appeal to a broad cross section of opinion-makers. Bloomberg quotes the Vatican's official newspaper, *L'Osservatore Romano*, as saying: "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service." (Totaro 2009). Commenting on Islamic finance principles, Willem Buiter

[34]Tarek El-Diwany, "Banks Subvert Islam's Ban on Usury," *Financial Times* (13 July 2006): www.ft.com/intl/cms/s/1/3507f192-1296-11db-aecf-0000779e2340.html#axzz3EycU2sNy.

(2009), then professor of European political economy at the London School of Economics, has argued that "if too much debt and too little capital are (part of) the problem, then the conversion of debt into equity is (part of) the solution."

Kenneth Rogoff (2011), a Harvard University economist, while arguing against excessive debt and in favor of equity, suggests that "perhaps scholars who argue that Islamic financial systems' prohibition of interest generates massive inefficiencies ought to be looking at these systems for positive ideas that Western policymakers might adopt." Gillian Tett (2013), editor and columnist at the *Financial Times*, while writing about Islamic finance, notes that

> the core principles—if not all the practice—are fascinating. After all, the idea of tethering our financial system more closely to the 'real' economy and tangible, productive enterprises seems distinctly appealing these days. Likewise, building a system around equity, not debt, with less financial candy floss.

A reading of the literature on Islamic finance is likely to suggest that, owing to its imperfect practices, Islamic finance has been more successful in promoting an alternative perspective on finance than in offering an alternative financial system. Its emphasis on social consciousness, risk-sharing, redistribution of wealth and opportunity, and its insistence on tying finance to the real economy shows why Islamic finance is often described as "ethical finance."

The Islamic finance industry—and its literature as of 2014—is materially different in breadth and depth from where it was in the early 1970s or, for that matter, in the early 1990s. The industry continues to evolve, and there is no reason why, in the next two decades, the field will not have evolved considerably from where it stands today.

In the wake of the global financial crisis of 2007–2008, the ideas underpinning Islamic finance might appeal to those who aspire for a relatively restrained financial system and are concerned about the broader impact of finance on society.

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This qualifies for 5 CE credits.

Glossary

arbun	An advance payment provided as part of total payment toward the sale of a good, similar to call option
bai-al-inah	A credit sale followed by spot repurchase between the same contracting parties
bai ul dayn	Sale of debt
fatwa	Religious ruling, opinion
fiqh	Jurisprudence
fiqh ul ma'amlat	Islamic commercial jurisprudence
halal	Licit, permissible
haram	Illicit, prohibited
ijtihad	Independent reasoning
ijara	A lease
istisna	Manufacturing with forward delivery and flexible payments
mudaraba	Profit sharing or investment management
murabaha	A trust sale
musharaka	A partnership or co-ownership
qard hasan	An interest-free loan
salam	A forward sale with spot payment
Shari'a	The path, the Islamic way, Islamic law
sukuk	Islamic investment certificate, Islamic bonds
tabarru	Donation
takaful	Solidarity, mutual obligation, joint guarantee, Islamic insurance
tawarruq	Monetization, a credit sale followed by spot sale between different parties
tayyib	Wholesome
wadia	Safekeeping
wakala	Agency
waqf	Charitable trust
zakah	Social welfare tax

Suggested Readings

Introductory Texts

Hassan, M. Kabir, Rasem N. Kayed, and Umar A. Oseni. 2013. *Introduction to Islamic Banking and Finance: Principles and Practice*. Harlow, UK: Pearson Education.

> "Islamic banking and finance is becoming one of the most significant aspects of the modern global financial system. Why? Because it is a fast-growing industry that has developed rapidly within a few years from a niche industry to a global force to be reckoned with in the international arena. However, with the worldwide spread of Islamic financial products and the growing interest of students and financial experts in Islamic finance, numerous books, monographs, and academic articles are being produced to explain the significance of this new industry to the global financial system. Nevertheless, there has not been much focus on a professional textbook on Islamic banking and finance for students of higher education who require case studies and practical examples in their programs. This seemingly neglected aspect of Islamic financial literature is the gap that this book seeks to fill, focusing on the principles and practice of Islamic banking and finance in the modern world. In this dynamic industry, there is a need to present a textbook for the ever-increasing academic and professional institutions offering Islamic finance as a course." (p. xii)

Nethercott, Craig, and David Eisenberg, eds. 2012. *Islamic Finance: Law and Practice*. Oxford, UK: Oxford University Press.

> "This work is a practical and commercial guide to the fundamental principles of Islamic finance and their application to Islamic finance transactions. Islamic finance is a rapidly expanding, global industry and this book is designed to provide a practical treatment of the subject. It includes discussion and analysis of the negotiation and structure involved in Islamic finance transactions, with relevant case studies, structure diagrams and precedent material supporting the commentary throughout.
>
> "An introductory section describes the theoretical background and explains the principles (and their sources) of Islamic law which underpin Islamic finance practices, providing an important backdrop to the work as a whole. The work also considers the role of Shariah supervisory boards, Islamic financial institutions and the relevance of accounting approaches. . . . The second part of the book concentrates on Islamic financial law in practice and begins with a section on financial techniques. This section explains the basic requirements for

Islamic finance contracts both in terms of the underlying asset types and also both the applicability and acceptability of the underlying asset. There is a full discussion of the various types of contractual models such as Mudaraba (trustee finance), Musharaka (partnership or joint venture), Murabaha (sale of goods), and Sukuk (participation securities: coupons etc). The nascent area of Takaful (insurance) is also covered as are matters specific to the important field of project and asset finance." (Publisher's description, http://ukcatalogue.oup.com/product/9780199566945.do)

Usmani, Muhammad Taqi. 2002. *An Introduction to Islamic Finance*. The Hague, Netherlands: Kluwer Law International.

