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Foreword

Ethics and social values are inseparable from economics and finance. The movement for Islamic economics and finance, which has been gaining momentum since last thirty or forty years, can be seen in this light as a move to bring ethics and social justice into the core. Perhaps, Islamic economics and finance are the two fields that have generated substantially important new ideas and applications in the recent past than any of the other social sciences. This progress entails a need to periodically take stock of the achievements and identify the gaps in its development. It also calls for addressing the unresolved theoretical and operational issues that may be constraining the growth of the these disciplines or their practical applications in the economy and the financial sector.

The Sixth International Conference on Islamic Economics and Finance was organised precisely for the above mentioned purpose. It was sixth in the series of conferences that are held at regular intervals since 1976 when the first conference of this series was organized in Makkah about a year after the establishment of Islamic Development Bank. The Sixth Conference was held in Jakarta from November 21 to 24, 2005 and jointly organized by Islamic Research and Training Institute (IRTI), Bank Indonesia, University of Indonesia and the International Association of Islamic Economics.

Islamic Research and Training Institute is pleased to present volume one of the proceedings of this conference. I hope that the academics and professionals in economics and finance will find the present volume useful and stimulating. A companion volume-two of about the same size consisting of the remaining papers and comments is also expected to come out soon.

Bashir Khallat

Director, IRTI

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1

Introduction

***Munawar Iqbal*[*]**
***Salman Syed Ali*[**]**

Islamic Economics and Islamic Finance have great potential for optimally aligning the resources with the economic, financial and social needs of society. Capitalism, which dominates the present-day world, while having certain desirable features has miserably failed in other aspects which has created a number of problems for the humanity. Its neglect of economic and social justice and the resulting skewed distribution of wealth and power is obvious even to its proponents. Communism, which came as its anti-thesis created its own set of problems. It wrongly identified the cause of all ills in 'private ownership' and erected its foundations on the concept of collective ownership which killed the individual incentives. The central planning structure put in place to address the economic problems of allocation, production, and distribution itself became a source of power and wealth concentration. In the end, communism could not create welfare of all that it had promised, and collapsed under its own weight.

The demise of communism is sometimes regarded as a triumph of capitalism and its superiority. But this is an illusion; the present dominance of capitalism is only temporary as the ills of capitalist system remain un-rectified. In this scenario there is an opportunity for adherents of Islam to present the economic dimension of Islam as an alternative to both capitalism and communism.

Islam offers a way of life with its own social, economic, and financial systems that can bring better life and give humanity better goals. This is an open and time tested offer. History shows that the rise and dominance of Islamic system had not only benefited the Muslims but also proved beneficial for prosperity of the humanity in general. While partial implementation of one or the other aspect of

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Islam can bring some benefits, its full potential naturally lies in its implementation as a whole system.

The re-Islamizing efforts in the fields of economics and finance that started more than fifty years ago should be seen in this light. During the initial years the subject was discussed in general terms in the broader context of religion and sociology. With the passage of time the area has attained more maturity and focus. The intellectual and practical efforts for the development of Islamic economics and finance have played an important role in shaping its present state. Both these subjects are now taught at academic institutions, are attracting the interests of researchers and also shaping the functioning of various financial, economic and social institutions. Therefore, these areas now constitute important policy agenda items for various private and public policy making forums.

While Islamic economics is still sharpening its tools of analysis Islamic finance has made its way deeper into practice.[1] This experimentation and implementation approach has proved useful in the progress of Islamic finance. So far the direction of its development has been affected by the private sector's strategy of imitating the conventional finance in designing of new products and the public sector's strategy of encouraging a dual-system approach towards financial sector development. The potential of genuine innovation and a much wider scope of application remain largely unexplored.

At present, Islamic financial sector at the global level consists of Islamic banks – including commercial and investment banks; non-bank financial institutions such as investment and fund management companies; insurance (takaful) providers; capital markets – including market for shares and *ṣukūk*; and the infrastructure institutions such as rating agencies and organizations for setting the accounting and regulatory standards, etc.

It may be surprising that contrary to the general perception about newness of the issues currently being debated in the Islamic finance field, many of the challenges faced by Islamic finance are not that new. For example, Iqbal et al. (1998) writing in 1998 summarized the major challenges faced by Islamic banking sector as: (i) lack of proper institutional framework, (ii) increased competition, (iii) need to build strategic alliances, (iv) need to increase the size of individual banks, (v) need for financial engineering, (vi) need for mechanisms for Sharīʿah compliance and auditing, (vii) need for human capital development through teaching, training, research and development, (viii) need to increase the proportion of variable return

[1] The reasons for this difference are many. Foremost among them is that the Qur'anic commandment of prohibition of interest is a practical aspect requiring an immediate action. Some practical steps in this direction were possible even at the level of private sector institutions and individuals. Therefore, as Islamic financial institutions evolved in the private sector they faced various practical challenges which led to further development of Islamic finance both at practical and theoretical levels.

financing as opposed to fixed return financing, (ix) need for establishing equity financing institutions, (x) need to develop appropriate legal framework, and (xi) need for a proper supervisory framework. Same issues are prevalent now at the time of writing of these lines in 2007. Similarly, in the context of Islamic capital markets the challenges and problems faced in the past remain valid today. While this reflects a general lack of progress in addressing the challenges, there have been a number of notable changes between then and now.

There has been a "problem shift" (to use the term by Lakatos, 1976, 1978) in Islamic finance. The problem shift in the academic literature is from efforts to prove 'viability' of Islamic finance to addressing the 'implementation and functioning' issues. The problem shift in the practice of Islamic finance are:

- From looking at *murābaḥah* suspiciously to accepting it as a genuine and useful mode of finance.[2]
- In the private sector, from Islamic finance being a business on the sidelines to making it more centre stream.
- In the public sector, from a strategy of full Islamization to a gradual approach accepting dual system where interest and non-interest based institutions co-exist.
- In the structure of industry, from solely based on banking to a more diversified Islamic finance industry with inclusion of capital markets.
- In the menu of available financial products, from the offering of basic products to designing of a wider product range through combination of contracts that span larger risk-return space.

Such changes require periodic review with a fresh look at the issues as well as at the state of their development. The International Conference on Islamic Economics and Finance held in Jakarta during November 21-24, 2005 was organized for this purpose. It was sixth in the series of conferences under this title which have been periodically organized since 1976. The papers of this conference are being published in two volumes. The present volume contains 15 papers and a keynote address read at the conference. These papers reflect some new and some renewed issues that have recently come into greater focus due to the attention shift mentioned above, in the theory and practice of Islamic economics and finance.

The issues addressed in the present volume fall into four broad areas: (1) methodology of Islamic economics and the nature of Islamic finance, (2) need for, and implications of, transparency and risk management for Islamic financial institutions, (3) issues in corporate governance, and (4) performance evaluation.

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[2] There are still some aspects of the actual practice of murābaḥah which diverge from its theoretical construct resulting in what is called 'synthetic' murābaḥah. This needs to be corrected.

However, there are some papers that do not quite fit into the above classification scheme; yet they address other important issues in Islamic finance. They are introduced in the (5) miscellaneous topics section.

1. Methodology of Islamic Economics and the Nature of Islamic Finance

There is a consensus among scholars that the Islamic system differs from its secular counterpart in its world view. The practical manifestation of this world view is also apparent from Islam's different emphasis on the various economic and social aspects of life, a reflection of which is expected to appear in the individual and collective behaviour. While the need to look at human behaviour in a comprehensive and holistic manner is underlined by many, there is lesser agreement on how to analyze such behaviour. From this perspective the debate on ‘nature’ of and ‘need’ for Islamic economics and finance is not settled yet. However, the frequency with which this question was raised in the past has declined as the attention of the field has shifted to more practical issues. Nevertheless, the questions of nature and need are important in order to build the discipline on a solid foundation.

It is well known that a major function that an economic system has to perform is to allocate resources to their alternative uses. There are two aspects of this allocation problem. One how to utilize material resources - directing various factors of production into their alternative uses. Two, how to distribute the output - who is to receive what portion of products which are the outcome of the utilization of productive assets.

An economic system has to provide an institutional framework whereby the behaviour of participants is integrated, and their decisions are coordinated into a coherent interlocking process so as to provide answers to the two questions referred to above. Different systems accomplish this task in different ways. There are three major factors which distinguish one system from the other: (a) With whom lies the decision-making authority, (b) how the information reaches the decision makers in different sectors and (c) how this information is processed into allocation decisions i.e. the incentive system which motivates the participants to behave in a certain manner.

According to the method by which information is generated, transmitted to the participants, and the decisions are made there are two basic modes of allocation: The market allocation and the direct allocation. The market mode of allocation can further be divided into two extremes—laissez faire and regulated market, and a range of supervised market mechanisms between them. Where the supervision is provided through some central body. From that point of view, the centrally

administered supervised systems can be looked upon as a hybrid of direct transfer and market systems.

As against the above, in the Islamic system the markets are allowed to play a crucial role in the allocation of resources. However they are not left un-attended. The allocation decisions are not dictated by a central authority but taken by individuals who are motivated to confirm to social preferences and religious obligations. The market forces are not generally tampered with but are supervised. In case of extreme deviation from the ideal course, regulatory measures are resorted to. This system of allocation may be called, “morally administered system”.

The paper by **Al-Jarhi** and **Zarqa** entitled "Redistributive Justice in a Developed Economy: An Islamic Perspective" focuses on the distinct nature of Islamic economics and finance in their emphasis on market and non-market process of distribution and redistribution for economic justice. The authors argue that conventional economics "gave its utmost attention to distribution through the process of market exchange, but gave little attention to redistribution in the sense of reaching a certain level of social justice and equity". The capitalist system deems 'just' the distribution achieved through free-market process and views any redistribution through non-market means as an aberration. The socialist system on the contrary, considers market activities as exploitative and unjust; 'just' distribution (or redistribution) can only be achieved through need-based central planning.

In contrast, the Islamic system considers both the market and non-market mechanisms as integral part of Islamic system of economic justice and equity. Its system of obligations and rights provides the right balance between the self and the social interests while its principles of trade and finance curb exploitation and ensure mutually beneficial transactions. Hence, the targets of efficiency and equity become related without it necessarily having a trade-off between them. Conventional economics does not recognize this possibility, rather treats it as an irrelevant issue. However, recent literature in conventional economics is now giving way to the concepts of fairness, no-trade-off between efficiency and redistribution and the possibilities of growth with equity.

The paper by **Choudhury** “Islamic Economics and Finance: Where do They Stand” is on methodology. It provides philosophical critique of the two subjects as they stand today. It argues that Islamic economics and finance have knowledge foundation quite distinct from prevalent ‘scientific’ approach and from that of neoclassical thinking. It is altogether a different paradigm; therefore its ‘methods’ and ‘methodology’ should be differently developed for its progress. ‘Methods’ belong to the domain of evidence of data and ‘methodology’ is the way of analysis that provides understanding of reality. The choice of methods depend on the selection of methodology. According to him, the problem with the current literature on Islamic economics and finance is that it does not comprehend the

epistemological origin (knowledge process) and the required data for its purpose. Therefore, it has become trapped in the neoclassical framework.

