Abstract

The core and fundamental axiom of Islamic finance is the elimination of *riba* which literally means interest. Islam's unconditional prohibition of *riba* changes the landscape of the Islamic financial system. Prohibition of interest by Islam is actually an indirect prohibition of pure debt security. Instead of debt other forms of financing based on the principle of sharing of profit and loss are recommended under *Shariah* (Islamic law). We will look at most of the *shariah* compliant services and whether that is not just a leap of faith. However Plato's Theaetetus of belief, knowledge and understanding will try to bring out some light on that issue.

Electronic copy available at: http://ssrn.com/abstract=1093064

Contents

Abstract 1

Glossary 3

1. Introduction 4

2. Developments in Islamic Finance 4

3. Islamic Finance in the modern era 5

4. Types if Islamic Finance 6

5. Different paths, same goals 7

6. Islamic Securitization 8

7. Adapting the principles of Islamic finance to securitization 9

8. Conventional Securitization 10

9. Credit enhancement or reserve pool 12

10. What is a Sukuk? 13

11. Is Islamic finance the solution? 15

12. Belief, knowledge and understanding 15

13. Are we deriving something out of nothing? 16

14. Reality or mirage 18

15. Conclusion 19

Bibliography and references 21

Electronic copy available at: http://ssrn.com/abstract=1093064

Glossary

Bay' Bithamin Ajil (BBA)	Sale contract where payment is made in instalments after delivery of goods. Sale could be for long-term and there is no obligation to disclose profit margins.
Gharar	Any uncertainty or ambiguity created by the lack of information or control in a contract.
Ijarah	A sale contract which is not the sale of a tangible asset but rather a sale of the *usufruct* (the right to use the object) for a specific period of time.
Mudaraba	An economic agent with capital (*rabbul-mal*) can develop a partnership with another agent (*mudarib*), with skills to form a partnership, with the agreement to share the profits. Although losses are borne only by the capital owner, the *mudarib* may be liable for a loss, in case of misconduct or negligence of his part.
Mudarib	Economic agent, with entrepreneurial and management skills, who partners with *rabbul-mal* (owner of capital) in a *Mudaraba* contract.
Murabaha	A cost-plus-sale contract where a financier purchases a product, i.e. commodity, raw material or supplied, for an entrepreneur who does not have his/her own capital to do so. The financier and the entrepreneur agree on a profit margin, often referred to mark-up which is added to the cost of the product. The payment is delayed for a specified period of time.
Musharakah	Equity partnership. It is a hybrid of *Shiraka* (partnership) and the *Mudaraba*, combining the act of investment and management.
Quran	The Divine book revealed to the Prophet Mohammed (*pbuh*).
Rabu-mal	Provider of funds/capital in *Mudaraba* contract.
Riba	The premium (interest) that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension.
Shariah	Islamic law
Sukuk	Plural of the Arabic word *Sakk* meaning certificate, reflects participation rights in the underlying assets.
Sunnah	The practice of Prophet Mohammed (*pbuh*).
Takaful	Insurance contract through mutual or joint guarantee.

Electronic copy available at: http://ssrn.com/abstract=1093064

Introduction

The prohibition of interest-the ethical core of Islamic banking – derives from Islamic law, which is enshrined in the *shariah*. The word *shariah* literally means a waterway that leads to a mainstream, a drinking place, and a road or the right path. It is a term that encapsulates a way of life prescribed by Allah for his servants and it extends to every department of daily life, including commerce and financial activities of every kind (Fortune, 2002). Since the advent of Islam dates back to the seventh century, the application of ethical principles that were first established fourteen centuries ago to modern situations and circumstances can be a complex matter (Venardos, 2005).

The classical sources of Islam contain numerous prescriptions that lend themselves to the construction of economic norms, and the religion's early history offers an array of lessons concerning economic behaviour and institutions. But the notion of an economics discipline that is distinctly and self-consciously Islamic is very new. The great philosophers of medieval Islam wandered freely beyond the intellectual confines of the Islamic scriptures. And none of their works, not even the celebrated *Prolegomena* of Ibn Khaldun (1332-1406 c.e.), gave rise to an independent discipline of economics.

The origins of Islamic economics lie in the works of Savyid Abul-Ala Mawdudi (1903-79), a Pakistani social thinker who sought to turn Islam into a "complete way of life". In his writings, Mawdudi exhorted that Islam is much more than a set of rituals. It encompasses, he argued, all domains of human existence, including education, medicine, art, law, politics and economics.

Developments in Islamic finance

The impact of Islamization is especially widespread in banking. These developments are not occurring in an intellectual vacuum. A rapidly growing literature known as 'Islamic economics' seeks to guide and justify the ongoing reforms. The prescriptions in this literature rest partly on economic logic and partly on the *Quran* and the *Sunna*, the latter consisting of recollections of the words and deeds of the Prophet Mohammed and his companions. Several research centres have been established to

promote Islamic economics. The exponents of this discipline, who call themselves 'Islamic economists', emphasize that it covers far more than *zakat* and interest-free banking. The discipline aims, they say, to provide a comprehensive blueprint for all economic activity (Kuran, 2004).