"The present book is a revised collection of different articles that aimed at providing basic information about the principles and precepts of Islamic finance, with special reference to the modes of financing used by Islamic banks and non-banking financial institutions. I have tried to explain the basic concept underlying these instruments, the necessary requirements for their acceptability from the Shariah standpoint, and the correct method of their application. I have also dealt with the practical issues involved in the application of these instruments and their possible solutions in the light of Shariah." (p. 7–8)

Visser, Hans. 2013. *Islamic Finance: Principles and Practice*. 2nd ed. Cheltenham, UK: Edward Elgar Publishing.

"The aim of this book is to explore the products and practices of Islamic finance against the background of its ideology, including the tensions that may arise between the ideology and the practices. Islamic finance is an especially interesting phenomenon, because it presents itself as an alternative to conventional finance not only in Muslim countries but throughout the rest of the world as well, at times broadening its appeal to non-Muslims.... The structure of the book is as follows: Chapter 1 traces the motives for setting up a separate Islamic financial system; Chapter 2 describes the legal reasoning behind Islamic precepts and their religious foundation; Chapter 3 analyses what Islamic finance is all about, put against the backdrop of an Islamic economy; Chapter 4 gives an overview of Islamic financial instruments; Chapter 5 discusses the peculiarities of Islamic banking; Chapter 6 does the same for Islamic investment, insurance, and other; Chapter 7 goes into the problems confronting the central bank and the Treasury if they follow the Islamic finance principles and Chapter 8 finally tries to find an answer to the question of what can be seen as the successes and failures of Islamic finance, both from the point of view of conventional economics and in the eyes of some prominent Muslim scholars." (p. xi, xiii–xiv)

Islamic Economic Thought

Chapra, M. Umer. 1992. *Islam and the Economic Challenge*. Herndon, VA: Islamic Foundation/International Institute of Islamic Thought.

> "The ongoing revival of Islam in almost all Muslim countries has created the need for a clear, integrated picture of the programme that Islam has to offer to realise the kind of wellbeing that it envisages, and to counter the different problems now facing mankind, particularly in the economic field. Of special interest is a strategy that would help reduce to manageable limits the macroeconomic and external imbalances that most countries are now experiencing around the world, and would yet enable them to attain full employment, remove poverty, fulfill needs, and minimize inequalities of income and wealth. Can the Muslim countries formulate such a strategy within the framework of the secularist worldview of capitalism, socialism and the welfare state? Can Islam help them realise their goals? If so, what kind of a policy package do Islamic teachings imply? This book is an effort to answer these and other related questions." (p. 15)

El-Ashker, Ahmed, and Rodney Wilson. 2006. *Islamic Economics: A Short History*. Leiden, Netherlands: Brill.

> "The study covers Muslim economic thought from the emergence of Islam, long before economics became a separate discipline with distinctive analytical tools. The economic environment in ancient Arabia from which Islam emerged is examined, and the economic concepts in the Qur'ān and Sunnah are discussed, as well as the thinking of early Muslim jurists. Detailed consideration is given to Islamic economic thought during the dynasties of the Umayyads and the Abbasids, periods of administrative and economic reform, as well as of much later developments under the Ottomans, Safawids and Moghuls. Islamic revivalist reform movements are appraised, as these predated the reawakening of interest in Islamic economics in the last century, and subsequent profusion of writing, with the works of the leading contributors reviewed in this volume." (Publisher's description, www.brill.com/islamic-economics)

Iqbal, Zamir, and Abbas Mirakhor, eds. 2013. *Economic Development and Islamic Finance*. Washington, DC: World Bank.

> "Over the last three decades, the concepts of Islamic finance and Islamic economics have captured the attention of researchers. The growing market for transactions compatible with Islamic law (Shari-áh) is further evidence of growing interest in this mode of finance. By some estimates, the total volume of Islamic financial assets has grown by 15 to 20% a year since 1990 and now exceeds $1.3 trillion. The growth of the Islamic financial sector in 2006–2010 period surpassed the growth of conventional financial sector in all segments of the market, ranging from commercial banking, investment banking, and fund management to insurance in

several Muslim-majority countries. The growth of this market has been driven by the high demand for Shari-áh-compliant products, as well as the increasing liquidity in Gulf region due to high oil revenues. Following on from the significant developments that have occurred in what is viewed as the core area for this market, the predominantly Muslim countries, we are now witnessing the globalization of Islamic finance. In recent years, significant interest in Islamic finance has emerged in the world's leading conventional financial centers, including London, New York, and Hong Kong, and Western investors are increasingly considering investment in Islamic financial products. Although Islamic finance is one of the fastest growing segments of emerging global financial markets, it is often stated that the market is far below its true potential. At the same time, the concepts of Islamic finance are not fully explained and exploited, especially in the areas of economic development, inclusion, access to finance, and public policy. This volume attempts to highlight some of the key features of Islamic finance relevant to economic development. The objective of the volume is to improve understanding of the perspective of Islamic finance on economic development, social and economic justice, human welfare, and economic growth." (Abstract)

Khan, Muhammad A. 2013. *What Is Wrong with Islamic Economics? Analysing the Present State and Future Agenda*. Gloucester, UK: Edward Elgar Publishing.