The author supports his view by noting that neoclassical economics takes tastes and preferences as given and exogenous. These are the primitives in that theory. This approach leads to irrelevance of ethics in economic theory. Furthermore, the absence of a dynamic preference formation theory in the neoclassical framework results in aggregation problem. As opposed to this, Islamic teachings are prescriptive. They tend to develop preferences in certain ways both by inducement and observation of various happenings around us. Thus Islamic economics should focus on developing the idea of endogenous preference formation and interactive learning. Moral law and morality will thus exist in economy-wide explanations of institutions, social-economic interactions, policy and governance. This method of analysis may require abandonment of the concept of equilibrium and steady state as they exist now but may bring about new concepts of dynamical and interactive systems.

The author provides various examples and situations where economic analysis operates on the basis of given preferences and is devoid of a process of preference formation. However, the author does not suggest any alternate way to do just that. In commenting on this paper, Chapra points out that Islamic economics and finance are not new sciences. They were practiced during the era of Muslim dominance in the world and only declined after the decline of Muslim rule and stagnation of their intellectual efforts. The present day revival of Islamic economics and finance is part of the efforts for Islamic renaissance.

In passing, it may be mentioned that, **El-Ansary**, in his paper that appears in the companion volume to this, provides a critique of the neoclassical foundations and argues that the conventional framework of economic theory can address 'single objective' problems. Islamic economics, on the other hand, has a 'multi-objective' approach where analysis may require entirely a different methodology.

2. Needs and Implications of Transparency and Risk Management

The present day financial sector is composed of various types of institutions such as banks, financial markets and other non-bank financial institutions. Each of these types poses a different degree of opaqueness about their portfolios—asset holdings, their returns and risks—for the suppliers of capital (or for the account holders in case of bank). For example, in the conventional financial setup, banks are opaque as compared to investment funds traded in financial markets because information on a bank's asset portfolio and investment performance is neither available to general public on a day to day basis nor its portfolio is priced as frequently as that of market traded funds. Only accounting value information on their assets is available at the aggregate level and that too with lesser frequency in

the form of annual or semi-annual reports. This aggravates the problem of 'asymmetric information'. Therefore, the protection of investor/depositor interests becomes a public policy objective. It calls for a greater role and responsibility of the regulators of the banking sector because regulators receive, or have access to, such information more frequently as part of the statutory reporting requirements of the banks. By the same token hedge funds, although operating in financial markets, are more opaque than the banks. This is so because their clients are expected to be sophisticated investors and institutions that do not need publicly provided protection. Since hedge funds are not regulated they are not obliged to reveal information on their portfolio. Often the kinds of assets they hold are not priced because there is no active market for them.

These differences in transparency of various kinds of institutions have their own pros and cons which have bearings for the choice of financial contracts made by individual investors. This in turn affects the nature and composition of contracts at systemic level.

Let us view Islamic financial institutions from this aspect of transparency (or opaqueness) of portfolio and valuation. There are four parties to organization of an Islamic bank: (i) the shareholders who provide capital and retain control over management, their capital is of long-term nature; (ii) investment account holders who provide participatory capital but do not have control rights, their capital can be recalled on a short notice; (iii) the current account holders who are in a sense creditors to the bank who deposit their money for safekeeping or for utilizing the payment-system services of the bank, this money is callable on demand; and (iv) the managers who are appointed by the shareholders to look-after day to day running of the bank, they do not contribute any financial capital. The (theoretical) structure of Islamic banks – which share profits and losses on both their asset and liability sides—pose a greater need for transparency to its investment account holders. This is due to the agency problem faced by the investment account holders when they share in profit and loss of the bank, which themselves are the consequence of trade and investment decisions of the managers and shareholders of the banking firm. Bank shareholders (or their appointed management) as agent (*muḍārib)* for investment account holders exercise control over investment decisions. Unless their interests and risk profile is aligned with that of the depositors, agency problem will remain. Such agency problems give rise to the problems of adverse selection and moral hazard.

An added twist to this agency problem is provided by the current practices of Islamic banks pertaining to rate of return smoothing which creates another kind of agency problem for the equity holders of the banks, and also leads to weakening of market discipline for the managers. The problem is explained below:

Islamic banks, in order to offer competitive returns comparable to those of conventional banks, as well as to avoid sharp fluctuations in the rate of return to their investment account holders—profit to whom can go up in good years and

drop sharply in lean years—have resorted to "rate of return smoothing" by creating what is termed as "profit equalization reserve." In some banks this reserve is built by drawing down on a portion of the total profit before its division between bank owners and investment account holders. While in some other banks this reserve is built by drawing on a portion of owners' share of profit. The reserve, so built, is then used as an insurance pool to increase the return to investment account holders in the lean years to make it at least equal to what is available through conventional interest paying banks.

These practices have bearings for the overall financial risk of Islamic banks including the risks faced by investment deposit holders. The overall risk, therefore have implications for solvency of the banks. Moreover, such profit smoothing practices weaken the significance of market discipline by reducing the informational role that rate of return can play in evaluation of bank's performance.[3]

Another matter of difference between conventional banks and Islamic banks is in the area of the nature of risks that the two types of institutions assume in their investments (or financing operation). A conventional bank plays a pure financial intermediary role which 'rents out money'. Therefore their primary risk is the credit risk emerging from the net worth conditions of the financed party. The operational and other risks of the business it finances are not directly assumed by the bank. There are other secondary risks emerging from the banking business itself, these are contract performance risk, legal risk, interest rate risk (also called opportunity cost risk or market risk) etc. Some other similar risks, which can be subsumed under the above types of risks, are "created" resulting from the overall composition of the portfolio at the aggregate level. For example, loan concentration or single party exposure can affect credit risk.

As opposed to this, an Islamic bank is not supposed to be a pure financial intermediary. It either participates in business of the financed party through some profit-loss sharing arrangement or earns a margin by entering into a genuine trading operation. In the latter case it buys tradable goods at a lower spot price and sells them dear on a deferred payment basis. This structure brings in some direct operational risks, market risk, credit risk, and liquidity risk for the bank. Such sharing of risks and returns between the bank and the financed party; and between the banks and their investment account holders can prove to be very healthy for the economy and stability of financial sector. For in this arrangement businesses (i.e., financed parties), can absorb economic shocks better and can avoid pre-mature bankruptcy when their financial obligations vary according to rise and fall of their business earnings. Similarly banks become more stable, since on the asset side of their balance sheet they hold diversified investment portfolio and on the liability

[3] This problem can be addressed by revealing the actual full profit. Once the FULL rate of return is DECLARED, it has performed its informational role. Then if part of it is put in a reserve, by mutual consent, it has some useful implications for the stability of the system since there will not be DRAMATIC movement of funds in and out of the banks.

side they share profit and loss with their investment account holders. Hence they naturally match up in both good and bad times.

However, the benefits of this system will accrue if this wider variety of risks are managed efficiently. Risk management techniques of the conventional banks may not be sufficient for this purpose. Other ways need to be devised emphasizing mitigation of the reducible risks and mutual sharing of the non-reducible risks rather than risk shifting strategies such as trading of financial derivatives. Therefore, a first step in this direction would be to devise ways to measure these various risks and then analyze their interaction and aggregate affect in order to better manage them at the bank and systemic levels. Conventional techniques will help in the measurement of individual components and analyzing their interaction after some modifications. For the next step, i.e., ways to manage these risks, as stated above, it will require breaking new grounds and developing new techniques and environments.

Three papers in this volume discuss the issues of risk, transparency and regulation of Islamic banks.

Sundararajan's paper "Risk Measurement and Disclosure in Islamic Finance and Implications of Profit Sharing Investment Accounts" addresses some issues in risk measurement, its control through proper management, supervision and regulation. The paper explicitly recognizes that the nature of profit sharing investment accounts in Islamic banks calls for special consideration by the banks and their regulators in measuring risk and devising its control methods. The paper calls for greater disclosure in treatment and reporting of changes in profit equalization reserves because it influences effective risk to the bank.

By analyzing cross country data on a sample of Islamic banks, the paper finds considerable smoothing of returns paid to profit and loss sharing investment account holders, despite wide divergence in the risk faced by these banks. This suggests that the profit sharing between shareholders and investment account holders is fairly limited and most of the losses are absorbed by the shareholders: a situation referred to as "displaced commercial risk" to the bank in the Islamic banking literature. This is the extra commercial risk borne by the banks' shareholders, over and above their due responsibility in a *muḍārabah* contract, in order to remain competitive viz á viz other commercial banks[4].

Recognizing the risk mitigation benefits of a genuine profit-loss sharing arrangement in the financial sector Sundararajan proposes giving regulatory incentives towards such a scheme. The proposal is to link the extent of capital relief on account of profit and loss sharing investment accounts to the bank to supervisory review of the actual risk borne by the investment account holders, and

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4 See for example, AAOIFI (2005).

by requiring adequate disclosure of these risks. Going a step further, he proposes a value-at-risk (VAR) methodology to measure these risks.

Ariffin, Archer, and Karim in their paper "Transparency and Market Discipline in Islamic Banks" provide a survey of perceptions of Islamic banks and their regulators regarding the need for greater transparency and market discipline in Islamic banking. Transparency viewed as public disclosure of information relevant to assess financial condition and performance, is a key factor for proper working of the market forces that impose discipline on banks' activities and behaviour. The survey covered 28 Islamic banks in 14 countries and their regulators as well as external agencies such as auditing organizations, rating agencies, and standard setters like IFSB and AAOIFI.. The major finding is that Islamic banks and their regulators think that owing to the unique nature of Islamic banking, which emphasizes profit loss sharing with their investment account holders, there is a greater need for publicly disclosed information that can help in assessment of risks. Setting up of appropriate regulatory standards for relevant information disclosure will be helpful.

The most important categories of information in the eyes of supervisors of Islamic banks were found to be:

(i) information on type of risks;
(ii) risk management and asset quality;
(iii) compliance with Sharīʿah requirements.

Likewise, transparency and risk reporting by Islamic banks themselves are very important. Effective disclosure is needed for market discipline to work, Basel-II also places such requirements. However, the standards issued by Basel Committee on Banking Supervision in this regard are difficult for Islamic banks to apply due to constraints of appropriate human resources and costs faced by Islamic banks.