Accordingly, a list of suggested research topics published by the International Centre for Research in Islamic Economics covers every major category of research recognized by the American Economic Association, including consumer behaviour, market structure, central planning, industrial relations, international trade and economic development (DeLorenzo, 1997). However, some Islamic economists are quick to admit that in most of those realms the blossoming discipline has yet to make a significant contribution. But they generally agree that the fundamental sources of Islam harbour clear and definitive solutions to every conceivable economic problem (Iqbal, 1998).

So Islamic economics is as much a response to contemporary grievances as it is a nostalgic escape into the imagined simplicity, harmony and prosperity of an ancient social order. Notwithstanding much of its rhetoric, in its applications it seeks to revive only bits and pieces of the seventh century Arabian economy, not to restore it in toto. In practice it thus exhibits more willingness to accept economic realities than it does in theory.

Islamic finance in the modern era

In contrast to conventional finance, where interest represents the contractible cost for funds tied to the amount of principal over a pre-specified lending period, the central tenet of the Islamic financial system is the prohibition of *riba*, whose literal meaning 'an excess' is interpreted as any unjustifiable increase of capital whether through loans or sales. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of interest and any positive, fixed, predetermined rate of return that are guaranteed regardless of the performance of an investment (Iqbal and Tsubota, 2006; Iqbal and Mirakhor, 2006). Since only interest-free form of finance are considered permissible in Islamic finance, financial relationships between

financiers and borrowers are governed by shared business risk and return from investment in lawful activities.

Islamic law does not object to the payment for the use of an asset, and the earnings of profits or returns from assets is indeed encouraged as long as both the lender and the borrower share the investment risk together. Profits must not be guaranteed *ex ante*, and can only accrue only if the investment itself yields income. Any financial transaction under Islamic law assigns to investors clearly identifiable rights and obligations for which they are entitled to receive adequate return[1].

Types of Islamic finance

Hence, Islamic finance literally 'outlaws' capital-based investment gains without entrepreneurial risk. In light of these moral impediments to 'passive' investment and secured interest as form of compensation, *shariah*-compliant lending in Islamic finance requires the replication on interest-bearing, conventional finance via more complex structural arrangements of contingent claims (Mirakhor and Iqbal, 1988).

Islamic 'loans' create borrower's indebtedness from the purchase and resale contract of an (existing or future) asset in lieu of interest payments. The most prominent of such a 'debt-based' structural arrangement is the *murabaha* ('cost-plus sale') contract. Interest payments are implicit in an instalment sale with instantaneous (or deferred) title transfer for the promised payment of an agreed sales price in the future. The purchase price of the underlying asset effectively limits the degree of debt creation. A *murabaha* contract either involves (i) the sale-repurchase agreement of a borrower-held asset ('negative short sale') or (ii) the lender's purchase of a tangible asset from a third party on behalf of the borrower ('back-to-back sale'). The resale price is based on original cost (that is purchase price) plus a pre-specified profit markup imposed by the lender, so that the borrower's repurchase of the asset amounts to a 'loss-generating contract' (Useem, 2002).

---

[1] While the elimination of interest is fundamental to Islamic finance, *shariah*-compliant investment behaviour also aims to eliminate exploitation pursuant to Islamic law.

Different instalment rates and repayment and asset-delivery schedules create variations to the standard *murabaha* cost-plus sale. The most prominent example are *salam* (deferred delivery sale), *bai bithaman ajil* (BBA) (deferred payment sale), *istina* (or *istisna'a*) (purchase order), *quard-al-hasan* (benevolent loan), and *musawama* (negotiable sale). As opposed to the concurrent purchase and delivery of an asset in *murabaha*, asset purchases under a *salam* or a *bai bithaman ajil* contract allow deferred payment or delivery of existing assets. *Salam* closely synthesizes a conventional futures contract and is also sometimes considered an independent asset class outside the asset spectrum of *murabaha* (Batchvarov and Gakwaya, 2006). An *istina* contract provides pre-delivery (project) finance for future assets, such as long-term projects, which the borrower promises to complete over the term of the lending agreement according to contractual specifications. A *quard al-hasan* signifies an interest-free loan contract that is actually collateralised. Finally, a *muswama* contract represents a negotiable sale, where the profit margin is hidden from the buyer[2].

Different paths, same goals

In Islamic profit-sharing contracts (equity-based), lenders and borrowers agree to share any gains of profitable projects based on the degree of funding or ownership of the asset by each party. In a trustee-type *mudharaba* financing contract, the financier (*rab ul maal*) provides all capital to fund an investment, which is exclusively managed by the entrepreneur (*mudarib*) in accordance with agreed business objectives. The borrower shares equity ownership with the financier (that is a call option on the reference assets) and might promise to buy-out the investor after completion of the project. At the end of the financing period, the entrepreneur repays the original amount of borrowed funds only if the investment was sufficiently profitable.