"One of the main arguments of this book is that the enterprise of developing Islamic versions of mainstream economics was misplaced. It tried to convey the impression that Muslims were different from other human beings. The fact remains that they are not. They are very much like other human beings. In their assertion of being 'different', they tried to coin assumptions that appeared to be different from those of mainstream economics. For example, they argued that Islamic economics is couched in altruism, cooperation, sacrifice, justice, fraternity and brotherhood.... They further argued that since mainstream economics does not accept these assumptions there was a need to develop Islamic economics as a distinct social science. While this was an imprecise understanding of mainstream economics, the set of assumptions pushed the Muslim economists in the blind alley of an ideal Islamic society which did not exist anywhere. The postulates of Islamic economics could not be tested for want of empirical data. The new social science was still-born." (p. xiii)

Kuran, Timur. 2004. *Islam and Mammon: The Economic Predicaments of Islamism*. Princeton, NJ: Princeton University Press.

"If ANGER, RESENTMENT, FRUSTRATION, AND ENVY were four of the factors that sowed the horrors of September 11, 2001, another is the belief that Islamic offers solutions to entrenched problems of human civilization. Militants who strike in the name of Islamism, like millions of peaceful Islamists, argue, some no doubt with conviction, that Islam holds the key to a social order capable of providing social justice along with economic prosperity.... There exists a voluminous modern literature that purports to identify Islam's economic wisdom and to derive implications relevant to the present. Grounded in medieval Islamic thought, it is known as 'Islamic economics.' Notwithstanding the claims of its promoters, the significance of their literature does not lie in its substance.... The significance of this literature lies chiefly in the support it gives to the quest for the distinctly Islamic social order.... However, peaceful and well intentioned the Islamic economists themselves, their works may contribute to global economic instability. In hindering institutional reforms necessary for healthy economic development, they contribute to social despair. As important, they allow Islamic militants to rationalize crimes as serving a sacred cause." (p. ix, xv)

Tripp, Charles. 2006. *Islam and the Moral Economy: The Challenge of Capitalism*. Cambridge, UK: Cambridge University Press.

"In this study, however, the main focus will be on those who have tried to understand and to respond to capitalism, and above all to the moral freight of capitalism, from a self-consciously Islamic perspective. Some have confined themselves to publishing their views of how to guard or extend specifically Islamic identities and the interests of the imagined Islamic community in a world where material growth, technological achievement and economic power are not simply divorced from Islamic principles, but may be in conflict with them. Others, theorising about the kind of world that is coming into being, have tried to engage actively with it, or have urged Muslims to do so. Underlying both approaches has been the desire to challenge unthinking acceptance of the way the world is and to alert people to the imbalances of power inherent in forms of capitalist domination." (p. 7)

Islamic Commercial Jurisprudence and Legal Perspectives

Al-Zuhayli, Wahba. 2003. *Financial Transactions in Islamic Jurisprudence*. Translated by Mahmoud El Gamal. Damascus, Syria: Dar al-Fikr.

This is an English translation of two volumes of Wahba Al-Zuhayli's, "Islamic Jurisprudence and Its Proofs." According to the translator El Gamal, his "goal in providing this translation was to give non-Arabic readers access to the rich Islamic juristic literature on financial transactions" (Translator's Preface, p. v).

Hasan, Zulkifli, and Mehmet Asutay. 2011. "An Analysis of the Courts' Decisions on Islamic Finance Disputes." *ISRA International Journal of Islamic Finance*, vol. 3, no. 2:41–71.

"Most Islamic financial institutions operate in an environment where the legislative framework consists of mixed legal systems where the Shariah

(Islamic law) co-exists with common law and civil law legal systems. As such, every transaction, product, document and operation must comply with the Shariah principles as well as relevant laws, rules and regulations. In the case where Islamic law is the ultimate legal authority, such as in Iran and Saudi Arabia, any issue in Islamic banking cases may not pose a big problem; whilst in the countries of mixed legal systems as in the case of Malaysia or in a non-Islamic legal environment such as in the United Kingdom, the issue is very significant.... This paper strongly advocates that a proper legal framework and infrastructure as well as the substantial support of the legal fraternity are the prerequisites for the advancement and significant growth of the Islamic finance industry." (Abstract)

Kamali, Mohammad H. 2000. *Islamic Commercial Law: An Analysis of Futures and Options*. Cambridge, UK: Islamic Texts Society.

"Those who have passed prohibitive judgments on futures and options have not only failed to produce decisive evidence in support of their positions but have done so on the assumption that futures trading has no social utility and has no bearing on the welfare (*maslahah*) of the people. Their arguments consist of dogmatic negations that fail to provide viable alternatives or explore reasonable solutions. Not one of the critics of futures and options has advanced a fresh perspective on them, and almost all of them have adopted the imitative approach of applying the *fiqh* rules of conventional sale to a new phenomenon." (p. 206)

Kuran, Timur. 2010. *The Long Divergence: How Islamic Law Held Back the Middle East*. Princeton, NJ: Princeton University Press.

"The heart of the agenda [of this book] is to examine the dynamics of private economic organization in the premodern Middle East. Why critical transformations failed to occur is the question we seek to answer. Where the particulars involve religion, it is to religion that the argument must lead." (p. 24)

Vogel, Frank E., and Samuel L. Hayes. 1998. *Islamic Law and Finance: Religion, Risk and Return*. The Hague, Netherlands: Kluwer Law International.