Muljawan approaches the risk management issue from regulation and supervision point of view in his paper "A Design of Islamic Banking Rating System: An Integrated Approach." For use by supervisory authorities, the system of assessment of operational soundness of Islamic banks should be attuned to special nature of Islamic banks, and forward looking to enable formulation of supervisory actions. He proposes that the existing rating methodology of CAMELS can be applied to Islamic banks after some adjustments to account for the unique nature of such banks. The adjustments will be needed in several aspects such as: (i) the capital adequacy assessment should consider the agency problem induced by investment accounts. (ii) consideration should be given for profit distribution. (iii) identification of, and adjustments for, the new risks which are not part of conventional banking. (iv) management quality assessment should incorporate Islamic values and norms besides Sharīʿah compliance. The author goes further to develop some assessment ratios on these lines for use in supervisory process.

3. Corporate Governance and Social Responsibility

Corporate governance and social responsibility of Islamic financial institutions is an important area in its own right. Development of best practices and suitable mechanisms are needed that should work for the protection of the interests of all stakeholders[5] and not just for the protection of shareholders' rights. This would go a long way in the efficient working of Islamic financial institutions and also in the realization of the socio-economic benefits inherent in Islamic financial system.

As mentioned earlier, avoiding interest-based finance would provide ground for growth with equity. If debt is replaced by participatory finance then this potential is even greater. Moreover, general public has also built up certain hopes that the conversion to a fully Islamic system will bring about social justice and cure for many ills that stand in the way of provisioning of basic needs and alleviation of poverty. However, on the operational side, the Islamic financial institutions face difficulties in using participatory or profit and loss sharing modes – the modes which are most conducive for a broad-based growth with equity. Most Islamic financial institutions resort to greater use of *murābaḥah* and other such fixed return contracts. Among the many reasons for this choice of contract(s) the principal ones are: higher monitoring costs, agency problems, and adverse selection that are associated with business participation. Notably for Islamic banks, as compared to Islamic non-banking financial institutions, the agency problem arises at two levels: first, between the banks and the firms they finance, and second, between the banks and their investment account holders.

The key importance of a sound system of corporate governance lies in its ability to reduce the severity of such agency problems. In this regard, the organizational structure of the bank, its internal operating rules and procedures, the incentive system, reporting and disclosure system are key factors that should be under focus.

The corporate social responsibility and its disclosure is also part of this corporate governance. Each institution draws its strength and legitimacy for existence from its social and religious acceptance as well as from its goals which should conform to the norms of the society. Therefore, it is the responsibility of Islamic banks to remain within the bounds of Sharīʿah in all their activities and undertake actions in socially responsible ways. They should not only abide by the rules and norms but also be seen to do so. Otherwise, public confidence in these financial institutions will be lost.

There are further reasons for the importance of social responsibilities that come from the status and economic power of the financial institutions in the market place. Financial institutions command a special status as compared to other business firms for their ability to supply finance—an important input in all business

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[5] Stakeholders in Islamic financial institutions are: shareholders, investment account holders, depositors, management, and the larger society.

activities. This power of IFIs also increases their corporate social responsibility towards the society.

Three papers in this volume discuss the nature, disclosure, and performance of corporate social responsibility actions of Islamic financial institutions. These are followed by an interesting discussion on the issue by two discussants and a rejoinder by one author.

Farook and Lanis in their paper "Banking on Islam? Determinants of Corporate Social Responsibility Disclosure" take the view that Islamic banks are accountable to fulfil social and ethical role inherent in their 'Islamic' character. They also have duty to disclose information on their activities in ways that enable others to gauge the degree of their socially responsible behaviour. A cursory observation reveals that Islamic banks generally release less than expected amount of CSR information. Therefore, the authors tried to objectively measure, through information contained in the annual reports of Islamic banks, the social disclosure levels based on a benchmark index constructed on the lines of Maali et al. (2003)[6]. Then the authors also attempted to find the correlates of CSR disclosure keeping in view certain existing theories which postulate that CSR disclosure may be influenced by economic incentives as well as other factors such as political freedom and various corporate governance factors. Using a sample of 47 Islamic banks from 14 countries they found that disclosure is positively correlated with political freedom, corporate governance factors (such as the existence of Sharīʿah board and quality of its members), and the proportion of investment accounts to shareholders' equity.

There is a special significance of the role of investment account holders in determining the level of disclosure because Islamic banks rely on their support for investable funds. Therefore, the banks cannot remain indifferent to the social responsibility perceptions of these deposit holders who would require such information disclosed to them. **Dusuki and Dar** in their paper "Stakeholders' Perceptions of Corporate Responsibility of Islamic Banks: Evidence from Malaysian Economy" focus on CSR perceptions of seven categories of stakeholders (customers/clients, accountholders, regulators, Sharīʿah advisors, bank employees, bank managers, and the general public) in Malaysian market. The authors found that CSR factor was one of the important criteria for bank selection decision by the stakeholders and they generally have positive views about CSR of Islamic banks.

Sairally in her paper entitled "Evaluating the 'Social Responsibility' of Islamic Finance: Learning from the Experiences of Socially Responsible Investment Funds" focuses on CSR performance (CSP) of Islamic financial institutions (IFIs) which include both bank and non-bank types. She advocates for assigning "explicit social objectives to IFIs over and above their economic, legal, Sharīʿah and ethical

[6] As quoted by Farook and Lanis in this volume.

responsibilities." The paper evaluates performance of IFIs as socioeconomic contributor to human welfare using a sample of 48 IFIs in 19 countries. The author concludes that IFIs have assumed a peripheral approach towards CSR whereas more integral and deliberate ethical policy is needed.

The discussants[7] of the set of these three papers do not agree with making social welfare goals a part of the objectives of IFIs. The objections are based primarily on the ground that IFIs are for-profit business entities. CSR is important to them but only to the extent that it is important to any other business under Islamic system. The discussants also point out that a clear identification of the set of CSR which is binding from Sharīʿah point of view is needed before any research in this area. Together, the papers, the comments by discussants and then the response by one author, form an interesting dialogue and food for thought for further research.

There is a growing realization in the development literature that broader access to finance is more important than financing of a few powerful businesses. Some very important reasons for exclusion of many entrepreneurs from financial services are (i) lack of collateral, (ii) institutional or infra-structure bottlenecks, and (iii) religious or cultural factors that keep people away from conventional finance. Islamic finance has the potential to be more inclusive and broad-based because: (i) it confirms to the religious boundaries and moral norms of a large population thus easing a barrier against their participation. (ii) The profit and loss sharing arrangements available under it have the capacity to broaden the scope of finance by also considering non-physical and non-financial collateral such as demonstrated managerial abilities of a business team, their moral capital of trustworthiness, ingenuity and feasibility of the venture idea etc. All these are of lesser relevance in loan-based financing schemes. (iii) Moreover, various kinds of restrictions in Islam that define non-permissible set of contracts and transaction practices minimize the susceptibility to manipulation of the financial markets which would encourage genuine investors and deter pure speculators thus enhancing the stability and confidence of the public in the financial system. Such confidence and mutual trust go a long way in encouraging broader participation and hence creation of diverse set of financing products and further development of this sector. The task of realizing this potential of a more inclusive Islamic finance requires good corporate governance, socially responsible actions, along with disclosure of such information. This would enable the depositors and investors (principals) to effectively monitor Islamic financial institutions acting as their agents. Role of CSR and self-regulation for IFI from the above perspectives can form an important area of policy oriented research.

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[7] Abou-Ali and also Sadeq.

4. Performance Evaluation

Of recent a number of authors have empirically evaluated the performance of Islamic banks regarding their efficiency. These studies have covered a number of Islamic banks across various countries evaluating their input-output efficiency by using parametric and non-parametric econometric methods such as stochastic frontier approach and data envelopment approach. Similarly, quite a few studies have emerged on risk and return performance of Islamic investment funds as well as Islamic market indices. These funds and indices are based on a set of Sharīʿah screening criteria. The performance evaluation is generally based on rate of return, Sharpe ratio, different volatility measures, predictability, and multifactor portfolio theory. The present volume contains three papers on performance evaluation of IFIs. The studies together, not only focus on alternative segments and approaches to performance evaluation but also evaluate alternative approaches to performance evaluation.

Hasan in his paper "Evaluation of Islamic Banking Performance: On the Current Use of Econometric Models" provides appraisal of the current approaches of judging Islamic banks' performance and questions their validity. A number of authors have evaluated performance of Islamic banks based on profit maximization or cost minimization criteria, using advanced econometric techniques referred to above. Based on a survey of these techniques and their results, Hasan argues that these efficiency evaluations though valid, miss the essence of Islamic banking; which, according to him, is attainment of certain social objectives. He raises the question whether a business appraisal can be done independent of the broader priorities of a social organization. He proposes that a better criterion for evaluation of Islamic banks would be their contribution to attainment of some pre-defined social goals, subject to attainment of their economic break-even points.

The issue raised by him is important. However, Islamic banks, as any other private business in an Islamic system, are for-profit organizations. Therefore, expecting each bank to gear all its activities towards social well-being after achieving a break-even profit is to expect too much. Arguably, the seemingly objective concepts of output and input are subjective in nature. Their identification depends on the frame of reference as well as moral and social factors.[8] An alternate

[8] For example, there is no consensus of opinion on what constitutes input and output of conventional banks even in the studies that attempt to measure efficiency of these banks. Those who conceive banks as financial intermediary consider amount of deposits, cost of labour and capital as inputs and the amount of loans as output. But banks provide other financial services too. They now operate in financial markets too, providing risk management services, increasingly moving away from a pure financial intermediary role, thus requiring a new definition of inputs and outputs. Others who view the workings within the bank as operations and processes and are interested in operational efficiency, consider

possibility to account for social goals is to pose the question of evaluation in another way: Are Islamic banks efficient subject to certain minimum levels of social and religious constraints? A proper definition of these constraints will make the problem well defined for econometric estimation in the usual way. One minimum constraint for Islamic banks is that they should avoid interest in all their dealings. This constraint can be revised upwards and augmented, with the progress of Islamic finance over time, to include other social objectives; the efficiency can be periodically re-evaluated with increasing social constraints. An example of augmented constraint is that a financial institution not only avoids interest in its dealings but also contributes to development of financial sector environment in such a way that the urges that promote seeking of interest and the compulsions that induce agreeing to pay interest are eradicated in the society.

Another possible social goal could be promotion of risk and profit sharing over risk shifting behaviour. Among the many possibilities one way to operationalize this idea in the form of a constraint is to first decide about some socially desirable proportion of sharing and fixed-return financing contracts. One may find the deviation of actual proportion of these contracts from the desired proportion for the bank, and then recompose the output constraint of Islamic banks by constructing weighted output constraint where the weights are the inverse of the deviation of actual proportion from the desired proportion of profit-sharing and fixed-return contracts. This deviation adjusted (profit) output constraint can now be used in cost minimization problem to judge the efficiency of Islamic banks. The result would reflect a combination of (profit) output constraint and a social constraint. Such an approach to performance evaluation for Islamic banks is yet an unexplored area.

