Ends and Means in Islamic Banking and Finance

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Abstract: This article uses the framework of ends and means in Islamic finance to explore, first, the divergence between the ideal conception and the reality of the actual practice of Islamic banking, and second the efficiency of Islamic banking operations. Following this analysis, these themes are then taken up in the six other articles in this special issue. A guide to the articles, and an evaluation of the issues, is provided in this introductory essay.

I. Ends and Means

Banking and financial systems based on Islamic tenets exist primarily to provide religiously-acceptable services to the Muslim community (*ummah*), and do so by the establishment and operation of financial institutions and organizational structures dedicated to that purpose. There are thus ends and means. In examining the efficacy of Islamic banking and financial markets, it is valuable to keep this distinction in mind. How well do the Islamic financial services meet the religious aims and the expectations of the Islamic community? By what means and how effectively are those ends attained?

This distinction is apparent in the six papers that follow this introductory essay. Three of the papers are concerned with the objectives of Islamic financial systems, the nature of the services provided and the extent to which the services of Islamic banks and financial institutions are in accord with the religious principles and duties. The other three papers, broadly speaking, are concerned with how efficiently those services are

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provided and the organizational structures for stock market investment in the Muslim world. In order to provide an introduction and commentary on these issues, we begin by outlining the objectives of an Islamic financial system and the role of the institutions involved.

II. The Objectives of Islamic Finance

To Westerners, finance is a means to an end. Under Islam, finance is a religious duty, an end in itself. There are two major differences from the conventional financing framework. First, and foremost, an Islamic organization must serve God and adopt an ethos that differentiates it from non-Islamic bodies. Second, following on from this obligation, the bank must design and provide acceptable financial instruments and products. It is in both aspects that the concept of 'stewardship' is valuable for understanding the behaviour of those enjoined in this task. The Islamic concept of *amānah,* or trust, signifies that "wealth belongs to God and man is, individually and collectively, custodian of wealth" (Ali, 1999: 13). Wealth can only be employed for defined ends. The purpose is to create a collective morality and spirituality which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life.

There are accordingly obligations on both sides, banks and customers alike.

> Islamic banks have a major responsibility to shoulder... all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God, the Almighty. (Janahi, 1995: 42)

Further, these obligations extend also to the Islamic community (*ummah*):

> Muslims who truly believe in their religion have a duty to prove, through their efforts in backing and supporting Islamic banks and financial institutions, that the Islamic economic system is an integral part of Islam and is indeed suited for all times … through making legitimate and *Halal* profits. (Janahi, 1995: 29)

The Islamic concept of *ummah* or solidarity amongst Muslims is in turn linked to that of *amānah* or trust: wealth is to be acquired, used and distributed within the framework of *Sharīʿah.* No person has an absolute

right to use his wealth as he wishes but may only use it for purposes consistent with Islamic values. The same concept of *amānah* also means that Islamic banks act as trustees for the investors whose funds they manage, and they have to fulfil their obligations responsibly and with due diligence. In particular, when mobilizing deposits and making investments, the Islamic financial institution differs from a conventional bank because the institution has an overriding obligation to obey a different set of rules – that of Islamic law, the *Sharīʿah* – and generally comply with the expectations of the Muslim community by providing partnership financing on the basis of profit-and-loss-sharing (PLS) arrangements or other acceptable modes of financing.

Based on Islamic law, four main principles shape the activities of the Islamic bank. First, Muslims are banned from taking or giving interest (*ribā*) and otherwise benefiting from profits derived from fixed, predetermined interest payments. Profit earned from trade in goods and services is acceptable, but not that obtained from the exchange of money for money. Second, for this reason, financial transactions need to be based on real economic activity, not monetary exchanges. Third, no Islamic financial institution (or for that matter no Muslim) can engage in financing anti-social activities such as alcohol, pork, armaments, and gambling that are illegal (*ḥarām*) to an adherent to the faith. Fourth, because of the prohibition on gambling, financial products and economic transactions that carry a high level of risk or uncertainty (*gharar*, literally 'hazard') are not permitted.

Interest-free banking in its purest form is based on the concepts of *shirkah* (partnership) or *mushārakah,* and *muḍārabah* (profit-sharing). An Islamic bank is conceived as a financial intermediary mobilizing savings from the public on a *muḍārabah* (trustee) basis and advancing capital to entrepreneurs on a PLS partnership basis. Ideally, a two-tiered profit-and-loss-sharing arrangement (PLS) should operate.

In practice, Islamic banks deviate from the two-tiered PLS system. On the deposit side, most funds (at least in value terms) are raised on the basis of a *muḍārabah* PLS contract, although there are also deposits made on an interest-free loans (*qarḍ ḥasan*) or *wadīʿah* (safe-keeping), on which the bank may make *ex gratia* payments. On the asset side, however, PLS instruments are in reality rarely employed. Instead, a variety of debt or quasi-debt financing modes are used, designed to be based around trading activities, and involving a pre-agreed profit-sharing formula. For example, rather than lending money to purchase property or goods, the Islamic bank

buys the asset itself and re-sells it to the buyer at a pre-determined profit. In order to provide security and protect itself from the risk of default, the bank enters into a purchase and resale contract (*murābaḥah*), in which the asset is purchased by the bank from a supplier at the request of its customer and then re-sold to the customer on a cost plus profit mark-up basis, with the bank repaid on a deferred basis or in instalments.