Profits are distributed according to a pre-agreed rate between the two parties. Investors are not entitled to a guaranteed payment and bear all losses unless they have occurred due to misconduct, negligence, or violation of the conditions mutually agreed by both financier and entrepreneur. The equity participation and loss sharing in

[2] This for of murabaha is only permitted for merchant banks, as in the case of the Kuwait Finance House's in-house car dealership.

a *musharakah* contract is similar to a joint venture, where both lender and borrower jointly contribute funds to an existing or future project, either in form of capital or in kind, and ownership is shared according to each party's financial contribution. Although profit sharing is similar to a *mudharaba* contract, losses are generally borne according to equity participation.

Overall, the different basic types of Islamic finance combine two or more contingent claims to replicate the risk-return of conventional lending contracts or equity investment without contractual guarantees of investment return or secured payments in reference to an interest rate as time-dependent cost of funds. Such arrangements may become complicated in practice, once they are combined to meet specific investor requirements under Islamic law (El-Qorchi, 2005).

Although both Islamic and conventional finance are in substance equivalent to conventional finance and yield the same lender and investor pay-offs at the inception of the transaction, they differ in legal form and might require a different valuation due to dissimilar transactions structures and security design (Jobst, 2006a). Most importantly, Islamic finance substitutes a temporary use of assets by the lender for a permanent transfer of funds to the borrower as a source of indebtedness in conventional lending. Retained asset ownership by the lender under this arrangement constitutes entrepreneurial investment. The financier receives returns from the different participation in asset performance in the form of state-contingent payments according to an agreed schedule and amount[3].

Islamic securitization

Islamic capital markets are generally underdeveloped. Religious constraints on permissible investment rule out conventional forms of interest-bearing debt finance. In the absence of tradable debt and valuation problems of financing contracts, Islamic finance has proven conceptually difficult especially for money management. Banks operating under Islamic law are predisposed to adopt buy-and-hold investment

---

[3] The underlying asset transfer of Islamic lending arrangements provides collateralization until the lender relinquishes ownership at the maturity date. In equity-based Islamic investments, lenders do not have any recourse unless pre-mature termination enables the lender to recover some investment funds from the salvage value of project assets.

strategies and carry excess short-term reserves for lack of sufficient long-term reinvestment opportunities, which has inhibited efficient financial intermediation and capital-market deepening (Rosly and Sanusi, 1999). Nonetheless, financial institutions have been able to develop various forms of Islamic finance instruments that are virtually identical to their conventional counterparts in substance. These securities are not surrogates for conventional interest-based securities that mimic the interest rate structure.

Since most Islamic financial products are based on the concept of asset backing, the economic concept of asset securitization is particularly amenable to the basic tenets of Islamic finance. Asset securitization describe the process and the result of issuing certificates of ownership as pledge against existing or future cash flows from a diversified pool of assets (reference portfolio) to investors. It registers as an alternative, capital market-based refinancing mechanism to diversify external sources of asset funding in lieu of intermediated debt finance based primarily on the risk assessment of securitized assets (Jobst, 2006b).

Islamic securitization transforms bilateral risk sharing between borrowers and lenders in Islamic finance into the market-based refinancing of one or more underlying Islamic finance transactions. In its basic concept, originators would sell existing or future revenues from lease receivables (asset-based), 'sale-back profit' (debt-based) or private equity from a portfolio of Islamically acceptable assets to a special purpose vehicle (SPV)[4], which refinances itself by issuing unsecured securities to market investors, who are the 'capital market corollary' to a singular lender in Islamic finance. They assume the role of a 'collective financier' whose entrepreneurial investment does not involve guaranteed, interest-based earnings (El-Gamal, 1999).

Adapting the principles of Islamic finance to securitization

The implementation of Islamic securitization requires a two-stage fundamental verification process, which assess the *shariah* compliance of (i) the type of assets in

[4] In conventional securitization, a SPV is set up solely for the purpose of the securitization and might be a trust, limited liability company, partnership, or a corporation. In Islamic securitization, the objectives set out in the constitutional documents of the SPV also must not infringe on the prohibition of riba and haram under Islamic law.

the underlying reference portfolio and the generation of investment returns, and (ii) the transaction structure, which includes the configuration of credit enhancement and the form of ownership conveyance. Securitization under Islamic law bars interest income and must be structured in a way that rewards investors for their direct exposure to business risk, that is, investors receive a share of profits commensurate to the risk they take on in lieu of pre-determined interest. All three asset types of Islamic finance are principally eligible for Islamic securitization; however, unresolved issues, including restrictions on debt trading or the management of prepayment risk could limit their indiscriminate use as collateral (El-Gamal, 2000).

Characteristics of conventional securitization only apply if they convey a sufficient element of ownership to investors as entrepreneurial investment in real economic activity within an interest-free structural arrangement. In addition, also administrative issues, such as underwriting standards, issue placement and the procurement of ratings, are subject to religious scrutiny. Any capital generated from securitized issuance under Islamic law is to be exclusively used for the repayment of the initial funding.