"The objective of this book has been to introduce the subject of Islamic banking and finance, explaining it in terms of both Islamic religious law and secular western financial law and both theoretically and in concrete application.... No doubt many of the legal challenges now facing Islamic finance are disquieting and difficult—such as creating derivatives or other risk hedging devices or encouraging trade in financial instruments. If *fiqh* scholars take too cautious and literalist an approaching, backing away from the deeper competitive and functional analysis and bolder legal reasoning or *ijtihad* which is now needed Islamic finance could languish. Given the record to now, however, we are optimistic about the future." (p. 291, 295)

Prohibitions of *Riba* and *Gharar*

Al-Dhareer, Siddiq M.A. 1997. "Al-Gharar in Contracts and Its Effect on Contemporary Transactions." Eminent Scholars' Lecture Series No. 16, Islamic Research and Training Institute, Islamic Development Bank (www.irtipms.org/PubText/56.pdf).

> "In his study on Gharar jurisprudence and its implications, Dr. Al Dharir presents the Islamic Shari'ah viewpoint regarding Gharar and its implications on contracts, particularly in connection with sale contracts and other economic and financial transactions." (p. 7)

El Diwany, Tarek. 2003. *The Problem with Interest*. 2nd ed. London: Kreatoc Zest.

> "I have argued that the original and most important reason for the growth of commercial banking was the profit that arose in the process of manufacturing money for lending at interest. Banking was the industry, money the product. In the modern world the same motive drives commercial banking in a highly sophisticated way. An individual can be arrested for 'manufacturing' money in his own home but the commercial banking system is given the full protection of law in doing what amounts to the same thing. There is no justice in this. . . . There are those who say that we must develop an Islamic alternative to modern commercial banking. But why *must* we do so? The Islamic alternative to the cigarette industry is no cigarette industry, and were we to remain true to our principles we might realize that the Islamic alternative to commercial banking is no commercial banking." (p. 237, 240)

El-Gamal, Mahmoud A. 2001. "An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence" (www.ruf.rice.edu/~elgamal/files/riba.pdf).

> "The forbidden bay' al-gharar can best be translated as 'trading in risk'. In the face of risk, any trade would involve some degree of trading in risk, and thus jurists disagree over whether a specific contract is forbidden or not based on their varying assessments of whether the amount of risk is substantial or small. Moreover, the prohibition is often overruled in cases where clear economic benefit can only be served by a contract which includes substantial trading in risk. We show that 'trading in risk' is generally inefficient relative to other forms of risk sharing. Hence if a contract can attain its economic aim of increasing economic efficiency through either form of risk transfer, the prohibition of trading in risk should be applicable. Cases where such a prohibition is moot because the risk trading instrument is not used do not affect this general conclusion. In cases where trading in risk is integral to the contract, but where the contract is important to meet economic needs (e.g., salam and 'istisna) the analysis is still useful in two regards: (i) we can consider whether or not there is a risk sharing mechanism which can reduce part of the inherent trading in risk (e.g., financial vs. mutual

insurance), and (ii) we should consider such alternatives if secondary tools for managing the resulting risk are sought." (Abstract)

"Judgment Relating to Riba by Shariah Appellate Bench of the Supreme Court of Pakistan." 1999.

"The upshot of the above discussion is that: Any additional amount over the principal in a contract of loan or debt is the riba prohibited by the Holy Qur'an in several verses.... [Prophet Mohammad] has also termed the following transactions as riba: (i) A transaction of money for money of the same denomination where the quantity on both sides is not equal, either in a spot transaction or in a transaction based on deferred payment. (ii) A barter transaction between two weighable or measurable commodities of the same kind, where the quantity on both sides is not equal, or where the delivery from any one side is deferred. (iii) A barter transaction between two different weighable or measurable commodities where delivery from one side is deferred."

Siddiqi, Mohammad N. 2004. *Riba, Bank Interest and the Rationale of Its Prohibition*. Jeddah, Saudi Arabia: Islamic Research and Training Institute.

"Muslims have always agreed that *riba* is prohibited. What constitutes riba has, however, been a subject evoking deliberation and debate over the centuries that followed the age of divine revelation. Not surprisingly, the practice has reflected the differences in interpretation. Yet the core idea, the prohibition relating to the additional payment demanded by giver of a money loan, has sustained itself in the imagination of Muslim peoples in all ages. Its avoidance in practice has, however, had a chequered career. It has ranged from strict adherence to conformity with some exceptions, made on the ground of necessity or because of living outside the lands ruled by Islam, to widespread violations under some stratagem or other. During the modern times with the system of money and banking based on interest, controversy surrounds bank interest, is it the *riba* prohibited in the Quran or is it not? The overwhelming majority of religious scholars and most of the laymen consider bank interest to be *riba* while a few scholars and a section of Muslim laymen think it is not. The issue has acquired political significance in recent times because of some Muslim countries' constitutional commitment to adhere to Islamic Law (shariah). This book is a modest effort to clarify the issues involved." (p. 13)

Islamic Banking

Hassan, M. Kabir, and Mervyn Lewis, eds. 2007. *Handbook of Islamic Banking*. Northampton, MA: Edward Elgar Publishing.