The divergence of such mark-up financing from the ideal of PLS partnership financing (in which the profit-sharing is conditional upon the end-result or outcome of the project) has been, and continues to be, a source of disagreement between the practitioners, on the one hand, and the scholars, on the other. At the same time, it is often claimed that there is meant to be more to Islamic banking, such as contributing towards economic development and a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra, 1982). On both counts, Hamoudi (2006: 8), for example, speaks of "the failures of Islamic finance" which have led to the creation of "a bizarre and highly artificial construct that does nothing to address the social concerns that are the central reason for the creation of Islamic banking and finance". These two issues, the role of PLS contracts in Islamic banking and the broader socio-economic objectives of the system, constitute the topics examined in the first three articles which follow this introduction.

III. In Whose Interest?

Obviously, the *raison d'être* of an Islamic banking and financial system is to allow the Muslim communities to undertake financial services in Islamically acceptable ways. Many, as noted, would go further and argue that in addition to this special function, the banking and financial institutions, like all other aspects of the Islamic society, are expected to "contribute richly to the achievement of the major socio-economic goals of Islam" (Chapra, 1985: 34). The most important of these are economic well-being with full employment and a high rate of economic growth, socio-economic justice and an equitable distribution of income and wealth, stability in the value of money, and the mobilization and investment of savings for economic development in such a way that a just (profit-sharing) return is ensured to all parties involved. Perhaps the religious dimension should be presented as a further explicit goal, in the sense that the opportunity to conduct religiously legitimate financial operations has a value far beyond that of the mode of the financial operation itself.

The validity of these general objectives is seldom questioned. However, there is no consensus about the appropriate structure of the overall financial system needed to achieve them, and rarely are those with a stake in the result asked their views on the topic. This omission is addressed by Asyraf Wajdi Dusuki in his article *The Ideal of Islamic Banking. A Survey of Stakeholders' Perceptions.*

Dusuki takes as his starting point the two conceptions of an ideal Islamic financial system identified by Lewis and Algaoud (2001). One vision is the framework proposed by Chapra (1985) and Siddiqi (1983). The other is that of Ismail (1986). They differ in terms of the behaviour that is expected from the constituent institutions. Chapra suggests a system comprising the following institutions: central bank; commercial banks; non-bank financial institutions; specialized credit institutions; deposit insurance corporations; and investment audit corporations. Although on the surface this structure appears to be much the same as that for a conventional financial system, Chapra envisages that there are differences in the functions, scope and responsibilities of the institutions concerned. Each of the institutions is seen as an essential component of the integrity of the system and as such necessary for the achievement of the desired objectives of abolishing interest, achieving an equitable distribution of income and wealth, and promoting economic development.

In particular, Islamic commercial banks in this setting would differ from conventional commercial banks in two main ways. The first and most significant difference would be the abolition of *ribā*. In turn, this prohibition would force banking to develop new methods of operations based primarily around PLS arrangements. A second principal difference would be that funds which come from the public should be used to serve the common interest and not individual gain. Thus banking transactions should not be solely profit-oriented, but instead aimed at the overall needs of Islamic society. In order to achieve these twin goals, Islamic banks would thereby tend to become universal or multi-purpose banks instead of purely commercial banks: a "cross-breed of commercial and investment banks, investment trusts and investment-management institutions..." (Chapra, 1985: 154).

Those projects and sectors of the economy that might not be attractive to commercial banks or other profit-motivated institutions, but are nevertheless important from a wider communal perspective, would be financed by the specialized credit institutions. Their field of operation could include farmers, artisans, and other small businesses and entrepreneurs.

The deposit insurance fund and the investment audit corporation would be government-sponsored organizations set up respectively to insure demand deposits in commercial banks and to safeguard the interests of profit-sharing investors and equity holders. There is no equivalent to the investment audit corporation in Western banking because of the importance of the PLS principle in Islamic finance. For these reasons, the auditing process would reach beyond conventional auditing principles to consider investment projects and the reliability of management practices so as to ensure an equitable division of the returns between shareholders and profit-sharing depositors.

In short, the main characteristic of Chapra's framework is the dispersal of social welfare responsibilities and religious requirements to all levels of the financial system, ranging from the central bank to private commercial banks to the deposit insurance and audit corporations. This communal role explicitly adds an extra parameter to the objective function of the Islamic financial agent.

An alternative setting for Islamic banking is proposed by Ismail (1986), who argues for a more thorough division of responsibilities. He sketches an Islamic economic system which consists of three sectors, namely: *siyāsī*, the government sector, which encompasses public finance and central banking; *ijtimāʿī*, the welfare sector, with responsibility for the administration of taxes, and *tijārī*, the commercial sector, which covers all private sector commercial activities. In each of these sectors there would be several different types of institutions, all of them working on the basis of general *Sharīʿah* principles but applied to the particular operations undertaken. The Islamic financial system constitutes institutions from all three sectors.