Conventional securitization

Conventional securitization, which originated from non-Islamic economies, invariable involves interest-bearing debt. Note holders would typically hold (secured) contingent claims on the performance of securitized assets, which entitle them to receive both pre-determined interest and the repayment of the principal amount. However, the issuance of interest-bearing debt securities with a secured redemption cannot be reconciled with Islamic financing principles on the prohibition of profit from debt and speculation. Financial relationships under Islamic law are not governed by interest but by shared business risk (and returns) from investment in religiously acceptable services, trade, or products, with clear and transparent rights and obligations to investors.

In particular any gains from Islamic fixed-income securities are related to the purpose for which the funding is used. Such purpose under Islamic law must involve the funding or the production of real assets rather than the purchase of financial securities,

which would amount to second-order financing analogous to lending for derivatives (Wilson, 2004), with the subsequent gearing being speculative. Islamic securitization must confer upon investors clearly identifiable rights and obligations in securitized assets in order to ensure direct participation in the any distribution of risk and reward between lenders and borrowers with limited risk mitigation and (or) indemnification through credit enhancement. Hence, from a procedural and substantive perspective, Islamic securitization would need to involve the conversion of uncertain, business related proceeds of direct investment in religiously-sanctioned real economic activity.

Hence, adapting the basic principles of conventional securitization for Islamic purposes requires compliance with the following conditions: (i) there should be a real purpose behind raising funds via securitization, and the type of collateral assets realizing the securitized revenues must be clearly identified and cannot be consumed; (ii) each transaction participant should share in both the risk and return, an investor should receive positive pay-off from profitable ventures only; (iii) collateral assets must not be debt, cash or prohibited as *haram* and must not be associated in any way with unethical or exploitative operations or with speculation and uncertainty (*gharar*) from non-productive investment; (iv) the structure should provide investor compensation for business risk from direct participation in securitized assets and should not imply an exchange of debt for interest-generating investment return; (v) investors should hold an unconditional and unsecured payment obligation not a guaranteed promissory note; (vi) a sufficient element of ownership must be conveyed to investors; (vii) the contribution from investors in the form of proceeds from issued notes cannot be reinvested in short-term cash investments or interest-bearing debt[5]; (viii) the underlying assets and securitized obligations must not be employed for speculative purposes, and turnover should be kept low; (ix) because conventional insurance violates *shariah* provisions, *takaful* should be employed instead; and (x) any form of credit enhancement and (or) liquidity support and limitations of prepayment risk must be in permissible form.

[5] Instead, commodities could serve as religiously acceptable short-term investments.

Credit enhancement or reserve pool

In principle, the flexible security design of conventional securitization allows issuers to devise various mechanisms of risk sharing, which includes subordination as one form of credit enhancement to improve the quality of issued securities. Issuers frequently subordinate investor claims into a three-tier transaction structure of junior, mezzanine, and senior tranches, which concentrates expected losses in a small junior tranche. While capital market investors receive the mezzanine and senior tranches as subordinated debt-like notes, the issuer commonly bears most of the asset exposure and shifts most unexpected risk to larger, more senior tranches by retaining the junior tranche as a residual equity-like class to avert to *ex ante* moral hazard and possible adverse selection.

Alternatively, issuers of transactions could set aside some of the cash flow generated by securitized assets to fund a 'reserve account' or 'first loss pool' as a form of self-insurance. Other types of credit enhancement also involves overcollateralization, spread counts, standby letters of credit to the securitization conduit (or by a sponsoring bank), pool insurance, or monoline insurance.

Islamic law does not rule out the use of credit enhancement *per se* as long as it is optional for investors and does not change the overall character of the transaction. For instance, tranche subordination of conventional securitization can be replicated by a lease buy-back *(ijarah)* transaction under *shariah* law (Usmani, 1998). The issuer would assign partial ownership rights of the underlying asset portfolio in return for fixed rental payments conditional on the option to repurchase the reference portfolio at a pre-determined sales price at some future date. The rental payment and the repurchase price are set such that they support a fair market return for investment risk (El-Gamal, 2002).

What is a *sukuk*?