"Many people are interested in the phenomenon of Islamic banking and in the question of how it differs from conventional banking, yet, despite the expansion over the last 30 years, Islamic banking remains poorly understood in many parts of the Muslim world and continues to be a mystery in much of the West. Our aim in this volume is to provide a succinct analysis of the workings of Islamic banking and finance, accessible to a wide range of readers." (p. 1)

Jaffer, Sohail, ed. 2010. *Islamic Investment Banking: Emerging Trends, Developments and Opportunities*. London: Euromoney Institutional Investor.

"Sections will cover various subjects, including the latest developments in the Islamic investment banking arena, in the two main Islamic financial hubs (Middle East and Malaysia), but also in the international arena. You will also find sections on capital markets, wealth management, international developments and regulations. . . . The content of this book is organised in five distinct parts: I: Islamic investment banking: global trends, II: Islamic capital markets, III: Wealth management, IV: New trends and developments in the international arena, [and] V: Shari'ah, regulatory and supervisory framework." (p. xxii–xxiii)

Islamic Capital Markets and Derivatives

Al-Amine, Muhammad A.M. 2011. *Global Sukūk and Islamic Securitization Market: Financial Engineering and Product Innovation*. Leiden, Netherlands: Brill.

"The Sukūk market is the fastest growing segment of international finance. The study explores the dimension of this market, its growth globally and the main Sukūk markets. The liquidity in this market, the main currency denomination, the subscription diversification, the subprime crisis effects and the dominant structures are elaborated. The difference between sovereign and corporate Sukūk, the benefits and reasons behind Sukūk issuance as well as the Sharī'ah basis are analysed. Securitisation as the best way forward for Sukūk structuring is scrutinized. The study also discusses the various legal, Sharī'ah, financial and operational risks facing Sukūk as well as the default controversies. Finally the book examines the methodologies in rating Sukūk and highlights the issues of Sukūk listing, Sukūk index and Sukūk fund." (Publisher's description, www.brill.com/global-sukuk-and-islamic-securitization-market#BIONOTE_1)

Iqbal, Imran, Sherin Kunhibava, and Asyraf W. Dusuki. 2012. "Application of Options in Islamic Finance." International Shari'ah Research Academy Paper No. 46.

"The objective of this research is to provide a clearer understanding of the options contract in Islamic finance. Option contracts provide economic benefits of hedging and flexibility of use; however, they are also used for speculative purposes that contravene the Shari'ah. Options are also objected to because of the payment of a premium, and conditional options are not allowed in currency exchanges. Islamic options have

been engineered, and some Islamic banks do use them for hedging purposes. This paper begins with an explanation and description of options in conventional finance, including the benefits, and moves on to explain the Shari'ah view on conventional options. The paper then moves on to describe Islamic options that exist within Islamic finance itself—*urbun* (earnest money), *hamish jiddiyyah* (security deposit), and *khiyar al-shart* (stipulated option)—and thereafter explains Islamic options created by Islamic banks to hedge against risk, focusing specifically on currency risk, *sukuk* (Islamic bonds) and commodity hedging. The paper concludes by discussing which types of options may be deemed to be acceptable from a Shari'ah point of view." (Abstract)

Jaffer, Sohail, ed. 2004. *Islamic Asset Management: Forming the Future of Shari'a-Compliant Investment Strategies*. London: Euromoney Books.

"During the last few years there has been a remarkable evolution in the world of Islamic asset management. This industry has evolved and its focus has enlarged from a regional one to becoming a truly global business. The world of Islamic asset management has expanded significantly and takes pride in the creation of new financial instruments such as *sukuk* and alternative investment products. It has also had a positive impact on the rapid pace of development of general *takaful* and personal lines of business, including life insurance, medical plans and protection benefits. Furthermore, it has widened the acceptance of new *Shari'a*-compliant asset classes such as hedge funds, private equity and asset-backed securities. Specialist equity indexes such as the Dow Jones Islamic Market index and the FTSE Global Islamic Index Series has been launched successfully." (Editor's introduction)

Jobst, Andreas A. 2008. "Derivatives in Islamic Finance." *Islamic Economic Studies*, vol. 15, no. 1.

"In principle, futures and options may be compatible with Islamic law if they: (i) are employed to address genuine hedging demand on asset performance associated with direct ownership interest; (ii) disavow mutual deferment without actual asset transfer; and (iii) eschew avertable uncertainty (gharar) as prohibited sinful activity (haram) in a bid to create an equitable system of distributive justice in consideration of public interest (maslahah)."

Takaful

Archer, Simon, Rifaat A.A. Karim, and Volker Nienhaus, eds. 2009. *Takaful Islamic Insurance: Concepts and Regulatory Issues*. Singapore: John Wiley & Sons.

"Takaful is the means of bringing the social and economic benefits of modern insurance converge in a form consistent with their religious beliefs, to Muslims and to the emerging economies of many

> predominantly Muslim countries…yet the development of takaful faces some formidable barriers.…These barriers are largely due to the complex structure of takaful undertakings and the unresolved issues associated with it, which make the development of an appropriate legal and regulatory infrastructure for takaful problematic. Other problems are the consequence of the newness and relatively small size of many takaful undertakings coupled with a lack of Shariah compliance reinsurance (Retakaful) capacity, within a globalising insurance industry in which the 'law of large numbers' and risk diversification play a key role and economics of scale are of major importance." (p. 287)

Gönülal, Serap O., ed. 2013. *Takaful and Mutual Insurance: Alternative Approaches to Managing Risks*. Washington, DC: International Bank for Reconstruction and Development/World Bank.