Within this framework, the Islamic commercial banks belong to the *tijārī* or the commercial sector, and their responsibilities are limited to commercial activities. The task of ensuring an equitable income distribution does not burden the Islamic bank, but rather it concerns the *siyāsī* as a task of public finance. Likewise, the collection and distribution of taxes is not a commercial bank task but rather the responsibility of different *ijtimāʿī* institutions.

This example highlights the differences between the two structures. According to Chapra, each of the institutions in an Islamic economic system must explicitly take responsibility for the fulfilment of the general economic and social objectives, sometimes at the cost of individual profitability. The operations should consequently be biased in favour of socially, but

not necessarily financially profitable projects. In Ismail's framework, by contrast, Islamic banks are overridingly commercial institutions, with responsibilities essentially to shareholders and depositors; society is served by them pursuing their self-interest (in effect Adam Smith's invisible hand), augmenting profit and income, along with *zakāt* distributions.

To our knowledge, Dusuki's study is the first to investigate the views of Islamic bank stakeholders (customers, depositors, employees, local communities, regulators, managers and *Sharīʿah* advisors) on such matters – these being the PLS principle, distinctiveness of products, profit maximization, social welfare role and enhancement of the community rather than shareholder wealth. His survey was undertaken in Malaysia.

Although there was (perhaps surprisingly) strong agreement on a number of issues, there were also instances where the views of the stakeholders differed. Specifically, employees, customers and depositors gave more weight to the idea that PLS is the only principle that represents the true spirit of an Islamic banking system than did *Sharīʿah* advisors, managers and regulators. There was a similar divergence between these groups on the distinctiveness of current practices and products of Islamic banks in Malaysia.

These findings provide an appropriate setting for the papers by Jalaluddin and Farooq, which deal with the issue of PLS financing modes.

IV. PLS Financing Modes

Most Islamic financial institutions are concentrated in the Middle East and South and Southeast Asia (with Bahrain and Malaysia being the largest centres). However, there are also Islamic institutions providing financial services in Europe (with London as the biggest hub), the United States and Australia. In the second of the six articles that follow this introduction, Abdul Khair Jalaluddin surveys the attitudes of 385 small business enterprises in Sydney, Australia to PLS methods of finance. He found that a large number (although certainly not all) were favourably disposed to this financing mode. Risk-sharing with banks and the reduction in the chances of bankruptcy due to business support in hard times were identified statistically as two major reasons why the small business firms were attracted to PLS finance rather than to borrowing from a conventional bank.

Ironically, if these small business enterprises actually obtained finance from an Islamic bank (and there are two Islamic financial institutions operating in Australia, the Muslim Community Cooperative Australia and

Balance Finance) they would find, for the most part, that they face financial conditions not dissimilar to those on conventional loans. Admittedly, the Islamic bank does not earn interest from loans, but it does receive profit-share income from cost-plus services (*murābaḥah* mark-up) or fixed charges from the leasing of assets (*ijārah* lease rentals).

In fact, a special feature on Islamic banking in the *Monash Business Review* for April 2007 was announced with dramatic artwork on the cover showing a large 0% and underneath the words 'Islamic banking's point of difference'. The practical reality, however, is that the point of difference seems to be to a large degree terminological with a cost plus service mark-up or a fixed leasing charge substituting for the rate of interest. In the main article in that issue, Ariff (2007: 9) accepts that Islamic banking is a variant of conventional banking and that "Islamic banking at this early stage is considered by some to be merely an approximation bordering on a legal fiction (*ḥiyal*) of what they should truly be'.

The phrase 'at this early stage' in the quotation above could be considered as a point of mitigation if the system were still in its formative years. It is true that the 30-year history of Islamic banking does not equate to the hundreds of years over which conventional banking has evolved. Nonetheless, it would seem that the two systems are coming closer together rather than drawing further apart. For those seeking evidence on this convergence, three examples will suffice.

First, there is the transition from traditional *murābaḥah* to what Saadallah (2007) calls 'financial *murābaḥa*h'. According to Saadallah, the instrument of *murābaḥah*, as inherited from and recognized by Islamic jurisprudence, was not designed to meet the needs of bankers and other financiers for a substitute financing technique. *Murābaḥah* simply means mark-up sale. It is a particular type of sale that Islamic jurisprudence considers as a trust contract, because the seller and the buyer do not negotiate the price, but rather agree on a certain profit margin added to the cost, as declared by the seller. As such, it was never conceived of as a mode of finance, since it was not necessarily concluded on the basis of deferred payment, and sale for cash was the rule rather than the exception. The shift to credit *murābaḥah*, or *murābaḥah* with deferred price, is a first requisite for its transformation into a technique of finance. The second amendment is the requirement that the sale contract be preceded by the customer's promise to buy the desired goods, once they are acquired by the financier. So transformed, the financial *murābaḥah* is differentiated

from the original *murābaḥah* sale in two respects: credit is an indispensable feature of the transaction, and not just a mere possibility; and the existence of a prior promise to buy is a precondition for the extension of credit. The consequence, in the opinion of Ahmad (1994: 46-7), is that