Alpay evaluates the performance of Islamic financial institutions in Turkey where they are called Special Finance Houses (SFHs). The paper traces the evolution of SFHs during the last two decades amid Turkey's volatile macroeconomic conditions and especially during the financial crisis of 2000-2001. He finds SFHs showed greater stability during the crisis.[9] They have been able to attract more funds, increase their capital, and expand their investments in the post crisis period. Another important contribution of these institutions is to increase the size and volume of Turkish banking sector. This is achieved by making finance more 'inclusive' through offering of the products which are nearer to the religious norms of the society.

Performance of portfolio of Sharīʿah screened stocks is another area on which evaluation studies have recently focused. It is thought that Sharīʿah screening which reduces the investment universe of stocks (by eliminating from investment scope such stocks that do not fulfil Sharīʿah conditions for wealth and/or its

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the number of deposit accounts opened and the number of loans processed as output and the amount of wage cost and capital as input ignoring the interest paid-out on deposits or the income earned. Some others do not consider deposits as output, but as input.

[9] See also Ali (2004) for stability of SFHs under financial distress.

tradability) may restrict potential for diversification and hence, may reduce the returns to investors in such constrained set of stocks. **Hussein** in his paper "Islamic Investment: Evidence from Dow Jones and FTSE Indices" evaluates the performance of Sharīʿah screened stock indices. His choice to analyze the representative market indices rather than an individual fund avoids the selection bias and investment strategy effects of individual funds on their performance. His paper finds that risk-adjusted returns on Islamic indices (DJIM and FTSE Islamic) are not statistically different from returns earned on the counterpart general indices Dow Jones World Index and FTSE All-World index over the period Dec 1993 to Dec 2004. Breaking down this period into sub-periods he reports that the Islamic indices performed better than un-screened indices during bull period. However, opposite was true during bear period.

5. Miscellaneous Topics

There are various theoretical and operational models of Islamic banking and a variety of legal environments under which the Islamic financial institutions are currently operating. What are the possible business models of Islamic banking and which one is most suitable? What are the legal and economic constraints faced by Islamic finance in the present time? And how Islamic finance is useful for public projects? These are some interesting questions addressed by a set of four papers in this volume.

Anjum in his paper "An Inquiry into Alternative Models of Islamic Banking" provides a survey of various models of Islamic banking that have been proposed in the literature. He describes and analyzes them on their nature, structural and operational features and congruence with human and developmental aspect of Islamic economy. He proposes a global setup of pan-Islamic monetary regime for Islamic banking. **Shakespeare** in "Non-Interest Resource Mobilization for Public Capital Projects: The Use of Islamic Endogenous Loans" puts forward his views on how interest-free system can lower the cost of capital.

Siswantoro and **Qoyyimah** in their paper "Analysis on the Feasibility Study of *Musharakah Mutanaqisah* Implementation in Indonesian Islamic Banks" compare *mushārakah mutanāqisah, ijārah muntahiyyah bittamlīk* and *murābaḥah* with each other on price, risk and other factors in the context of Indonesian banking environment. Their paper explains why *mushārakah mutanāqisah* is not so commonly used by Indonesian banks. **Djojosugito** contributes a very important paper on the legal dimension of Islamic finance process entitled "Necessary Legal Reforms to Create Legal Basis for Effective Islamic Asset Securitization (*Sukuk*) in Indonesia". He argues that asset securitization (*ṣukūk*) has the potential to become a powerful vehicle in the modern times for the development of Islamic finance. However, the Indonesian legal system posses some difficulties in the issuance of *ijārah ṣukūk*. The legal system of the country is based on civil law, which does not separately recognize legal ownership and equitable ownership. These are the key

concepts in effective use of Special Purpose Vehicle (SPV) and trust structures for issuance of *ṣukūk* and also in instituting *muḍārabah*. Progress of Islamic banking in Indonesia is conditional upon suitable changes in the legal and regulatory framework.

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Globalization and Islamic Finance

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Introduction

Globalization is a multifaceted and multidimensional process of growing interconnectedness among nations and peoples of the world. Its main dimensions are: (i) cultural; (ii) socio-political; and (iii) economic. Its economic dimensions include: growing trade flows, unhindered movements of finance, investment, and production accompanied by standardization of processes, regulations, and institutions, all facilitated by the free flow of information and ideas. Globalization is the result of reduced information and transportation costs, and liberalization of trade, finance, investment, capital flows, and factor movements (O'Rourke, 2001; Crafts, 2004).

The last few decades have witnessed dramatic and rapid changes in the structure of financial markets and institutions across the world. Advances in financial theory, rapid pace of innovation in practice of finance, the revolution in information technology, deregulation, and institutional reforms have irreversibly changed the nature of financial relations and a "new finance" has emerged. As a result, "people can borrow greater amounts at cheaper rates than ever before, invest in a multitude of instruments catering to every possible profile of risk and return, and share risks with strangers from across the globe. … These changes have altered the nature of the typical transaction in the financial sector, making it more arm's length and allowing broader participation. Financial markets have expanded and

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have become deeper. The broad participation has allowed risks to be more widely spread throughout the economy" (Rajan, 2005).

The new finance has an important role in levelling economic playing fields, thus becoming the great equalizer of our time: it requires no passport, and does not discriminate on the basis of colour, creed, race, or national origin. It unwinds and un-bundles, dissects, analyses, and prices risk, and searches for the highest return. It explores all opportunities for risk-return sharing, in order to exploit the wedge between the real rate of return to assets and the real rate of interest, leading to greater reliance on risk sharing.

This paper focuses on three central ideas: First, as globalization gathers momentum and becomes pervasive, and as more economies liberalize in order to integrate into the global economy, the new finance will grow and so will the risk-sharing and asset-based securitization:[1] both are the core of Islamic finance. So far, the present globalization is considered unfair because the risks and rewards of the process are not shared equitably. But, as equity-based and asset-backed financing grows, the fruits of globalization could be distributed more widely and more equitably among the participants than has been the case thus far,[2] at least in terms

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[1] Evans and Hnatkovska (2005) report that "gross capital flows between industrialized countries (the sum of absolute value of capital inflows and outflows) expanded 300 percent between 1991 and 2000. much of this increase was attributable to the rise in foreign direct investment and portfolio equity flows, which both rose by 600 percent. By contrast, gross bond flows increased by a comparatively modest 130 percent" (p.4). For the US alone, they suggest, "US ownership of foreign equity increased rapidly peaking at roughly 22 percent of GDP in 1999," compared with less than 1 percent of GDP before the middle of 1980s. "In short, foreign equities have become a much more important component of US financial wealth in the last decade or so" (p.5).

[2] Lucas (2000) expresses a similar idea that the 21st century will witness a reversal of the widening inequality among nations during the 20th century. His assertion is based on an analysis of a Solow-type neoclassical model with global capital mobility assuming that all countries have access to the same technology and institutions as well as to market-friendly economic policies. In this case, the "Lucas Paradox" (Lucas, 1990)—that capital did not move from rich to poor countries—will no longer hold, and a "catch-up" process will rapidly narrow the income gap among countries. While some disagree with the assumptions of this model, (e.g., Henderson, et al., 2001), Lucas's contention that capital movements will be reversed is reasonable as more developing countries adopt policy and institutional structures that reduce risk premiums on investment. The same set of policies and institutions—e.g., best practice international standards of transparency, accountability, and good governance as well as legal institutions that protect property and investor rights—will promote risk sharing. Evidence that the new finance is shifting investment in favour of risk sharing in industrial countries can be gleaned from a recent paper by Cardoso and da Cunha (2005), in which two tables (5A and 5B, p. 35) are presented comparing the composition of financial assets of households in Europe, USA, and Japan between 1995 and 2003. the tables indicate that in the Euro area, European Union, and the USA, households allocated a

(continued)

of the financial linkages. There remains the question of protectionism in industrial countries, segmented labour markets, impediments to the transfer of technology and the like, which require full international cooperation to be addressed and mitigated.

Second, if the present globalization process is characterized as the free flow of trade, investment, and production, then it would be possible to identify a similar episode of globalization: that of the Middle Ages with similar characteristics. During the period referred to as "the age of the commercial revolution" (Lopez, 1976), trade flowed freely across the then-known world, supported by risk-sharing methods of finance, which were developed in the Muslim countries consistent with the Shariah. Information regarding the basic features of these methods was transmitted via the intermediation of Jewish scholars and merchants, and importantly also Spain, from the Muslim world to Egypt, Europe, India, and North Africa (Mirakhor, 2004; Fischel, 1937; Gaiani, 1953; Goitein, 1954, 1955, 1961; Lieber, 1968). These new financial techniques were also transmitted by Muslim merchants to Eurasia, Russia, China as well as to East Asia (Abu-Lughod, 1989, 1994; Ashtor, 1976; Frank, 1990; Gills and Frank, 1994; Hogdson, 1974; Lombard, 1975; Lopez, 1976; Lopez and Raymond, 1955; Marfoe, 1987).

Third, a major economic-historical puzzle is why, after dominating the world of finance for eight centuries, risk-sharing methods lost supremacy to debt-based financing. This paper suggests that one important reason may be that, since risk sharing is trust-intensive, a systemic breakdown of trust in Europe has led to the emergence of debt-based financing. Europe became the dominant financial and economic power in the late Middle Ages and the latter type of financing expanded, particularly during the 19th and 20th centuries, to the rest of the world. Recent cross-country research indicates that best performing countries are those with relatively high trust level and strong institutions (Zak and Knack, 2001; Beugelsdijk, et al., 2004). In poor performing economies the level of trust is low, and institutions are either absent or weak. If trust is low, strong institutions should be established to protect property and investors' rights as well as to enforce contracts. While current Muslim societies have low level of trust, they are adopting best practice and international standards of policy formulation and implementation as well as legal

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larger portion of their portfolio to risk sharing instruments over the period. The information extracted from the tables in the paper of Cardoso and da Cunha are presented at the end of the present paper. For a recent view on the "Lucas Paradox," see Alfare, et al. (2005), who, based on empirical evidence, concludes that "institutional quality is the leading causal variable" in explaining the Paradox (p. 21). Mishkin (2005) suggests that financial globalization creates incentives for institutional reform. He concludes, however, that "although globalization can be a strong force for good; it can also go very wrong if a country doesn't manage the process properly" (p.28). In this context, see Stiglitz (2002) criticism of globalization.

institutions and practices that compensate for this weakness. Therefore, it could be expected that risk-sharing methods of Islamic finance would expand rapidly in these countries.

Section I of the paper covers briefly the growth of world-wide trade and finance by risk sharing instruments during the period of the Middle Ages. Section II explores the contention that the Islamic financial techniques, which were used in the Middle Ages, were based on mutual trust and that the breakdown in trust may have been among the important causes that led to the increasingly greater role for debt financing methods. It discusses the available empirical evidence on the relationship between trust, financial development—particularly risk sharing—and economic performance. Section III discusses the importance of trust for Muslim countries, arguing that, as religiously mandated, obligations of trust and trustworthiness are considered crucial in identifying the strength of adherence to the Islamic belief system. Section IV is a summary of the paper's main ideas.