> "Access to insurance, as part of a broad range of essential financial services, is especially important for poor households in order to smooth consumption, build assets, absorb shocks, and manage risks associated with irregular and unpredictable income. Without access to good formal insurance services, the poor depend on less reliable and often far more expensive informal sector mechanisms. Yet, in many majority Islamic countries, accessing and using insurance products has been quite limited, as many Muslims avoid such services over concerns about riba (interest), gharar (uncertainty and ambiguity in contracts), and maysir (speculative risk), among other factors. Takaful insurance products are emerging as a central part of the Shariah-compliant family of financial services, helping meet insurance needs in ways that are consistent with the local norms and beliefs of many majority Islamic countries. Takaful has been developing steadily since the first Shariah-compliant insurer was founded in 1979, based on a Shariah-compliant cooperative model resembling mutual insurance. This is based on a group of participants donating funds into a pool that members can then use in the event of specified unfavorable contingencies. While practitioners have applied varying business models and standardization remains a challenge, many policy makers recognize the potential of takaful to expand financial inclusion and have aimed to promote the industry with supportive legislation and effective regulation. The response has been strong, with premiums growing about 30 percent (inflation adjusted) annually between 2007 and 2010, reaching US$8.3 billion. This robust performance is expected to continue, based on substantial latent demand in Muslim majority countries and improvements in the industry, including better distribution capabilities." (Publisher's description, http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000333037_20121018005518)

Islamic Microfinance

Ali, S. Nazim, ed. 2012. *Shari'a-Compliant Microfinance*. New York: Routledge.

> "This book brings together original contributions from leading authorities on the subject of Shari'a Compliant Microfinance (Islamic Microfinance) to propose innovative solutions and models by carefully studying experiments conducted in various countries. Where critiques of the current microfinance concepts, methods, regulatory measures and practices have often revolved around its practice of charging very high interest, this book discusses the several models that draw on both theory and case studies to provide a sustainable Shari'a compliant alternative. Arguing that while Islamic finance might have made a remarkable contribution in the financial markets, there remains a big question with regards to its social relevance, the book provides new perspectives and innovative solutions to issues facing the Islamic microfinance industry." (Publisher's description, http://routledge-ny.com/books/details/9780415782661)

Regulation and Governance

Archer, Simon, and Rifaat A.A. Karim, eds. 2013. *Islamic Finance: The New Regulatory Challenge*. 2nd ed. Singapore: John Wiley & Sons.

> "Since this book deals with a large range of regulatory issues arising from the application of Basel II and Basel III to Islamic banks, authors who have been chosen are specialists drawn from a variety of relevant backgrounds: banking and capital markets supervisors; the legal and accounting professions; banks and financial institutions; and academia. The book is organized into four main parts, reflecting different aspects of the regulatory challenge, and a concluding chapter.... Part One: The Nature of Risks in Islamic Banking.... Part Two: Capital Adequacy.... Part Three: Securitisation and Capital Markets.... Part Four: Corporate Governance and Human Resources.... Part Five: Conclusion." (p. 6–11)

Hasan, Zulkifli. 2012. *Shari'ah Governance in Islamic Banks*. Edinburgh, UK: Edinburgh University Press.

> "In view of the lack of an intensive and in-depth book in the area of Shari'ah governance, this book provides comprehensive information on the extent of Shari'ah governance practices. It aims to provide useful information on the framework and practices of Shari'ah governance of IFI's, particularly on the aspects of design and implementation, strategy and framework at the institutional, national, and international levels; the role of the regulatory authority in improving the standards and best practices and the role of Shari'ah board practices.... [It is] divided into four parts, as follow. Part 1: Theoretical concept of corporate

governance; Part 2: Theoretical concept of Shari'ah governance; Part 3: State of Shari'ah governance practices; and Part 4: Concluding remarks." (p. 2–3)

Wilson, Rodney. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. Edinburgh, UK: Edinburgh University Press.

"A detailed examination of the global banking laws and regulatory systems that govern Islamic finance. From Iran, where all banking is Shari'ah compliant, to Malaysia and the gulf, where Islamic financial institutions compete with conventional banks, Rodney Wilson examines how Islamic financial institutions are licensed and governed by common and civil law. Covering Islamic banks, takaful operators, fund management and Shari'ah-compliant securities, it examines how their assets and liabilities differ from their conventional counterparts and what the implications are for risk management." (Publisher's description, www.euppublishing.com/book/9780748645053)

Islamic Finance and Ethical Finance

Housby, Elaine. 2013. *Islamic and Ethical Finance in the United Kingdom*. Edinburgh, UK: Edinburgh University Press.

"What exactly is ethical finance? Is Islamic finance ethical? Is ethical finance Islamic?

"Islamic finance is routinely described as ethical. This reflects the fact that self-described 'ethical' finance is a large and growing sector of the market. It has a very positive image with which Islamic financial services seek to associate themselves. Yet the claim that 'Islamic' and 'ethical' are synonymous is rarely seriously examined, and nor is the claim that there exists a consistent and generally understood definition of 'ethical' practice. This book examines a wide range of financial institutions in the UK which fall broadly within the ethical sector, considering the nature of their principles and practices, and how they relate to Islamic models and to Muslim communities." (Publisher's description, www.euppublishing.com/book/9780748648955)

Political Economy of Islamic Finance

Henry, Clement, and Rodney Wilson, eds. 2004. *The Politics of Islamic Finance*. Edinburgh, UK: Edinburgh University Press.