> … the current practice of 'buy-back on mark-up' is not in keeping with the conditions on which *murābaḥah* or *bayʿ muʾajjal* are permitted. What is being done is a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of *Sharīʿah* injunctions.
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> …as a student of economics and *Sharīʿah* I regard this practice of 'buy-back on mark-up' very similar to *ribā* …

Similarly, Zaman (1994: 208) writes:

> …in order to make themselves eligible to a return on their operations, the banks are compelled to *play tricks with the letters of the law*. They actually do not buy, do not possess, do not actually sell and deliver the goods; but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfil a legal requirement but *it is by violating the spirit of prohibition.*

As a second example, there is the practice of *tawarruq*, cited by El-Gamal (2007) as one recent illustration of the fact that Islamic banks have developed according to a model that is very similar to conventional banks. Under the *tawarruq* mechanism (the process of monetization of a commodity), a bank purchases and then sells its customer a commodity at a marked-up price over spot to be paid over a specified time period. The customer then resells the commodity for cash at the current market spot price. Interest as such is not levied, with the bank's profit coming from the difference between the purchase price and the higher price agreed upon by its customer. All three trade transactions (cash sale to the bank, credit sale to the customer, and cash sale back to the commodity dealer) which justify its Islamicity can be handled by the bank, virtually instantaneously, acting as agent for both dealer and customer. However, the upshot is that the customer has obtained cash, in this roundabout way, in the form of an unsecured loan. El-Gamal sees this practice as an example of what he calls '*Sharīʿah* arbitrage', when conventional lending practices are replicated in Islamically acceptable ways

in the balance sheets of Islamic financial institutions. To him, the Islamic finance industry has degenerated into one that is dominated by form over substance, the chief aim of which is to circumvent, rather than comply in any meaningful way, with the Qur'anic injunctions against *ribā* (interest) and *gharar* (excessive uncertainty).

A third example is the development of Islamic bonds, or *ṣukūk*. Consider, for example, the case of a *ṣukūk al-ijārah*. The originator holds assets (land, buildings, aircraft, ships, etc.) that are to generate the returns to the *ṣukūk* investor. These assets are sold by the originator to a special purpose entity (SPE) and then are leased back at a specified rental. The SPE securitizes the assets by issuing *ṣukūk* certificates that can then be purchased by investors. Each *ṣakk* certificate represents a share in the ownership of the assets, entitling the investor to periodic distributions from the SPE funded by the originator's rental payments on the leased assets. The returns can be either fixed rate or floating rate. Since the yield is predetermined and the underlying assets are tangible and secured, the certificate can be traded, enabling a secondary market to develop (Mirakhor and Zaidi, 2007; Obaidullah, 2007).

Islamic banks can thus deal in, hold and buy and sell these bonds. Interestingly, on religious grounds devout Muslims refuse to buy conventional bonds because they violate the prohibition against earning predetermined interest returns. Yet, the fixed rate or LIBOR-linked *ṣukūk*s do comply with Islamic laws by virtue of the ownership of the underlying assets. For example, the certificates for the first *Sharīʿah*-compliant securitized market financing of US assets are structured so that Islamic investors effectively get a fixed rate of return (11.25% annually) while regarding themselves as owners of the underlying assets. An official *Sharīʿah* adviser issued a *fatwā*, or declaration, certifying that the instrument 'will yield returns, Allah willing, that are lawful and wholesome' (*Business Week*, July 17, 2006: 9). Tellingly, a press report on a later issue referred to 'so-called Islamic bonds – or *ṣukūk* – that are structured to avoid overt *ribā* payments' (*The Australian*, 2006: 47). The word 'overt' is revealing.

Carrying through this line of reasoning, some might consider it warranted to distinguish between interest-free or *ḥalāl* banks, which obey the letter of the Qur'ān but not its spirit, and true Islamic banks, which practise PLS modes rather than financing based on mark-up or lease charges and also have an explicit socio-economic responsibility (Khan, 1986: 2–3). On this division, most of the present Islamic banks should be referred to

as *ḥalāl* banks. Nevertheless, even in this case, the objective of eschewing interest is at least partly fulfilled if only in a strict legal sense. Individually, Muslims can choose to deal with banks which make interest-free financial transactions, even though Islamic principles concerning the use of funds may not be fully realized in terms of strict orthodoxy. It should also be noted that the distinction between an Islamic and a *ḥalāl* bank has not been recognized in jurisprudence.

Nor indeed should it be recognized if we accept the views of Mohammad Farooq in his article '*Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss-Sharing*' included in this special issue. We will let Farooq speak for himself, but it can be said that he makes a strong and compelling case for the impracticality of implementing traditional PLS financing modes such as *muḍārabah* and *mushārakah* in the context of a modern financial system. By implication, the Islamic banks have been unfairly criticized by scholars such as those cited earlier in this article for their reliance on the cost-plus, fixed rate of return instruments such as *murābaḥah* and *ijārah*.