I. Trade and finance in the Middle Ages

Before the beginning of the 20th century, economic historians of the Middle Ages all but ignored the importance of trade and financial relations between Europe and the rest of the world, which were crucial to the economic development of the West before the 15th century (Udovitch, 1967, p. 260). Abu-Lughod (1994) contends that this was due to the belief held by the Eurocentric scholarship that globalized trade became relevant only after the "rise of the west" in the late 15th century. According to Abu-Lughod, an advanced globalized system of trade "already existed by the second half of the Thirteenth Century, one that included almost all regions (only the "New World" was missing). However, it was a world-system that Europe had only recently joined and in which it played only a peripheral role" (p. 278). She maps growing global trade flows between 737 and 1478 A.D., demonstrating that trade flows first centred in Mesopotamia and spread rapidly over the next eight centuries throughout the then-known world to become global (p. 284).

Beginning with Postan (1928), economic historians have demonstrated that these trade flows were supported by a financial system sustained by an expanding risk-sharing credit structure based on **commenda** and **maona**.[3] Postan's paper, based on his investigations in the vast commercial archives of the Middle Ages in England, was path-breaking as it demonstrated that: (i) economists and historians had, until then, underestimated the growth of the volume of credit in the Middle Ages, and, (ii) the bulk of this credit was either commenda, or commenda-like,

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[3] *Commenda* was identical to *Muḍārabah*, and *Maona* partnerships were either *Mushārakah* or *Muḍārabah*, depending on the nature of activities undertaken by the partners (see Labib, 1969, pp. 91 and 94; Lane, 1944, pp. 191-196; Day, 2002; and Udovitch, 1962).

joint risk-sharing partnerships, even if they were "miscalled or modified" as loans (Postan, 1928, p. 252; see also Postan, 1957).

There is little doubt that the institutions of commenda and maona originated in the Islamic world (Udovitch, 1962, 1967, 1970). These institutions, along with financial instruments, such as **hawala** and **suftaja,** were transmitted to Europe and to other regions by Jewish scholars and merchants throughout the Jewish Diaspora (Fischel, 1937), and via Spain through trade and scholastic borrowing from Islamic sources (Mirakhor, 2004). Professor Goitein of Princeton University painstakingly researched the documents known as Geniza[4] records and reached the following conclusions (Goitein, 1964, pp. 316-319) that:

- Trade in the Middle Ages was both extensive and intensive, financed by risk-sharing partnerships;
- Partnership was used in industrial, commercial, and in public administration projects;
- "The Mediterranean and Indian trade, as revealed by the Cairo Geniza, was largely based not upon cash benefits or legal guarantees, but upon the human qualities of mutual trust and friendship;" (p. 316) and
- "… even a cursory examination of Geniza material proves that lending money for interest was not only shunned religiously, but was also of limited significance economically" (p. 317).

Studying both the Geniza records as well as Islamic Fiqh sources, Udovitch reaches the following conclusions: (i) "there is remarkable symmetry between the Hanafite legal formulations of the late-8th century and the documented commercial practices of the 11th and 12th century Geniza merchants" (Udovitch, 1970, p. 41); (ii) he reaffirms Goitein's conclusion that researching "the extensive commercial records of the Geniza, we found comparatively little evidence of usurious transactions" (Udovitch, 1970, p. 61). Moreover, research by Medieval historians demonstrated the extensive use of commenda and maona (see the list of references at the end of the paper).

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[4] Goitein (1964, p. 315) refers to "the so-called Cairo Geniza" as "a treasure of manuscripts written mainly during the Fatimid and Ayyubid periods and originally preserved in a synagogue in Old Cairo." Further, he indicates that "Geniza (pronounce: Gheneeza), as may be remarked in passing, is derived from the same Persian word as Arabic *"Janazah,"* burial, and has almost the same meaning. It is a place where discarded writings were buried so that the name of God, which might have been written on them, might not be discarded. Thus, *Geniza* is the opposite of an orderly archive." He further informs that "… the documents discussed in this paper, albeit mostly written in Hebrew characters, are in Arabic language." There are a number of Geniza centres of scholarship in the USA and the UK.

While risk-sharing techniques continued to be used in Europe until mid-17th century, beginning in mid-16th century, the institution of interest-based debt financing began to be used more widely and extensively throughout Europe (Munro, 2003). The explanation for the initial utilization of this method of financing and its dominance over risk-sharing methods has been a combination of several factors, including (i) the demise of the scholastic prohibition of usury (Munro, 2003; Sauer, 2002); (ii) the appearance and rapid growth of fractional reserve banking that led to specialization of finance by intermediaries who preferred to provide financing to agent-entrepreneurs at fixed interest rates based on contracts enforceable by law and the state in order to reduce monitoring and transaction costs; (iii) inflow of vast amounts of gold and other riches into Europe from the European colonies in the Americas and elsewhere. This immense inflow reduced the incentive for the elite classes to continue financing trade on the basis of risk sharing. Instead, they preferred to turn their wealth over to intermediaries, or to loan directly to merchant-entrepreneurs on the basis of fixed interest debt contracts; and (iv) the emergence of nation-states whose governments were in need of finance for wars or other state activities, but could not raise resources except by means of fixed interest rate contracts according to which an annuity was paid in perpetuity without the need for governments to repay the principal (Munro, 2003).

More importantly, however, it is likely that the breakdown of trust in Europe and elsewhere was a major factor for the loss of dominance of risk-sharing finance by the end of the Middle Ages. Risk-sharing finance is trust-intensive, and trade financing during the Middle Ages was based on risk sharing which, in turn, was based on mutual trust (Goitein, 1964, p. 316). Recent research indicates that traumatic experiences contribute to the breakdown of trust in a community and among its members (Alesina, et al., 2002). If so, the Middle Ages certainly witnessed enormous, continuous, and extensive traumas, including four crusades, three Mongol invasions, numerous wars in Asia and among Muslim states, and long period of continuous religious wars in Europe, which are but some of the traumatic experiences of the age. Added to these events was the Bubonic plague of the mid-15th century that spread rapidly throughout the then-known world along well-established and intensively travelled trade routes (Abu-Lughod, 1994).

But the full-scale adoption of a fixed-interest-based financial system with a fractional reserve banking sector at its core had a major deficiency. The system is inherently fragile (Minsky, 1982; Khan, 1987). Toward end-1970s and early-1980s, existence of financial intermediaries, in general, and banks, in particular, were justified due to their ability to reduce transaction and monitoring costs as well as to manage risk. However, very little attention was paid to reasons why banks operated on the basis of fixed, predetermined interest-rate-based contracts, i.e., on a fixed interest system that rendered the system fragile and unstable requiring a lender of last resort to regulate it.

Generally, interest rate theories explain the rate as an equilibrating mechanism between supply of and demand for finance, which is a rate that prevails in the market as a spot price and not as a price determined ex ante and fixed, tied to the principal and the period covered by the debt contract. In an important paper, Bhattacharya (1982) argued that: "… with risk-neutral preferences, when the choice of risk level is unobservable, then any sacrifice of higher mean asset payoff constitutes an inefficient choice. The classical model of intermediaries existing to save on transactions/monitoring costs in asset choice does not explain why their liability structure should not be all equity" (p. 371). With the development and growth of information economics and agency literature, another explanation was added to the list of reasons for the existence of intermediaries. They served as **delegated** monitoring as well as signalling agents to solve the informational problems, including asymmetric information existing between principals and agents.

Based on the findings of the developing field of information economics (see, in particular, Stiglitz and Weiss, 1981), Yoon Je Cho (1986) argued that adverse selection and moral hazard effects in a banking system operating on the basis of fixed-fee contracts in the presence of asymmetric information—particularly in cases where this problem is acute—means that some groups will be excluded from the credit market even when the expected rate of return for these groups may be higher than for those with access to credit. Furthermore, he argued that, in case of risk-return sharing, contracts—e.g., equity—are not subject to adverse selection and moral hazard effects, "the expected return to an equity investor would be exactly the same as the expected return of the project itself" (p. 197).

The fragility of a financial system operating on the basis of fixed, predetermined interest rate was underlined by Stiglitz (1988) who argued that "interest rate is not like a conventional price. It is a promise to pay an amount in the future. Promises are often broken. If they were not, there would be no issue in determining creditworthiness. Raising interest rates may not increase the expected return to a loan; at higher interest rates one obtains a lower quality set of applicants (adverse selection effect) and each one's applicants undertakes greater risks (the adverse incentive effect). These effects are sufficiently strong that the net return may be lowered as banks increase the interest rates charged: it does not pay to charge higher interest rates" (Stiglitz, 1988, p. 312).

The findings of the new field of information economics strengthened the arguments of Professor Minsky (1982) and others that a debt-based financial system with the fractional reserve banking operating with a fixed, predetermined interest rate mechanism at its core is inherently fragile and prone to periodic instability. Stiglitz's findings underlined Minsky's argument that, as returns to banks declined, unable to raise interest rates on their loans, they enter a liability-management mode by increasing interest rates on their deposit. As this vicious circle continues to pick up momentum, the liability management transforms into

Ponzi financing and eventually bank runs develop. The last two decades of the 20th century witnessed a number of global bouts with financial instability and debt crises with devastating consequences for a large segment of humanity, thus raising consciousness regarding vulnerabilities and fragilities of the financial system which are based, at their core, on fixed-price debt contracts. The risks of country-specific debt crises with potential risks of contagion have not diminished, particularly for a number of emerging economies, including some Muslim countries.

The question is why greater use is not made of equity finance with its risk-sharing characteristics? Prescott and Mehra (1985) demonstrated that over many decades, a large differential existed between the real rate of return to equity and the real rate of return to a safe asset, i.e., US Treasury bills. Furthermore, the differential was too large to be explained by existing theories of rational investor behavior. This result became known as the "Equity Premium Puzzle." It is a puzzle why rational investors, noting the differential, would not invest in equities until the point where the remaining differential could be explained as the risk premium on equities. Subsequent research demonstrated that the puzzle existed in other countries as well. Since the publication of the paper, a large body of literature has attempted to explain the puzzle, but Mehra (2003) argued that all explanations failed, for one reason or another, to provide a satisfactory resolution. Interestingly, also in the same paper, Mehra reports that the real worth of one dollar invested in 1802 in equity would have been nearly $560,000 in 1997, whereas the real worth of the same $1 invested in 1802 in Treasury bills would have been $276 over the same period (Mehra, 2003, p. 55).