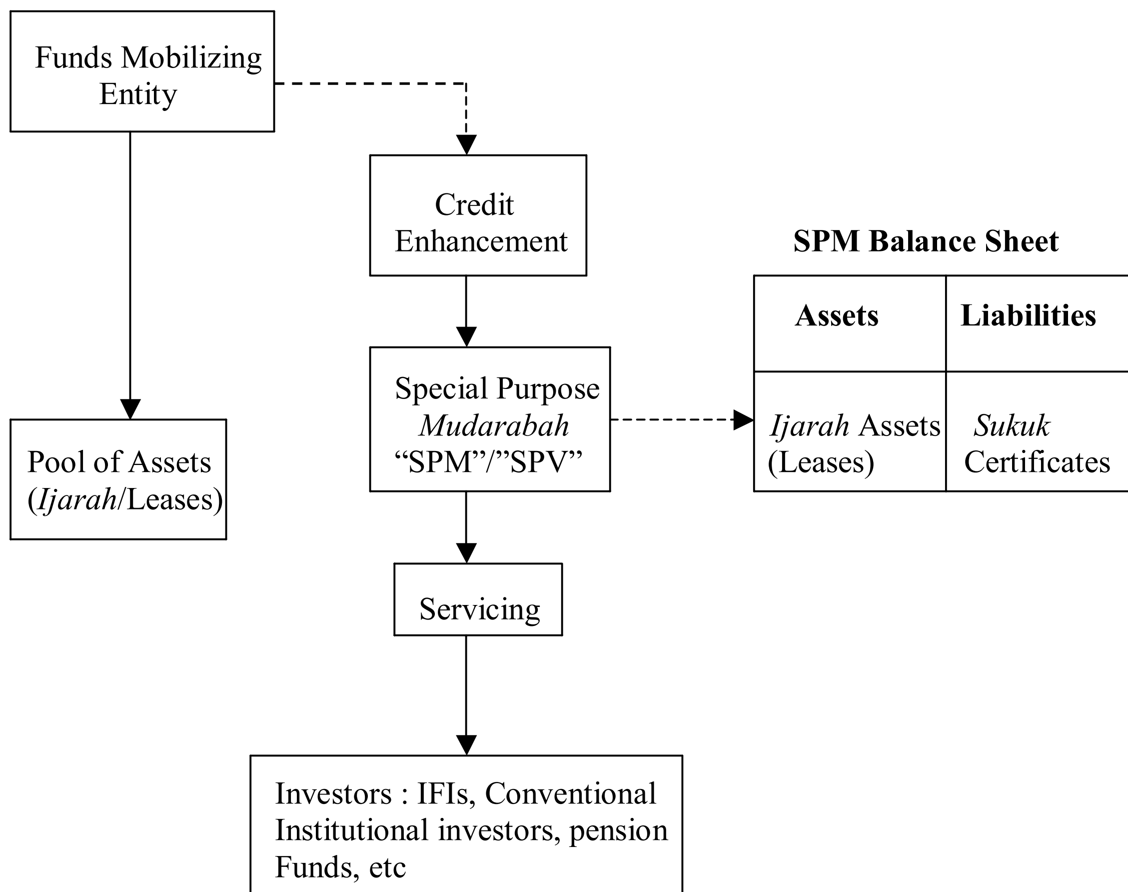
The term *sukuk* is recognised in the traditional Islamic jurisprudence. The idea behind *sukuk* is simple. The prohibition of interest virtually closes the door for a pure debt security, but an obligation that is linked to the performance of a real asset is acceptable. In other words, the *shariah* accepts the validity of a financial asset that derives its return form the performance of an underlying real asset. The design of a *sukuk* is very similar to the process of securitization of assets in conventional markets where a wide range of asset types are securitized. These assets types include mortgages, auto loans, accounts receivables, credit card payoffs, and home equity loans. Just as in conventional securitization, a pool of assets is built and securities are issued against this pool. *Sukuks* are participation certificates against a single asset or pool of assets.

Formally, *sukuk* represent proportionate beneficial ownership of an asset for a defined period when the risk and the return associated with cash flows generated by underlying assets in a pool are passed to the *sukuk* holder (investors). *Sukuk* is similar to a conventional bond as it is also a security instrument that provides a predictable level of return. However, a fundamental difference between the two is that a bond represents pure debt of the issuer but a *sukuk* represents, in addition to the risk on the creditworthiness of the issuer, an ownership stake in an existing or well-defined asset or project.

Also, while a bond creates a lender/borrower relationship, the relationship in *sukuk* depends on the nature of the contract underlying the *sukuk*. For example, if a lease *(ijarah)* contract underlies a *sukuk*, then it creates a lessee/lessor relationship, which is different from the typical lender/borrower relationship. Although asset-based *(ijarah) sukuks* are the most common form of Islamic securitization, *sukuks* on other Islamic finance transactions have been structured as well over the recent past. *Ijarah sukuks* are financial obligations, issued by a lessor, and backed primarily by cash flows from lease receivables from a credit lessee *(guthrie)* such as sovereign governments, regional governments, corporations and multilateral lending institutions (Richard, 2006).

The core contract utilized in the process of securitization to create *sukuk* is the *mudarabah*, which allows one party to act as an agent (manager) on behalf of a principal (capital owner) on the basis of a pre-agreed profit-sharing arrangement. The contract of *mudarabah* is used to create a Special Purpose *Mudarabah* (SPM) entity similar to the conventional Special Purpose Vehicle (SPV) to play a well-defined role in acquiring certain assets and issuing certificates against the assets. The underlying assets acquired by the SPM need to be *shariah*-compliant and can vary in nature. The tradability and negotiability of issued certificates is determined on the basis of the nature of the underlying assets.

The figure below shows the process and the linkage among the different players involved in structuring a *Sukuk*. This process is a generic process and there will be differences depending on the type of underlying instruments used to acquire the assets.



Anatomy of a Sukuk: Source: Iqbal (1999)

Is Islamic finance the solution?