While in broad sympathy with many of his sentiments, we would nevertheless take issue with Farooq on two points. First, he issues a challenge:

> The distinctive characteristics of *muḍārabah*, as specified by classical Islamic jurisprudence, illustrate the underlying problems as to why such arrangements are not so compellingly attractive to rational financiers on a PLS basis. Hence in the context of bank participation to a project, financing would come from the bank; the entrepreneur would make no financial contribution to it. Thus, risk of financial loss would be borne by the bank... the financing partner, while the entrepreneur's loss would be limited to his labor. Would a rational investor or financier find such an arrangement attractive?

Well in some cases, yes, is the answer. One notable example can be given, for this arrangement is essentially what happens with a standard book-publishing contract. Royalty payments mean that the author and publisher have a predetermined profit-sharing formula, but if the book fails to sell, the publisher bears the financial loss while the author's loss is limited to his labour. To be sure, the publisher has control over quality (since the completed manuscript when it is delivered might not survive the editorial process) and has control over marketing, which does not occur with *muḍārabah*. Nevertheless, the similarity is still apparent.

However, we would suggest that such a contractual agreement can be thought of as 'the exception that proves the rule'. There is clearly a high degree of trust between publisher and author that is not so obviously paralleled in modern financial systems. Many Islamic banks operate in business environments in which the 'underground' or 'black economy' is active, and have to deal with firms that maintain multiple sets of books (one for the taxman, one for the bank, one for family partners) so that profit and losses become malleable. Others operate in an international context in which, say, a letter of credit under the *murābaḥah* principle enables buyers to take delivery of goods for international trade, with the bank acting as intermediary. Trade financing by such fixed-return instruments is a corollary of their involvement in the international trade network. The more international the bank, and the more it is involved in trade, the more such instruments are likely to feature in their balance sheets. Moreover, there is a further implication. In such a global environment, the potential for bank customers to shift profits to an offshore location and leave losses on the local books to be shared with the financier reinforces Farooq's concerns about the incentive compatibility and moral hazards of PLS techniques when they are removed from their historical scriptural context.

We also have an issue with Farooq's conclusion. He argues:

> …the fascination with PLS-only as the ideal Islamic mode is a carryover from classical Islamic jurisprudence, which the so-called *homo Islamicus* is finding insurmountably difficult to implement…
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> … The evidence of IFI [Islamic financial institutions] behaviour is quite clear that, even though they aim to be interest-free and thus avoid monetary debt contracts, in reality they have landed on *ḥiyal* (ruse; legal stratagems) by following the prohibition in form, while circumventing it in substance.
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> …the IFIs make up ruses (*ḥiyal*) to manufacture products and services that are only legally Islamic or *Sharīʿah*-compliant. But there isn't much difference in substance between IFIs and conventional financial institutions. This being the case it is no wonder that conventional financial institutions are aggressively grabbing their share of this niche market as they can easily adapt the form of their operations.'

Our disagreement is not with this statement, but rather where one goes from there.

A number of possibilities suggest themselves. First, one possibility, that we suggested earlier (Hassan and Lewis, 2007), is to encourage a four-way dialogue between the *fiqh* academies, Islamic bankers, IFI *Sharīʿah* scholars, and the general public with the aim of shifting the focus of competition away from the replication of conventional banking in *Sharīʿah*-acceptable forms to a broader Islamic agenda. The result might be the development of 'good housekeeping awards', and ratings based on banks' adherence to 'true' Islamic principles serving as a different form of competitive advantage. Second, Neinhaus (2007) puts the blame for what is tantamount to *ḥiyal* on the nexus between Islamic bankers and the *Sharīʿah* advisory boards. In order to counter permissiveness in *Sharīʿah* board decisions, he recommends the establishment of independent, national *Sharīʿah* boards less amenable to cater to the bankers' financial interests. Third, El-Gamal (2007) sees the share-ownership structure of Islamic banks as a culprit, and recommends mutuality as an antidote to what he calls 'rent-seeking *Sharīʿah* arbitrage in Islamic finance' – although we would note that the mutual ownership credit unions have not found that the common bond of mutuality travels far in the modern financial world (Walter, 2006). Fourth, we have Farooq's own suggestion, which begins with the rhetorical question of whether PLS contracts could be modified and rendered workable under present-day conditions. He answers in the affirmative, while accepting that the contracts would need to be significantly delinked from classical Islamic jurisprudence. Presumably this means that Islamic banks would need to return to Chapra's (1985) original vision and become more like merchant/investment banks, German universal banks or French *banques d'affaires* and take equity stakes as a matter of course in complex financially engineered capital market arrangements.

Nevertheless, we wonder whether these ideas will lead the Islamic financial system towards the ideal structure it is meant to be. Although we do not want to put words into Farooq's mouth, some of his comments lead us to recall the (now strongly discountenanced) modernist or revisionist views of Fazlur Rahman (1964 [2007]). According to Rahman, the Prophetic *Sunnah* was never meant to remain static, but to evolve and develop. He thus opposes any literal application of *ḥadīth.* What is needed instead is to study *ḥadīth* in a situational context. A particular practice or law might be considered a true outworking of the *Sunnah* in one era, but considered dispensable or incompatible with *Sunnah* in another era. Rahman's primary example is the case of *ribā* (interest, usury). While the spirit behind the

prohibition clearly does date back to the Qur'an and the message of the Prophet, the particular definition given to *ribā* as formalized by early generations of Muslims (and enshrined in the *ḥadīth*) need no longer be applied. Rather, the *ḥadīth* should be studied to ascertain the spirit behind the injunction, leaving modern-day Muslims to work out the detail of the application for themselves (Brown, 1996).