II. Trust, Financial Development, and Economic Growth

As mentioned earlier, an important reason for the dominance of risk-sharing finance during the Middle Ages was mutual trust. It is possible that the breakdown in the general level of trust relationships may have led to the dominance of debt contracts beginning at the end of the Middle Ages. Eminent sociologists, such as Durkheim, Weber, and Parsons have focused on trust as an effective instrument of social cohesion for quite some time. (O'Hara, 2004). Economists, however, have been empirically investigating trust only recently[5] after Fukuyama raised the possibility that it may be an important factor in explaining cross-country economic performance (Fukuyama, 1996). Specifically, he asserted that the general level of trust, an important component of social capital, was a strong explanatory factor in the economic performance of industrial countries. Moreover, he indicated that a

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[5] Kenneth Arrow had suggested in 1974 that trust "is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people's word" (Arrow, 1975, p. 23). Also, Gary Becker, in his *"A Treaties on the Family"* (1991) dealt with trust and trustworthiness within households.

high level of general trust was reinforced in these societies by strong institutions. The last decade of the 20th century had already witnessed a large volume of empirical research that focused on the existence (or the lack) of strong institutions explaining cross-country differences in economic performance. This literature had isolated two specific institutions—those that protect property rights and those that enforce contracts—as the most important in explaining why some economies performed well and others did not (Acemoglu and Johnson, 2003).

The last decade has witnessed a growing literature about the importance of trust to, inter alia, development of the financial system (Calderon, et al., 2002; Guiso, et al., 2004). This body of research demonstrated that since finance, particularly risk-sharing instruments like equity, was trust intensive, high-trust societies exhibited more developed and deeper financial systems. In particular, this literature indicated that there is a high correlation between trust and development of the financial sector. If the level of trust is high, people rely more on risky assets, such as equity, invest a larger share of their wealth in stocks, use more checks, and have access to greater amount of credit than in low-trust countries. Importantly also, since the second half of the 1990s, a number of researchers, using variety of techniques, have attempted to demonstrate the impact of trust on economic performance (Knack and Keefer, 1997; La Poztam et al., 1997; Glaeser, 2000; Bengelsdijk, et al., 2004).

In a recent paper, Luigi Guiso, Paola Sapienza, and Luigi Zingales (2005) assert that evidence suggests low trust as a crucial factor in explaining the low level of stock market participation. If the results of this paper prove robust, trust may well become the long awaited solution to the Equity Premium Puzzle. The authors define trust as "the subjective probability that individuals attribute to the possibility of being cheated." Their paper reports that, based on the analysis of cross-country data, where the level of trust is high, investment in equities, in general, and in the stock market, in particular, is also high. Moreover, the paper suggests that in low-trust countries, equity participation depends on observance of the rule of law and the existence of legal institutions that protect property and investor rights and those that enforce contracts. It suggests that in low-performing economies not only is the level of trust low, but property and investor rights are poorly protected, and legal contract enforcement weak. Consequently, in these countries, corporations either do not form and if they do, they resort to debt financing. Policy implication for these economies is to strengthen legal institutions, improve transparency, accountability, and governance—both in private and public sectors—and to provide the public with a greater amount of information and education on risk-reward-sharing finance, in general, and equity markets, in particular.

III. Trust and Muslim Countries

If low trust is a crucial factor in explaining poor economic performance, then the results of recent research is a wake-up call for Muslim countries, since trust is

considered the most important element of social capital in Islam and the cornerstone of relationship of individuals with the Supreme Creator and with others in the society. Islam places a strong emphasis on trust and considers being trustworthy as an obligatory command. The root of the word **belief**—Iman—is the same as that of trust—***Amānah***. Moreover, abiding by one's contracts and remaining faithful to promises with other members of the society derives from the need to remain faithful to the original, primordial covenant between human beings and the Supreme Creator (Qur'ān, Chapter 7, Verse 172). Accordingly, the Qur'ān, in a number of verses, insists that a strong signal of true belief is **faithfulness** to **contracts and promises** made. Moreover, the Qur'ān makes clear that performing the obligations one has contracted or promised is **mandatory** for a believer. Indeed, fidelity to one's promises and the terms of contracts one enters into as well as maintaining trust are considered important characteristics of a true believer.

In the chapter of the "Faithful"—Chapter 23, Verses 1-8—keeping trust and promises are two of the major characteristics of the faithful. In the first verse of Chapter 5 of the Qur'ān, the faithful are ordered to abide by the terms of contracts they have entered into. Similarly, in Verse 34 of Chapter 17, the faithful are commanded to keep their promises, for they will be asked about their faithfulness to promises. There are other verses of the Qur'ān that emphasize the duty of the faithful to remain fully conscious of Allah (s.w.t.) while entering into contract or making promises, or being trustworthy when they are entrusted with objects for safekeeping (see, for example, Verse 283 of Chapter 2 and Verse 58 of Chapter 2). The Qur'ān also identifies a chief characteristic of prophets and messengers of Allah (s.w.t.) as trustworthiness (for example, see Chapter 42,Verses 107, 125, 143, 162, 178, 193) and chastises betrayal of trust (see Chapter 8, Verse 58 and Chapter 12, Verse 52). In short, Islam has made trust and trustworthiness obligatory—as well as keeping faith with contracts and promises—and has rendered them inviolable without explicitly permissible justification.

The life of the Prophet is a shining illustration of the implementation of guidance of Allah (s.w.t.) in maintaining trust and remaining trustworthy in his own life, both individually and within the community. Regarded as eminently trustworthy even before his divine appointment, the community conferred upon him (صل الله عليه وآله وسلم) the title of Al-Ameen (Trustworthy). The Prophet expended a great deal of effort, from his divine appointment until his passing, in modifying when possible and changing when necessary the behaviour of the members of community toward trustworthiness.[6] There are numerous statements,

[6] An important new field of research called **neuroeconomics** has recently discovered that, as a person feels trusted, a neuropeptide, oxytocin, "circulates in the brain and the body rises. The stronger the signal of trust, the more oxytocin increases. In addition, the more oxytocin increases, the more trustworthy (reciprocating trust) people are." (Paul Zak, 2003; see also Fehr, et al., 2005). This astonishing research demonstrates why Allah (s.w.t.) and

(continued)

actions, and circumstances attributed to him in which trust was the pre-eminent concern. For example, in a few very short, but highly significant statements, (quotations from Payandeh, 1984),

he (صل الله عليه وآله وسلم) declares:

لا إيمان لمن لا أمانة له ولا دين لمن لا عهد له .

The person who is not trustworthy has no faith, and the person who breaks his promises has no religion;

إن حسن العهد من الإيمان .

Maintaining promises perfectly is a sign of faith;

ثلاث ليس لأحد الناس فيه رخصة : برّ الوالدين مسلماً كان أو كافراً والوفاء بالعهد لمسلم أو كافر والأمانة الى مسلم كان أو كافر.

There are three (injunctions) that no one is allowed to violate: treating parents kindly regardless of being Muslim or non-believer; keeping a promise whether to a Muslim or to a non-believer, and returning what is entrusted for safekeeping regardless of whether the truster is a Muslim or a non-believer;

أد الأمانة الى من أئتمنك ولا تخن من خانك .

Return what is placed in your trust for safekeeping to the person who has trusted you and do not betray who has betrayed you;

Finally, he (صل الله عليه وآله وسلم) specifies the chief characteristics of hypocrites as follows:

ثلاث من كان فيه فهو منافق وإن صام وصلى وحج واعتمر وقال إني مسلم : من إذا حدث كذب واذا وعد أخلف وإذا ائتمن خان .

Three (behavioural traits) if found in a person, then he is a hypocrite even if he fasts, prays, performs bigger and smaller pilgrimages, and says "I am a Muslim:" when he talks, he lies; when he promises, he breaches; and, when trusted, he betrays.

While the above are only a few sayings of the Prophet (صل الله عليه وآله وسلم), they are comprehensive in their implications and profound in their brevity. Given the strong heritage of the seriousness of trust and trustworthiness in Islam, the low level of trust within and among Muslim societies is inexplicable unless one considers the historical erosion and loss of values, norms, and rules so critical to

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His beloved Messenger (صل الله عليه وآله وسلم) emphasized trust and trustworthiness on the part of individual Muslims, even without expectation of reciprocity. As sociologists have maintained for quite some time, trust and trustworthiness promote social solidarity which is, in turn, crucial for the strength of cooperation in economics activity as well as being indispensable to the preservation of the community (O'Hara, 2004).

Islam. While the present low economic performance in Muslim societies, attributable to the low level of trust, is discouraging, signs are emerging that the future is more hopeful. The governments of these countries are implementing policies to strengthen the institutional structure of the society, even if it is clear that the required level of trust will take a prolonged and sustained effort to achieve the strength commensurate with Islamic teachings. These policies include those intended to strengthen transparency, accountability, and good governance for public and private sectors; enactment of fiscal responsibility laws; capital market laws; instituting legal structures that protect property and investor rights and enforce contracts; financial sector reforms that create level playing fields for all participants and deepen these markets; and, liberalization of trade and foreign direct investment. Reform is also required in public education in Muslim societies with emphasis on Islamic values and behavioural norms and rules, including the importance of trust and trustworthiness. Depending on the speed of reforms, it is possible for Muslim countries to "leap frog" in achieving higher growth rates for their economies.

IV. Summary

The central idea of this paper is that, as globalization proceeds, its main engines—the new finance and advances in information technology—will shift the methods and instruments of financing trade, investment, and production in favour of more risk spreading and sharing rather than risk shifting via fixed-price debt contracts. It reasons that this is the result of financial innovations that are dissecting, analyzing, and pricing risk better, so that—combined with efficient availability of information and adoption of best international standards of transparency, accountability, and good governance in public and private sectors—the *raison d'être* of fixed-price debt contracts will erode. The rapid progress in development of risk-sharing techniques and asset-backed instruments is evidence of this shift; in particular, there is already a perceptible shift of household portfolios toward equity and share holding in a number of industrial countries. It was also suggested that the major characteristics of the present phase of globalization are similar to an earlier episode that lasted from middle of the 8th century to the latter part of the 16th century. Risk-sharing finance of trade, investment, and production—based on Islamic modes of finance—dominated interest-based mode of financing throughout the then-known world based on mutual trust between agents and principles. By the same token, the breakdown of trust may have been crucial among factors that explain the decline in risk-sharing finance as well as the growth, and the eventual dominance of fixed-price debt contracting modes of finance.

Briefly reporting on the results of empirical research over the past decade, the paper explained the reason for poor economic performance of countries as low level of trust, combined with weak legal institutions protecting property and

investor rights and poor contract enforcement. In the case of Muslim countries, it could be argued that weak adherence to rules, norms, and values demanded by Islam, which constitute its social capital, may indeed be the explanation of poor economic performance (Chapra, 2000). The paper provides quotations from the Qur'ān and the Prophetic tradition that emphasize trust and trustworthiness as duty and obligation, fidelity to which is a strong signal of adherence to Islam.