The substantive divisions within Islamic economics are more nebulous than, say, those between neoclassical economics and Marxian economics. Whatever its internal divisions, Islamic economics has always presented a united front in justifying its own existence. The dominant economic systems of our time, virtually every text asserts, are responsible for severe injustices, inefficiencies and moral failures. In capitalism interest promotes callousness and exploitation; in socialism, the suppression of trade breeds tyranny and monstrous disequilibria.

The fundamental sources of Islam prohibit interest but allow trade; hence, a properly Islamic economy would possess the virtues of these two systems without their defects. With everyone "subject to the same laws" and "burdened with the same obligations," injustices would be minimised. Resources would be allocated very efficiently, ensuring a rapid rise in living standards.

Belief, knowledge and understanding

This brings us to the argument of belief, knowledge and understanding. Plato draws a distinction between knowledge and belief, and in doing this he makes a twofold distinction between, on the one hand, two different states of mind, and on the other between two different sets of objects corresponding to these different states of mind. It is when we come to this distinction that serious difficulties begin, difficulties moreover which raise points of much general philosophical importance. He further discusses that knowledge is infallible, unerring, whereas belief is not so, mistakes can be made. In the first place, the sense in which knowledge is unerring should be the same as that in which belief is liable to error. Plato proceeds to argue that in the case of knowledge the something that is known must be something that is real, and that in the case of belief, while something believed cannot be real, as in the case of knowledge, it must nevertheless have some sort of reality, it cannot be completely unreal – if it were the latter then in belief we would be believing the completely unreal, that is nothing.

Hence then the subsequent argument by which Plato seeks to show that the objects of belief are the many particular things which occupy a half-way position between the completely real, which is the object of knowledge, and the completely unreal. In both cases, then, he is committed to a search for appropriate objects and in both cases the object must have some sort of reality. Now if we consider knowledge by acquaintance, it is plausible to say that if I am acquainted with something (here Islamic finance), there must be a real something for me to be acquainted with. If I know Geremi, that is I am acquainted with him, then there must be a real person Geremi for me- I can see him and hear him and touch him.

The situation, however, is quite different, in the case of knowledge by description and with belief. Plato argues that the 'object' must have some sort of reality, which otherwise we would not know or believe at all? Suppose I believe that there is a desk in the next room. That would be the object of my belief. It seems clear that it is a mistake to raise the questions about the reality of this sort of object as we would raise the questions about the reality of what we familiarly call objects, such as chair and desks. Whether there really is a desk next door or not, my belief is still the same. Only, if there is no desk next door, the belief is false. While it is in order to talk of objects and the reality of objects in the case of knowledge by acquaintance, in the case of knowledge by description and of belief such talk is mistaken or at best highly misleading.

Are we deriving something out of nothing?

The objects that we are thinking about when we do make necessary statements must be different from the objects of the sensible world: they must be permanent and not subject to change, they must retain a fixed nature independently of the conditions under which they are apprehended, and they must be perfect. Only when granted such objects can we account for necessary truths and for a possibility of a *priori* knowledge.

There is a passage in Plato's *Republic*, the *Theaetetus* where he discusses false judgement. He argues that it is not possible for a man to see something and yet see nothing – if he is seeing any one thing he must be seeing a thing, which is (that is,

exists), and similarly with hearing and touching. Similarly, then, a man who is judging some one thing is judging something which is (exists). A man who judged something which is not (that is, falsely) would be judging nothing, and a man judging nothing would not be judging at all.

To sum up a stretch of argument which is difficult both because it is so abstract and because of Plato's undifferentiated notion of *being*. Plato has not proved anything about knowledge. He has made assumptions about knowledge which his hearers share, and proved a conclusion about belief. He has assumed of knowledge not just that it is of what is the case, but that it is infallible: it is of what is the case in such a way as to exclude the possibility of error about it.

Moreover, in the present case it has the very important consequence that Plato uses it in establishing a wide-reaching metaphysical view which distinguishes between two classes of objects, Forms on the one hand and sensible particulars on the other, and two levels of reality or existence, that of Forms, which are completely real or existent, and that of the sensible particulars, which are semi-real, partly existent and partly non-existent[6].

The theory of Forms then is the metaphysical theory, in that it claims to be telling us something that is true about what there is independently of human beings and minds. We will use a phrase used by Socrates in the dialogue, the *Parmenides*, the Forms are "*as it were patterns fixed in the nature of things*", that is, they are the permanent furniture of the universe. There are various difficulties in this ontological aspect of the theory of Forms, but one word of caution may be relevant. The theory maintains that our ordinary, everyday objects, for example the chair I am sitting in, are not 'real' or 'really real', but are in a sense only appearances; and the unphilosophical reader may be tempted to reject out of hand a theory which denies the full reality of the chairs he sits in, the houses he sees when he goes out into the street, and so on.

---

[6] In its ontological aspect, what the theory of Forms is maintaining is that there is a world of permanent, unchanging and perfect entities which are unaffected by variations in circumstances or conditions and which compromise reality. It is they that are 'real' or, as Plato sometimes says 'completely real' or 'truly existent'. The ordinary, everyday, sensible world, on the other hand, is not completely real: it is only semi-real: it is the world of appearance as opposed to the world of reality, namely the Forms; and further, it owes such reality as it does have the Forms.