"This book focuses on the emerging connections between 'Islamic capital', broadly defined but with a focus on Islamic finance, and Islamist political movements in Middle Eastern and North African countries. Most of these opposition movements are at least as opposed to transactional terrorist networks as to the incumbent regimes. The 'Islamic' commerce that is expanding in much of the region also deserves the close attention in its own right of political analysts and policy-makers as well as economists. Islamic entrepreneurs and capitalists are largely self-defined, but operate through Islamic financial institutions or express their interest through other self-consciously Islamic forms of association. They accumulate or channel at least a salient part of their 'Islamic' capital through these distinctively 'Islamic' financial institutions even if they also use conventional banks and stock exchanges. The Islamic banks are markers that serve to identify 'Islamic' capital and to distinguish it from other capital that is allocated through conventional banks. In this book we also cast our net more widely, by including not only the funds deployed by distinctively Islamic financial institutions but also the asset of Muslim entrepreneurs who, as in Turkey are affiliated with Islamically oriented business associations, or who, as in Egypt were black market money-changers advertising themselves as 'Islamic' despite their failure to be recognized by the formal Islamic financial sector." (p. 1–2)

Warde, Ibrahim. 2010. *Islamic Finance in the Global Economy*. 2nd ed. Edinburgh, UK: Edinburgh University Press.

"The book is divided into three parts. The first part provides background information on Islamic and finance.... It debunks common myths about Islamic and Islamic finance, traces the historical evolution of Islamic economics and finance, as well as the mechanism by which Homo Islamicus and Homo Economicus were reconciled, and considers religious injunctions as they pertain to finance.... The second part of the book introduces and describes the world of Islamic finance.... It traces the birth and evolution of modern Islamic finance the three phases... and places Islamic finance in its proper political and economic context.... The third part deals with the issues and challenges facing Islam from different vantage points.... The concluding chapter of the book addresses the impact of the global financial meltdown on Islamic finance." (p. 5)

Form vs. Substance

Dusuki, Asyraf W., and Abdulazeem Abozaid. 2007. "A Critical Appraisal on the Challenges of Realizing Maqasid al-Shari'ah in Islamic Banking and Finance." *IIUM Journal of Economics and Management*, vol. 15, no. 2:143–165.

"This paper concludes that to realise the Maqasid al-Shari'ah, Islamic banking and finance institutions must ensure that all of its transactions are Shari'ah compliant not only in its form and legal technicalities but more importantly, the economic substance which is premised on the objectives outlined by the Shari'ah. As discussed, if the economic substance of a given transaction is identical to that

of the prohibited transaction, (such as the one in which the bank or the financier acts as a creditor not as a trader of real property) then this must render the transaction impermissible regardless of its legal form." (Abstract)

El-Gamal, Mahmoud A. 2006. *Islamic Finance: Law, Economics and Practice*. New York: Cambridge University Press.

"Islamic finance as it exists today has been shown to reduce economic efficiency by increasing transactions costs, without providing any substantial economic value to its customers. Many have argued that the industry is actually demand driven ... however, Islamic finance has been largely a supply driven industry with jurists who participate actively in Shari'a arbitrage.... The form above substance juristic approach to Shari'a arbitrage has also been shown to squander the prudential regulatory content of pre-modern Islamic jurisprudence, while reducing economic efficiency for customers though spurious transactions, not to mention legal and jurist fees ... most of the shortcomings and inherent dangers of Shari'a-arbitrage behaviour can be minimized by redefining the brand name of Islamic finance in terms of truly religious social and economic developmental goals." (p. 190)

Nienhaus, Volker. 2013. "Islamic Finance: Attractive for Non-Muslims?" *Islamic Business and Finance*, vol. 78 (April/May):36 (www.cpifinancial.net/flipbooks/IBF/2013/Apr/files/assets/basic-html/page36.html).

"Given meager market shares of 10 per cent or less of total bank deposits from the general public even in many Muslim countries where Islamic finance is operating since two decades or (much) more, it becomes apparent that Islamic finance as it is practiced today is not so well received by the average Muslim. Thus it may be a good idea not only to look for non-Muslim clients, but also to target the 90 per cent or more of Muslims who still prefer conventional finance. Maybe they have similar problems as non-Muslims have to appreciate a difference in substance that could compensate for increased contractual complexity and legal risks without higher returns or superior product qualities."

Usmani, Muhammad Taqi. 2007. "Sukuk and Their Contemporary Applications." AAOIFI Shariah Council, Bahrain (www.muftitaqiusmani.com/images/stories/downloads/pdf/sukuk.pdf).

"Undoubtedly, Shariah supervisory boards, academic councils, and legal seminars have given permission to Islamic banks to carry out certain operations that more closely resemble stratagems than actual transactions. Such permission, however, was granted in order to facilitate, under difficult circumstances, the figurative turning of the wheels for those institutions when they were few in number [and short of capital and human resources]. It was expected that Islamic banks would

progress in time to genuine operations based on the objectives of an Islamic economic system and that they would distance themselves, even step by step, from what resembled interest-based enterprises. What is happening at the present time, however, is the opposite. Islamic financial institutions have now begun competing to present themselves with all of the same characteristics of the conventional, interest-based market place, and to offer new products that march backwards towards interest-based enterprises rather than away from these. Oftentimes these products are rushed to market using ploys that sound minds reject and bring laughter to enemies." (p. 13)

Education

Belouafi, Ahmed, Abderrazak Belabes, and Cristina Trullols, eds. 2012. *Islamic Finance in Western Higher Education*. New York: Palgrave.