The paper also suggests that there is hope that as Muslim societies continue the process of strengthening legal institutions, which some have already begun, their economic performance would improve. Efforts at reforming education with concentration on adherence to Islamic values, norms and rules should strengthen the social capital—including, importantly, the level of trust—in these countries. One result of strengthening institutions and enhancing general level of trust will be adoption of Islamic financial techniques of risk- and reward-sharing. Consequently, a global convergence process may be already at work toward risk-sharing in the West and in the Islamic world. As the risks of globalization are shared more equitably, so will its rewards, at least in terms of financial transactions and investment.

International comparisons – (as a percentage of total financial assets – composition at end-1995 and end-2003)

	Share and other equity (1995)	of which: mutual funds shares	Share and other equity (2003)	of which: mutual funds shares
Portugal	25	7	27	9
Belgium	29	9	29	16
Denmark	23	7	17	9
Germany	19	7	22	12
Spain	31	11	39	13
France	35	12	36	10
Italy	20	4	35	17
The Netherlands	20	5	11	4
Austria	6	4	16	10
Finland	5	1	41	5
Sweden	30	7	40	12
United Kingdom	20	4	16	5
Euro area (9)	24	8	29	11
European Union (12)	23	7	26	9
USA	46	5	48	10
Japan	14	2	11	2

Source: Household wealth in Portugal: 1980-2004, by Fatima Cardoso and Vanda Geraldes da Cunha, WP 05 June, 2005.

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Part-I

Methodology of Islamic Economics and the Nature of Islamic Finance

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3

Redistributive Justice in a Developed Economy: An Islamic Perspective

Mabid Ali Al-Jarhi*
Muhammad Anas Zarqa**

This article presents a selective review of recent literature on the relationship between redistribution on the one hand and efficiency and growth on the other. Experimental economics have given rise to fairness models and justice models, where self-interest no longer runs supreme but still serves as one of the alternative hypothesis regarding human behaviour. The traditional trade off between equity and efficiency is finally giving way to a positive relationship between two variables in several important areas. The positive relationship between redistribution, efficiency and growth now has some solid grounds both theoretically and empirically.

The new models introduce behavioural hypotheses that bring the Islamic values of solidarity, fraternity and reciprocity to the forefront of economic theory. The study explains that Islam has a viable strategy towards redistribution that combines both direct and in-direct methods into a policy combination that is qualified to uproot poverty gradually and steadily.

Theoretically, zakāh proceeds are expected to play significant role in eradication of poverty. However, actual Practise falls short of this expectation. One reason may be the attachment of policy makers in Muslim countries to narrow interpretations of the scope of zakātable assets. It may be advisable to develop a system of zakāh collection where both official and non-government channels can be effectively exploited. We propose for further consideration a government agency that competes with a network of NGO's in collecting zakāh. Proceeds may be channelled through Islamic banks to the poor in the form financing micro projects that would eventually

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become the property of the poor. This must be done under strict rules of transparency and close monitoring.

Introduction

Economics gave its utmost attention to distribution, in the sense of determining the share of each factor of production through the processes of market exchange, but gave little attention to redistribution in the sense of reaching a certain level of social justice and equity.

Income and wealth are generated and distributed by numerous economic, political and social activities that can broadly be classified into market and non-market activities.

Market activities are direct voluntary exchanges of goods and services. They generate a certain "distribution," which may be modified by a redistribution done by non-market processes.

In a capitalist system, free market activities and the resulting distribution of income and wealth are deemed just, and redistribution is viewed as an exception to be minimized. The socialist system in contrast deems most market activities as exploitative, and the distribution they generate as basically unjust. Redistribution, by political authority is the basic means to achieve justice under socialism.

Sharīʿah considers income and wealth generated by Sharīʿah compatible, i.e. *ḥalāl* or lawful, market exchanges to be wholesome and acceptable distribution. However, there is one serious reservation: being *ḥalāl* does not mean, from Sharīʿah point of view, being free of obligations towards others, especially in relation to promoting social welfare. Thus, Sharīʿah instituted several rules and schemes for redistribution, *zakāh* being the most prominent. Those rules and schemes embody the Islamic concept of justice and its strategy of implementing it through redistribution.

This paper attempts to present a careful survey of the Islamic approach to social justice. It draws on the results of prior research in this area by ourselves and by many other scholars, Muslim and non-Muslims, economists and non-economists.

Questions of distribution have always been important and still are. Even in today's very prosperous world, we see widespread abject poverty and inequality. According to the UNDP Human Development Report, 2004, there are 1100 million people living under $1 a day, 432 millions of them live in South Asia and 323 million in Sub-Saharan Africa. Out of those, there are 831 million undernourished individuals mostly living in South and East Asia.

Such statistics and much more indicate that the degree of deprivation is horrifying. Redistribution must therefore be addressed with serious and effective policy tools.

Traditionally, economics has treated efficiency and equity as separable. The theoretical basis for their separation is the Second Fundamental Theorem of Welfare Economics, which holds that any Pareto efficient outcome can be implemented as a competitive equilibrium given the appropriate lump sum taxes and transfers.[1]

Redistribution gained increasing interest among economists during the 1980's and 1990's. Several new contributions advancing new hypotheses have changed the economists' perception of the subject. Muslims, meanwhile, take pride in the redistributive system that is embodied by Islam, as it increasingly appear to be the best vehicle for social justice. The new contributions came from three directions. The first emanates from experimental economics and the associated theories of fairness. The second is a further application to the relationship between redistribution and efficiency. The third is based on a reassessment of the relationship between equity and growth.

2. Fairness and Justice Theories

We can think of at least two important reasons for seeking a descriptively accurate theory of impartial justice. First, social scientists must consider how justice, alone or in tandem with other goals (such as self-interest or reciprocity), affects the phenomena they study.

Second, the study of impartial justice consciously aims at separating the effects of unbiased, biased justice and other motives. Impartial justice provides a standard to evaluate and reconcile conflicting interests.

Justice is taken to refer to both distributive as well as procedural justice. Justice in economics mostly refers to material wealth, the chief concern of most economists. There are four elements of justice; each inspired a group of theoretical analysis.

A. Equality and Need

This element covers theories that incorporate a concern for the well-being of the least well-off members of society including egalitarianism, social contract theories and Marxism. They inspire the Need Principle, which calls for the equal satisfaction of basic needs.

B. Utilitarianism and Welfare Economics

This element comprises utilitarianism, Pareto Principles and the absence of envy concept, which have grown out of consequentialist ethics, or the tradition in philosophy and economics that emphasizes consequences and end-states. They are

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[1] (Furman and Stiglitz, 1998).

most closely associated with the Efficiency Principle, which advocates maximizing surplus.

C. Equity and Desert

This element includes equity theory, desert theory, and Robert Nozick's theory. Together they inform the Equity Principle, which is based on proportionality and individual responsibility.

D. The Context Family

This comprises a group of writings that deal with the dependence of justice evaluation on the context, such as the choice of persons and variables, framing effects, and issues of process. Such writings do not generate a distributive principle but rather discusses the ideas of their authors. (Elster, 1992; Frey and Stutzer, 2001a, b; Kahneman, Knetsch, and Thaler, 1986; Walzer, 1983; and Young, 1994).

2.1 Fairness Models

Economic theory assumes that all people are solely motivated by self-interest. Experimental economics suggests that many people are strongly motivated by other-regarding preferences and are concerned about fairness and reciprocity.[2] The persistence of non-competitive wage premia, the incompleteness of contracts, the allocation of property rights, the conditions for successful collective action and the optimal design of institutions are some of the puzzling problems that could not be explained by theories based on self-interest. Alternatively, they could be explained by theories of fairness.

Self-interest models can provide accurate predictions in competitive markets with standardized goods. However, they could lead to misleading predictions in markets with a small number of traders or informational frictions, in firms and organizations, and under incompletely specified and enforceable contracts. The newly developed fairness models show why in certain environments the self-interest model is so successful and why in others it is refuted, thereby providing insights into non-clearing markets or the widespread use of incomplete contracts.

In the 1980s, experimental economists started to study bilateral bargaining games and interactions in small groups in controlled laboratory settings.[3] The Ultimatum Game led many people to realize that the self-interest hypothesis is problematic.[4] In addition, the Gift Exchange Game, the Trust Game, the Dictator

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[2] Adam Smith (1759), Gary Becker (1974), Kenneth Arrow (1981), Paul Samuelson (1993) and Amartya Sen (1995), accepted that people care for the well-being of others. Obviously, this may have significant theoritical implications. Mainstream economics has not yet adjusted for that(Fehr and Schmidt, 2000). See (Fehr and Schmidt, 2000).

[3] (Roth, Malouf and Murningham 1981, Güth, Schmittberger and Schwarze 1982).

[4] (Güth, Schmittberger and Schwarze, 1982).

Game and Public Good Games all played an important role in weakening the exclusive reliance on the self-interest hypothesis.

For decades, economists believed that fairness motives would not matter much. They considered fair behaviour as a temporary deviation from self-interest. Under such relatively weak condition, experimental markets quickly converge to the competitive equilibrium. This has been interpreted as a confirmation of the self-interest hypothesis. However, the newly developed fairness models show convergence to standard competitive predictions can occur even if the fairness agents' motive is very strong.

Fairness models demonstrate unambiguously that many people are not only maximizing their own material payoffs, but that they are also concerned about social comparisons, fairness and the desire to reciprocate.[5] However, this does not imply that they will always behave fairly, for this depends on the strategic environment in which they interact and their beliefs about the fairness of their opponents.[6]

Fairness matters much more in the case of incomplete contracts, whose execution extend over time. labour markets are a good example.

Of particular interest to Islamic economics is the allocation of property rights in investment ventures. Under the assumption of self-interest, joint ownership cannot be optimal. This stands at odds with the existence of successful jointly owned companies, partnerships or joint ventures. Reciprocal fairness could work as an enforcement mechanism to induce more investment under joint ownership than under self-interest. In addition, fairness models suggest that joint ownership may do better than exclusive ownership because it offers wider scope for reciprocal behaviour.

We can also learn from fairness models that redistribution is important and is not contrary to efficiency as defined in a perfectly competitive model. In fact, redistribution could be a requirement for reaching such efficiency or Pareto optimality. This raises the question of what relationship exists between redistribution and efficiency.

2.2 Justice Models

Justice models include contractarian models as well as models of impartiality, solidarity and priority. Justice models allow individuals to rank policies while standing behind “a veil of ignorance” where everyone is in the same informational

[5] (Smith, 1962; Davis and Holt, 1993).
[6] See (Fehr and Schmidt, 2000).

position, they see all possible outcomes as possibly happening to them, but no one knows which group he will be in.[7]

2.2.1 Contractarian Models of Redistribution

Contractarian models start with a society that enjoys neither the voluntary respect for property rights nor the enforcement of contracts.[8] In such prisoner's dilemma, individuals tend to overinvest in defence and aggression, and underinvest in productive activities.[9] Credibly enforced property rights are a means to overcome this dilemma.