But now may Plato be mistaken in what he is saying, but his view cannot be rejected in this out-of-hand way. For one thing, many philosophers besides Plato have held that the everyday world is a world of appearances and have contrasted it with a reality beyond appearances; and if the unphilosophical reader is unmoved by this consideration, he must be asked why he himself calls the chair he sits in real, as opposed to a hallucinatory or dream chair. In fact he will find that the word 'real' is very tricky word. It might be suggested that when he calls the chair he is sitting in real, as distinct from a hallucinatory or a dream chair, he is employing certain criteria, not in themselves easy to formulate, which he regards the 'real' chair as satisfying. The point however is that it cannot be rejected out of hand simply because it denies the 'reality' of our everyday world.

Reality or mirage

There is no reliable evidence, however, on whether the redistribution of wealth sought about has brought about a major reduction in inequality. Still the literature is full with calls for the implementation of the holy laws of Islam (*Shariah*) in the form they ostensibly took almost a millennium and half ago, in one locality. In issuing such calls, Islamic economics denies that certain economic problems of the modern age has no counterparts in the past. It also denies that once-beneficial institutions might now be dysfunctional, even harmful.

Some of the rhetoric of Islamic economics thus conveys the impression that it seeks to rediscover and restore the economy of a distant past. At the same time, it draws heavily on modern concepts and methods, including many that originated outside the Islamic world. And it pursues such modern objectives as growth, employment creation and efficiency. It would be wrong, therefore, to characterize the doctrine's intense preoccupation with the economy of seventh century Arabia merely as a scholastic search for ancient solutions to ancient problems, although this representation does fit certain writings.

Conclusion

Islamic economics applies ancient solutions to perceived problems of the present; and where such solutions are lacking, it seeks spiritual justifications for its favoured reforms. Accordingly, Islamic economics shows interest in only some features of the seventh-century Arabic economic order. Having identified the prohibition of interest as the sine qua non of Islamic reform, it is engrossed in *Quranic* verses concerning lending and borrowing. It devotes comparatively little effort to exploring whether the Golden Age offers useful prescriptions against environmental pollution, having chosen, if only by default, to refrain from making the environment a major issue.

The search for knowledge is not the post-Cartesian search for a state immune to sceptical doubt. Rather it is a search for understanding. This means that he has no reason to think that knowledge will be achieved by a negative, corrosive doubting of all our previous beliefs. Rather than undercutting the beliefs we have, we advance to understanding their significance and finding them intelligible. Of course, when we have knowledge, we may find that some of the beliefs that we have accepted are in fact false. But we do not begin by trying to doubt the truth of particular beliefs in a wholesale way, as Descartes recommends that we do (Plato, 1966).

What matters is not to reject any truth in the beliefs we have, to go round trying to convince ourselves that this is not really a just action. Rather, what is required is imaginative widening of one's horizons to take in context that this action could be considered unjust, and to see that besides the unsatisfactory ascription of justice to particular actions there is also the possibility that there might be something that is unqualifiedly just, freed from all the contexts and limitations with an action's justice – the Form of justice, the only thing that is really and unqualifiedly just. This has already been likened to waking up from a dream, rather than to finding relief from doubt.

Islamic economics is appropriately categorised as a "fundamentalist" doctrine, because it claims to be based on a set of immutable principles drawn from the traditional sources of Islam. By no means does its flexibility in practice negate this

label's descriptive power. All doctrines labelled "fundamentalist" claim to rest on fundamentals set in stone, yet in application these prove remarkably malleable. Moreover, such doctrines assert a monopoly over knowledge and good judgement, even as they show receptivity to outside influences. The *shariah* is pre-eminently, a law of the book – a jurists' law – and this of course always implies a certain degree of artificiality.

Bibliography and References

Aggarwal, 'Islamic Banking and Investment Financing', *Journal of Money, Credit and Banking* 32 (2000), 93–120).

Arabi, O. (2001) *Studies in Islamic Law and Jurisprudence*. The Hague Kluwer Law International

Batchvarov, Alexander and Nicolas Gakwaya (2006), "Principles and structures of Islamic Finance", Merrill Lynch, European Structured Finance – ABS (8th September), London.

Chapra U (1996) "What is Islamic Economics" IDB Prize Winner's Lecture Series, No 9, Jeddah: Islamic Development Bank.

Cross, Robert C. (1964), Plato's 'Republic': A Philosophical Commentary, Macmillan; St Martin's Press 167-95.

El-Qorchi, Mohammed (2005), "Islamic Finance Gears up" *Finance and Development* (December), International Monetary Fund (IMF), 46-49.

DeLorenzo, Yusuf (1997), "*A Compendium of Legal Opinions on the Operations of Islamic Banks*", Institute of Islamic Banking and Insurance, 1997.

El-Gamal, M (1999), "Involving Islamic Banks in Central Bank Open Market Operations", *Thunderbird International Business Review*, 41 (4,5), 501-21.