A revisionist agenda on a redefinition of *ribā* would begin by recalling the characteristics of Arab society at the time – a largely agricultural, partly nomadic, civilization living as settled communities, linked by caravan routes to each other and Asia Minor. In such an environment, the need for borrowing often arose, not from normal commercial expansion, but from misfortune – famine, crop failure, loss of a caravan, and so on. To charge interest to kin, under such circumstances, would violate tribal loyalty. Indeed, a system of lending freely without interest could be seen as a sort of mutual-help insurance system in an environment very different from that which largely operates today. On this basis, it might be argued that the prohibition of *ribā* was primarily to prevent exploitation and relates only to exorbitant interest rates and not to all forms of interest. The reference in the Qur'ān to *ribā* "doubled and multiplied" (3: 130) may reflect that at the rise of Islam the practice of lending money was being exploited in an unequal relationship in an uncompetitive environment so as to reap excessive gains from the interest charged on loans. If borrowers could not meet the due date by which to return the capital borrowed, the lenders would double and then redouble the interest rates thus reducing the debtor to penury. Such practices were deemed intimidatory, unjust and against social and economic welfare. The Islamic interdiction of *ribā* therefore fell into the net of social reform instituted by the Prophet upon pre-Islamic practices. Farooq ventures the view that 'although *ribā* is categorically prohibited, interest on loans for mutual benefits and mutually agreed, without any exploitative aspects, may not be prohibited'.

Broadly similar debates took place in the Christian Church in the sixteenth century, beginning with John Calvin's denial (in a series of letters beginning in 1547) that the taking of payment for the use of money was in itself sinful. Calvin argued that neither the Old nor the New Testament rulings on this (and other issues) were universally applicable and binding for all time because they were shaped by and designed for conditions that no longer exist. Rather, they should be interpreted in the light of individual conscience, the equity of the 'golden rule' (do unto others as you would have

them do unto you), and the needs of society. Seen in this light, the lender at interest is no longer a pariah but a useful part of society. Usury does not conflict with the law of God in all cases and, provided that the interest rate is reasonable, lending at interest is no more unjust than any other economic transaction; for example, it is as reasonable as the payment of a rent charge or leasing rate on land or other assets. As a consequence of the power of these ideas, usury was redefined as excessive interest, and 'usury laws' specifying a legal maximum rate of interest were enacted in Protestant Europe (Lewis, 2007).

To Western eyes, it might seem that Islam is in the process of making a similar transition. However, the situation in Islam is very different. In Islam there are four sources of law making. There are the primary sources, first the Qur'an (immutable and not subject to change), and next in importance the *ḥadīth* (probabilistic knowledge, subject to conformity with the Qur'an and history of narration). Then there are the secondary sources, *ijmā'* (consensus) and *qiyās* (analogical reasoning), both more speculative. That the Qur'an, the most important source, prohibits *ribā* in clear and unequivocal terms cannot be disputed. The prohibition therefore must be upheld. What is at issue (indeed if at all) is the meaning of *ribā*.

For those who have argued so passionately for Islamic banking practice to return to the 'purity' of PLS partnership financing, it would be a loss of faith if the ends and means were to be aligned, not by adjusting the means, but by in effect redefining the ends, although in our view this is unlikely to happen. Yet it has to be said that things have changed. Tradeable Islamic bonds bearing virtually certain, predetermined fixed rates of return would have been unthinkable only ten years ago. They now exist, and are marketed much like conventional bonds. There are now many more in the Islamic banking industry who are talking about a reference 'rate of interest', and some are even making a distinction between 'interest' and 'usury' in this context. The basic problem of the rift between theory and practice in Islamic financing, that has troubled the system from the very beginning, has not gone away.

V. Operational Issues

Since the International Association of Islamic Banks ceased publishing statistics on the number of Islamic banks, no-one knows with any accuracy how many Islamic banks and financial institutions there are in operation (or, more correctly perhaps, no-one has bothered to use national and

other sources to draw up a definite list). Thus, Benaissa *et al.* (2005) in the *McKinsey Quarterly* estimate there to be 270 Islamic banks, El Qorchi (2005) in the IMF's *Finance and Development* puts the figure at 'over 300', while Ariff (2007) in the *Monash Business Review* suggests 'about 400' Islamic banks.

Whatever the precise number, there has been a dramatic change since 1975 when the first two (one developmental, the Islamic Development Bank, and one commercial, the Dubai Islamic Bank) commenced operations. While most of the Islamic banks that have been established *de novo* since then have followed the example of the Dubai bank and have been founded as 'pure-play' Islamic institutions, many have been existing commercial banks that have transformed themselves, fully or partially, into Islamic banks. This development has followed the Islamization of the financial systems of Iran and Sudan, the progressive transformation of the Pakistani financial system, and the expanded Islamic banking market share in Malaysia that has resulted from government initiatives.