"This book has been divided into three parts. Part I provides a detailed overview of IF education in the United Kingdom, France, and Italy, its trends, developments and future outlook. At the same time, it provides an analysis of the top ten business schools that offer IF.

"Part II, the central part of the books, provides a series of case studies from Western higher educational institutions in Europe and Australia. It describes their particular experience with IF, including their educational taught programmes, career placements, research opportunities and activities in this sector. These institutions include Reading University, La Trobe University in Australia, Reims Management School, Newcastle University, Bangor University, the Markfield Institute of Higher Education (an affiliate of the Islamic Foundation), Strasbourg University, University of Leuven, and Liverpool Hope University.

"Part III offers an insight into the research and other initiatives that have taken place in Western higher education institutions which include: the Islamic Finance Project of Harvard University, the Islamic Finance initiative at Westminster University, and the Saudi-Spanish Centre of Islamic Economics and Finance at IE Business School." (p. 9–10)

Empirical Studies

Beck, Thorsten, Asli Demirgüç-Kunt, and Ouarda Merrouche. 2010. "Islamic vs. Conventional Banking: Business Model, Efficiency and Stability" World Bank Policy Research Working Paper 5446 (October).

"This paper discusses Islamic banking products and interprets them in the context of financial intermediation theory. Anecdotal evidence shows that many of the conventional products can be redrafted as Sharia-compliant products, so that the differences are smaller than

expected. Comparing conventional and Islamic banks and controlling for other bank and country characteristics, the authors find few significant differences in business orientation, efficiency, asset quality, or stability. While Islamic banks seem more cost-effective than conventional banks in a broad cross-country sample, this finding reverses in a sample of countries with both Islamic and conventional banks. However, conventional banks that operate in countries with a higher market share of Islamic banks are more cost-effective but less stable. There is also consistent evidence of higher capitalization of Islamic banks and this capital cushion plus higher liquidity reserves explains the relatively better performance of Islamic banks during the recent crisis." (Abstract)

Hasan, Maher, and Jemma Dridi. 2010. "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study." IMF Working Paper No. 10/201 (1 September): www.imf.org/external/pubs/cat/longres.cfm?sk=24183.0.

"This paper examines the performance of Islamic banks (IBs) and conventional banks (CBs) during the recent global crisis by looking at the impact of the crisis on profitability, credit and asset growth, and external ratings in a group of countries where the two types of banks have significant market share. Our analysis suggests that IBs have been affected differently than CBs. Factors related to IBs' business model helped limit the adverse impact on profitability in 2008, while weaknesses in risk management practices in some IBs led to a larger decline in profitability in 2009 compared to CBs. IBs' credit and asset growth performed better than did that of CBs in 2008-09, contributing to financial and economic stability. External rating agencies' re-assessment of IBs' risk was generally more favorable." (Abstract)

Imam, Patrick, and Kangni Kpodar. 2010. "Islamic Banking: How Has It Diffused?" IMF Working Paper No. 10/195 (August).

"This paper investigates the determinants of the pattern of Islamic bank diffusion around the world using country-level data for 1992–2006. The analysis illustrates that income per capita, share of Muslims in the population and status as an oil producer are linked to the development of Islamic banking, as are economic integration with Middle Eastern countries and proximity to Islamic financial centers. Interest rates have a negative impact on Islamic banking, reflecting the implicit benchmark for Islamic banks. The quality of institutions does not matter, probably because the often higher hurdle set by Shariah law trumps the quality of local institutions in most countries. The 9/11 attacks were not important to the diffusion of Islamic banking; but they coincided with rising oil prices, which are a significant factor in the diffusion of Islamic banking. Islamic banks also appear to be complements to, rather than substitutes for, conventional banks." (Abstract)

Khan, Ayesha, and Tarun Khanna. 2010. "Is Faith a Luxury for the Rich? Examining the Influence of Religious Beliefs on Individual Financial Choices." Ninth Harvard University Forum on Islamic Finance.

> "This paper investigates how religious preferences affect the decision to invest in simple banking products. We look at a unique dataset of consumer level information on 9,078 individuals opening basic savings accounts at thirty matched branches of an Islamic bank and a conventional bank. We find that within the same location twice as many accounts were opened at the Islamic bank and held higher average balances—even though the comparable conventional bank was larger, better established and offered less risky returns. In order to determine the reasons for the popularity of Islamic bank, we administer a detailed questionnaire on individual religiosity and the determinants of banking choice to a randomly chosen set of customers from our sample. We test various reasons for the disproportionate popularity of the Islamic bank in our sample including a lack of awareness of alternative options, lower financial literacy, private information on management and the expectation of better services. Using responses from 1,480 customers we find that even in a generally religious population the level of religiosity is a significant predictor of financial choices. Our results reject the hypothesis that Islamic banking customers are not aware of alternative options or that they are not financially literate. We also find that the performance of Hajj—the Islamic pilgrimage to Mecca—is the single most significant predictor for opening an Islamic account. This finding, plus the fact that Islamic banking customers are older, better educated, have traveled to more countries and maintain higher average balances, indicates generally higher income levels for Islamic banking customers. We conclude that in addition to individual religiosity, wealth also matters. At least as far as opening an Islamic bank account is concerned, faith appears to be a luxury that is easier to afford for the wealthy." (Abstract)

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