El-Gamal, M (2000), "An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence", *Proceedings of the Third Harvard University Forum on Islamic Finance*, Cambridge: Centre for Middle Eastern Studies Harvard University.

El-Gamal, M (2002), "The Economics of 21st Century Islamic Jurisprudence", *Proceedings of the Fourth Harvard University Forum on Islamic Finance*, Cambridge: Centre for Middle Eastern Studies Harvard University.

Fazlur Rahman, *Toward Reformulating the Methodology of Islamic Law*, 12 N.Y.U.J INT'L & Pol 219, 223 (1979).

Gerry, U (2002), "Devout Muslims Don't Pay or Receive Interest. So how can their financial system work?", *Fortune*, 10 June 2002, 61-5.

Haneef, M. (1995) *Contemporary Islamic Economic Thought: A Selected Comparative Analysis*. Kuala Lumpur: Ikraq.

Ibn Manzur, (1992). *Lisān al-#Arab*, Beirut: Dar Sadr. Kuran, T. (1995) "Islamic Economics and the Islamic Subeconomy", *Journal of Economic Perspectives*, 9(4), 155-73.

Iqbal, Munawar and Abbas Mirakhor (2006), *An Introduction to Islamic Finance – Theory and Practice*. Wiley Finance Editions, John Wiley & Sons, Inc, Hoboken/NJ.

Iqbal, Z (1999), "Financial Engineering in Islamic Finance", *Thunderbird International Business Review*, Vol. 41, No. 4/5, July-October 1999, 541-60.

Iqbal, Zamir (1998), "Islamic Banking Gains Momentum", *Middle East Executive Reports*, January 1998.

Iqbal, Zamir and Hiroshi Tsubota (2006), "Emerging Islamic Capital Markets", Islamic Finance Review, Euromoney Handbook, Euromoney Institutional Investor PLC, London, 5-11.

Jobst, Andreas A. (2006a), "Asset Securitization: A Refinancing Tools for Firms and Banks", *Managerial Finance*, Vol. 32, No. 9, 731-60.

Jobst, Andreas A. (2006b), "What is Structured Finance? An Analysis of Derivatives, Securitization and Islamic Finance", *The Securitization Conduit*, Vol. 8, No. 1. *Reprinted in ICFAI Journal of Risk Management* (2007).

Kuran, T. (1996) "The Discontents of Islamic Economic Morality", *American Economic Review*, 86(2), 438-42.

Kuran, T. (1997) "The Genesis of Islamic Economics: A Chapter in the Politics of Islamic Identity", *Social Research*, 64(2).

Kuran, T (2004) Islam and Mammon: The Economic Predicaments of Islamism, Princeton University Press 9-18.

Mirakhor, Abbas and Zaidi Iqbal (1988), "Stabilisation and Growth in an Open Islamic Economy", IMF Working Paper No. 88/ 22, International Monetary Fund (IMF), Washington, DC.

Nasr, S-H. (1991) "Islamization of Knowledge: A Critical Overview", *Islamic Studies*, 38-40

Pamuk (2000) *A Monetary History of the Ottoman Empire*, Cambridge: Cambridge UniversityPress.

Plato (1966), The Republic of Plato/ translated with introduction and notes by Francis Macdonald Cornford, Oxford: Oxford University Press 191-215.

Plato (2000), The Republic/ Plato; Edited by G. R. F. Ferrari; translated by Tom Griffith. The Republic. English , Cambridge: Cambridge University Press 2000, 143-67.

Posner, R. (1992) *Economic Analysis of the Law*. Boston: Little, Brown and Co., 4Th Edition.

Rosen, L. (2000) *The Justice of Islam*. Oxford: Oxford University Press.

Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer, and Robert W. Vishny ('Legal Determinants of External Finance', *Journal of Finance* 52/3 (1997), 1131–50).

Richard, Kristel (2006), "Two Aspects of Rating Sukuk: Shariah Compliance and Transaction Security", Standard and Poor's, Research.

Rosly, Sayful and Sanusi Mahmood (1999), "*The Application of Bay' Al-inah and Bay' Al-dayn in Malaysian Islamic Bonds: An Islamic Analysis*", 24th April 1999.

Siddiqi, M-N. (1983a) *Issues in Islamic Banking: Selected Papers*. Leicester, U.K.: The Islamic Foundation.

Siddiqi, M-N. (1983b) *Banking without Interest*. Leicester, U.K.: The Islamic Foundation.

Siddiqi, M-N. in Ahmad and Awan (1992) *Lectures on Islamic Economics*. Jeddah: Islamic Development Bank.

Stern, J. (1982) "Ribit: A Halachic Anthology", *Journal of Halacha and Contemporary Society*, 46.

Useem, J 9(2002), "Banking on Allah", *Fortune*, June 10, 2002.

Usmani, M-T (1998), An Introduction to Islamic Finance. Karachi: Idaratul Ma'arif

Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998)

Wilson, Rodney (2004), "Overview of the Sukuk Market", in: Adam, N. J. and A. Thomas (eds.) *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*. Euromoney Books, London.