However, in addition, the Islamic financial services market now includes many conventional banks offering, at the wholesale level, commodity-based and other Islamically acceptable investment vehicles, and acting as intermediaries between the commodity brokers and the purely Islamic banks (the 'pure-play' Islamic institutions). More significantly, at the retail level, an expanding array of conventional banks competes head-on with the purely Islamic banks by providing Islamic financial services in a variety of ways. Some are best described as 'hybrids', offering Islamic 'windows' or 'counters', hand-in-hand with conventional banking operations. Others have opened special branches that sell only Islamic banking products. In locations that restrict the operations of 'hybrids', conventional banks have established separate Islamic financial institutions with distinctive legal identity and management. HSBC has created a separate brand, Amanah, for its Islamic activities. In these different ways, new banks or subsidiaries or offshoots of conventional banks are rapidly appearing and widening their market presence.

Islamic financial institutions as a consequence face a 'dual' assault from the conventional banks, which not only provide tried and tested conventional banking facilities to their customers but also are able to combine the Islamic products they now offer with well-established customer service skills and marketing know-how. We have already seen Farooq's assessment that, because of the essential similarity between many Islamic and conventional

financial products, the Western conventional banks are able to adapt their products readily to this niche market and grab a sizeable market share as a result.

This raises the question of how competitive the Islamic banks are *vis-à-vis* the conventional banks, and this is the issue examined by Bader, Mohamad, Ariff and Hassan in their article. Theirs is not the only recent study on this topic. There are also, for example, investigations of the relative operating efficiency of Islamic and conventional banks by Hassan (2006) and Brown *et al.* (2007). However, the examination made by Bader, Mohamed, Ariff, and Hassan is a very extensive one, comparing 43 Islamic and 37 conventional banks in 21 countries over the years 1990 to 2005. Their results may come as a surprise to many readers. It is found that conventional banks are not more efficient than Islamic banks, nor are large banks uniformly more efficient than small banks. There do appear to be some differences between old and new banks, at least in terms of cost, but not between the efficiency of banks in the different regional groupings, including both conventional and Islamic banks. While these results may be contrary to some expectations, in general terms the finding that Islamic banks compare favourably in terms of overall profitability with conventional banks does tally with the analysis of Brown *et al.* (2007), for one, albeit that particular study covers a shorter period and fewer countries. In combination, the very comprehensive evidence presented in the article included in this volume is encouraging for those concerned that conventional banks will aggressively seize market share from the 'pure play' Islamic institutions.

Quite clearly, the application of new information technologies plays an important role in sustaining operational efficiencies. Transactions are the bread and butter of the financial services industry, and for many aspects electronic channels and interactive financial transactions have become a reality. This has led some authors to talk of the 'networked bank' (Howe, 1996; Lewis, 2003), distinguished from the traditional structure of the financial firm in six ways.

First, the geography of finance has been altered, with a geographical separation and conversion of location-specific services into 'long distance' services that is not dissimilar to the 'splintering' or 'disembodiment' of services analysed by Bhagwati (1984) in another context. Production can be geographically separated from delivery, arranging from legal booking, market interface from portfolio management, support systems from customer servicing. These developments have led to the creation of

financial centres specializing in market activity and support services. In Islamic banking, these concentrations are in Bahrain, London and Malaysia (Baba, 2007).

A second feature of the networked bank is the variety of its access channels, including tellers, ATMs, telephones, screen phones, and PCs, which enter the bank's system via branches, the ATM network, call centres, and on-line direct banking services, blurring the old distinction between front and back office. In an important sense, control of the channels passes into the hands of the consumer. With the proliferation of electronic channels and choice amongst providers, consumers hold the initiative and determine when, where, and how they will access their financial services. Consequently, marketing must be geared to this reality, and many of the fears about the competitiveness of 'pure play' Islamic banks relative to conventional banks are on this score.

The third characteristic of the networked bank is the core back-office system, that represents the bank's operational systems for transactions processing, loan application processing and servicing, providing support for retail and commercial banking functions, systems for subsidiaries or acquisitions, along with management information processing for human resource management, risk exposure and management, treasury operations and, perhaps most important, links into other content-providers' electronic systems.

The fourth component of the networked bank is the bank's customer information and relationship management system. This system becomes the bank's data warehouse of customer relationships, product information, and related tools and analytics. Modelling tools allow the bank to understand its most profitable customer segments by product and by access channel. Effective use of this customer relationship information becomes the bank's most valued asset and source of competitive advantage in the electronic age (Othman and Owen, 2005).

The fifth aspect is the nature of the market interface. Banking in general has always relied on a range of related markets for foreign exchange, interbank funding and for trading bills, bonds and other securities. In the case of Islamic banking, there are markets for *muḍārabah* and *mushārakah* certificates, *murābaḥah* and *istiṣnāʿ* certificates, *ṣukūk,* commodities trading, and interbank money market investments (Hakim, 2007). Obviously, the networked bank has to access these remotely. In addition, market interface includes access to news and market information services, use of accounting

and legal services, and the supporting infrastructure for the provision of payments services.

The last change is to the regulatory environment. The new technologies have assisted in the radical reconstruction of the way regulation is implemented. Historically, banks have been set a fixed ratio of capital to be maintained against either total or risk assets under national and BIS capital adequacy formulae, respectively. Under the new BIS accord called Basel II, there is a standardized approach but in addition the most sophisticated banks, if approved in the 'advanced' model, will be able to use their own internal measures of risk to determine how much capital has to be set aside against both credit and operational risks. Rather than validate how much capital a bank holds, the regulators would assess the bank's own risk management systems, leaving it up to the banks and their own risk-assessment models to determine capital requirements. Obviously, this places a premium on the banks' own management controls and computational models.

This leads us to the article by Ismail and Sulaiman in this special issue which is concerned with one aspect of Basel II insofar as it is affected by default and recovery rates on bank financing. Default and recovery rates might be expected to vary with the economic cycle. If so, because of these links, the internal ratings-based approach by the Basel Committee in the Basel II accord has the potential to increase bank capital charges, and restrict credit supply, when the economy is in a slower growth phase, and *vice versa* in a period of faster growth. Thus the framework could act pro-cyclically and accentuate upswings and downswings. In order to examine this possibility, Ismail and Sulaiman examine statistically the relationship between recovery rates and default rates for 15 Islamic banks in Malaysia over the period 1994 to 2004. They find a negative correlation between default and recovery rates that has important implications for portfolio credit risk models and for the debate about the application of the new standard guidelines for capital requirements on Islamic banks.

VI. Islamic Stock Exchanges

The technological innovations that we outlined in the previous section in the case of the 'networked bank' have also revolutionized stock market investment with the move to on-line trading platforms and global movements of capital. The demand for Islamically acceptable stock market investment has grown strongly, fuelled by the strength of the current economic upswing and the expansion of oil wealth.

What is remarkable is how quickly the oil exporters have, once again, become major suppliers of funds on the world markets. Between 2002 and 2005, net oil exports of the fuel-exporting countries rose by US$437 billion. By comparison, between 1973 and 1981, net oil exports increased by almost exactly the same amount, US$436 billion (although relative to world GDP the first episode was larger, 1.9% against 1.2%). However, these figures conceal a considerable size imbalance. The three largest non-US oil producers are Saudi Arabia, Russia and Iran, and they produce around one-quarter of the world's oil. Other large holders of proven oil reserves are, in descending order, Iraq, Kuwait, United Arab Emirates, Venezuela, Kazakhstan, Libya and Nigeria. In the 1970s, the oil- exporting countries held their petrodollars in short-term, liquid deposits with international banks. Now the oil revenues are being invested in long-term bonds and other more risky assets, such as hedge funds and a variety of capital market investments (Iley and Lewis, 2007).

Issues of *Ṣukūk* (Islamic bonds) and other *Sharīʿah*-acceptable capital market instruments based on real investments (construction, aircraft leasing) have flourished in this environment. So far, however, much of the demand for Islamic stock market investments has been met by the major Western stock markets, due to their size and liquidity. These investments in non-Islamic companies have been reconciled with Islamic investment precepts by means of 'screening' and 'purification' procedures (Hassan, 2001). There is no doubt that investment in the shares of enterprises dealing in the supply, manufacture or service of things prohibited by Islam (*ḥarām*), such as *ribā*, pork meat, alcohol, gambling, etc. must not take place. But companies which are not involved in such activities could be considered acceptable, so long as a major part of their operations does not involve *ribā*. After removing companies with unacceptable core business activities, the remaining list is tested by a financial-ratio 'filter', the purpose of such additional screening being to remove companies with an unacceptable debt ratio. Common benchmarks are that the debt/asset ratio must be less than one-third, accounts receivable/total assets must be less than one-half and interest income/operating income must be less than 10%. A dividend cleansing/impure income figure is then calculated. If say, 5% of the whole income of a company has come out of interest-bearing returns, 5% of the dividend must be given in charity. This process is known as 'purification'.

Nevertheless, there are Muslims uncomfortable with the arbitrariness of this process. Other things being equal, they would prefer to invest in

companies listed on the stock exchanges in OIC countries so as to stimulate development in those communities. Of course, other things are not equal, and this dissonance is addressed by Hassan and Yu in the final article in this special issue. The authors find that there are significant differences in regulatory and supervisory arrangements, market listings and capitalization, and trading intensity across the 15 OIC exchanges that make direct harmonization of the markets unlikely. To this end, they outline a blueprint that might allow a two-tiered exchange link to develop, under which the stocks of larger, blue-chip firms will be traded cross-border or cross-listed, while allowing the stocks of smaller enterprises to be traded in the local markets within individual OIC countries.

As Hassan and Yu concede, few of the many attempts at cross-border stock market cooperation have actually succeeded. In this particular case, it remains to be seen whether Islamic culture provides a strong enough bond to pull the OIC exchanges together. What would draw Malaysia to link with Indonesia rather than (or in conjunction with) Singapore and Thailand, or Turkey with Egypt and Jordan rather than with Europe? The potential to establish and unify Islamic systems of *Sharīʿah* supervision is one such factor that deserves to be given attention. But can the bond of culture and religion in investment overcome other forces of attraction? The challenge remains.

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