Conventional contractarian models begin with a set of property rights, and allow individual activities to define a primary distribution of income. The State carries on redistributive policies in order to bring the primary distribution closer to the desired level. A contractarian theory of justice views such redistribution as insurance against risks, which cannot be privately insured.[10] In the insurance theory of redistribution, initially equal individuals agree on redistribution in order to avoid the adverse consequences of becoming unequal.

Conventional models have been accused of three conceptual weaknesses. First, the insurance argument requires risk aversion of individuals in the initial situation behind the veil of ignorance. Economists tend to evaluate social policies in terms of ex post efficiency. Given a population of two groups A and B, and two alternative social policies P1 and P2, economists are willing to call P1 "inferior to" P2 if both groups prefer P2 but they are silent on policy ranking if A prefers P1 and B, P2.

One way to rank policies is to step back behind "a veil of ignorance" where no one knows which group anyone will be in. Behind the veil, everyone is in the same informational position. Individuals see all possible outcomes as possibly happening to them. This common perspective gives a way to rank social policies. P1 would be better than P2 if and only if it is better from the behind-the-veil perspective, i.e., it maximizes welfare from that perspective (Rawls, 1971; Phelan, 2002). However, the initial situation is merely a normative contrivance that reflects intuitive ideas of fairness and justice. Assuming that risk aversion is a reasonable justification of fairness cannot be accepted à priori.

Second, real individuals are not bound by contracts signed by hypothetical individuals in an initial situation. Hence, there is an inconsistency between the idea of legitimation underlying contractarian theories and the concept of a veil of ignorance. The theory has no obligatory power.

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[7] (Rawls, 1971; Phelan, 2002).
[8] (Bush and Mayer 1974).
[9] (Hirshleifer 1995).
[10] Rawls's theory of justice (1971) as well as Harsanyi's theories of utilitarianism (1953,1955) are examples for this line of argumentation.

Third, the enforcement of constitutional rules cannot be presupposed in the absence of an enforcement agency, as they could be abolished by the most powerful groups in society. Self-enforcement of rules cannot simply be presupposed.

Contractarian theories that avoid such weaknesses can be divided into two groups: positive theories that attempt to explain the emergence of institutions and normative theories that attempt to justify their legitimacy.

Most notably, Bos and Kolmar model,[11] legitimizes redistribution because individuals are different in the initial situation. They initially know that they differ with respect to their productivities. Redistribution of factors of production is a means to exploit these differences. Individuals who give up factors of production have a legitimate claim for compensation. The model contains rules of redistribution that serve as an institutional substitute for direct payments. Therefore, redistribution is legitimized neither by insurance motives nor by private charity, but follows from the principle of reciprocity in trade.

2.2.2 Models of Impartiality, Solidarity and Priority[12]

Dworkin, Harsanyi and Rawls have employed the veil of ignorance in different forms as a tool to enforce impartiality as a basis to determine how the worldly distribution of resources or wealth should be.[13] Some political philosophers argue that justice requires that priority be given to the worse off. To Rawls, differences in amounts of primary goods accruing to people are morally permissible only if they maximize the level of primary goods accruing to the worst off; this is the extreme form of priority.

Prioritarianism has been coined to indicate that the worse off should be given priority over the better off with respect to redistribution, but not necessarily the extreme priority that characterizes maximin (the difference principle).[14] Prioritarianism can be visualized as a social welfare function with strictly convex upper contour sets, bounded by maximin on one side, and utilitarianism on the other.[15]

Lately, the veil of ignorance has been shown to be inconsistent with prioritarianism as it will often recommend wealth distributions that give priority to the better off.[16] Justice is seen to require impartiality (the redistribution rule that

[11] Bos, Dieter and Martin Kolmar (2000).
[12](Moreno-Ternero and Roemer 2004).
[13] (Dworkin, 1981a,b; Harsanyi 1953 and Rawls, 1971).
[14] (Parfit, 1997).
[15] (Roemer (2004).
[16] (Moreno-Ternero and Roemer, 2004).

implements justice must be impartial. To insure impartiality, some propose to add solidarity, which implies fraternity or reciprocity.

Justice requires impartiality, which, as far as justice is concerned, is properly modelled by veil-of-ignorance thought experiments. However, veil-of-ignorance thought experiments in general recommend antiprioritarian allocations. To remedy this, a second principle must be added to impartiality to characterize justice. Moreno-Ternero and Roemer add solidarity and suggest that fraternity or reciprocity can also be employed.

It is interesting to note that such values as justice, solidarity, fraternity and reciprocity are on the top of the list of the moral values Islam strives to cultivate.

3. Redistribution and Efficiency

A concern for equity has long been an important aspect of economic analysis. Most policy analysis done by economists, however, has focused on efficiency rather than equity, dealing with such issues as the cost of government regulations, the deadweight loss of taxation or the labour supply effects of government transfers.

Most economists take for granted the idea that equity and efficiency cannot be achieved together; that greater equity must come at the inevitable cost of a loss of efficiency. Policy discussions centred on the equity versus efficiency argument since post-Second World War period. By the late 1960's, conflict between efficiency and equity was generally accepted.

Arthur Okun, in the late 1970's described the “leaky bucket experiment” in a dollar transferred from a richer to a poorer individual, leads to less than a dollar increase in income for the recipient, because of: Administrative costs of redistribution, changes in work effort, changes in savings and investment behaviour induced, and changes in attitudes.[17]

Lately, some economists have identified circumstances under which equity and efficiency may not trade off against each other, policies that promote greater equity with little effect on efficiency, policies where equity and efficiency complement each other.[18]

Rebecca Blank suggests three cases when redistribution needs not cause efficiency loss. The first case is when there is no individual agency. This happens when an individual has no capacity for response as in the case of disabled individuals, the elderly or children and in cases where jobs, wages and housing opportunities are limited by race, gender or ethnic background. Additional income

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[17] (Okun, 1975).

[18] (Blank, 2002).

to those groups will not cause an offsetting change in labour supply.[19] One exception is when it affects the behaviour of other family members. For instance, if supporting the elderly induces fewer children to support their parents, or if guaranteeing college scholarships leads parents to work and save less. Empirically, such effects are relatively small.[20] In short, an individual must be both without agency and socially isolated for transfers to involve no efficiency losses. This is an argument for providing higher degrees of support to orphans as well as those with no family.[21] Again, we are impressed by the priority that Islam gives to caring for the orphan.

The second case is associated with redistributive programs that combine income transfers with behavioural requirements, e.g., the welfare-to-work programs that reduce the costs.[22] In such case, redistribution, when combined with strong work requirements can lead to higher labour supply and income to the poor.

Both first and second cases provide redistribution with minimum efficiency costs, while keeping aggregate income constant. The third case occurs when transfers subsidize the provision of services that function as investments; that is, they change behaviour or opportunities in a way to increase future income.

Traditionally, economists would argue that cash transfers produce more benefits than do in-kind transfers. However, in-kind transfers that have long-term investment properties can be preferable to cash transfers. Examples of this include transfers that provide health assistance that reduces future health problems, like public campaigns to immunize children, human capital expenditures to subsidize child care, education, job training of disadvantaged adults or teens. This argues for Focussing subsidies on services that provide ongoing future income gains and less on policies that simply provide one-period benefits.

Jiandong Ju takes another approach to redistribution. He introduces a theorem on specific cases when redistribution leads to more efficiency. Redistributing more income to consumers who spend relatively more on goods that have larger price elasticities of supply leads to higher output of such goods at the expense of spending on goods with low price elasticities of supply. The increase in the output of the former goods would be more than compensate the decrease in the output of the latter goods. Consumers' surplus would increase leading to a potential Pareto

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[19] (Blank, 2002; Piketty, 1995).

[20] (Cox and Jakubson, 1995); Schoen, 1997).

[21] (Blank, 2002).

[22] Working-family tax credits programs enacted in the U.S. and the UK in recent years belong to this group. Earned Income Tax Credit (EITC) in the U.S., which provides supplements to the earnings of low-wage workers in low-income families has been credited with increasing labor supply of the poor.

improvement.[23] The Pareto optimum potential is reached only when the marginal aggregate consumers' surplus is equalized over all consumers. In a perfectly competitive economy, if the rich spends relatively more on goods with relatively inelastic supply and the poor spend relatively more on goods with relatively elastic supply, redistributing more to the poor will improve aggregate efficiency.

According to this approach, at a given level of income distribution, the perfectly competitive market is Pareto efficient at the individual level. Income redistribution adjusts aggregate demands and raises aggregate supplies. This in turn increases consumers' surplus, bringing potential improvement. In other words, redistribution can improve efficiency at the aggregate level.

4. Redistribution and Growth

Since the 1990's, economists have been preoccupied with the sources of productivity growth as the major long-run determinant of per capita income growth. They focused on the static effects of economic policy, the so-called size-of-the-pie effects or the policy effect on long-run economic growth.

Sources of productivity growth, including new investment, human capital formation, new technology and product innovation are driven by investment, innovation, education and trade. A new hypothesis adds social factors, including income and wealth distribution, social policy regarding health, education, labour market regulation and income support programs as major determinants of productivity growth. The new hypothesis runs against the traditional efficiency-equity trade off.[24]

4.1 Property Rights

Some economists suggests that income inequality fuels social discontent and creates political instability.[25] This in turn discourages investment and hinders economic growth. When income disparity is significant, some citizens will become wealth takers rather that wealth makers, reducing growth benefits of technological improvements. Others suggest that economic growth will be dampened when property rights are not secure.[26] Palda builds a model of an economy in which each individual faces a choice: to earn his living as a wealth maker, or to live by taking of others' wealth. Equilibrium prevails when no maker has an incentive to switch to the profession of taking, and vice versa.

At a critical level of property rights, the economy experiences a “takeoff” in which growth shocks amplify themselves. Government protection of property

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[23] (Ju, 2002).
[24] Harris, Richard G. (2002).
[25] Alesina and Rodrik (1994) and Alesina and Perotti (1996).
[26] Olson (1982), and Scully (1988, 1991).

rights will enhance the incomes of makers, and entice takers to become producers. Income redistribution would boost growth beyond the critical level of property rights. Otherwise, redistribution may encourage economic stagnation.[27]

4.2 Growth and Equity

In a dynamic setup, the trade-off between equity and efficiency takes the form of a trade-off between equity and growth.

Chou and Talmain confirm that wealth redistribution can enhance growth while making everybody better off. They postulate a connection between wealth distribution and growth, through labour supply in a setup without capital market imperfection. The social rate of return on investment exceeds the private rate, due to monopolistic competition in the product market. This wedge causes growth to exhibit positive externalities. Because of such externalities, even the provider of a wealth transfer can be better off.[28] They use a standard endogenous growth model with heterogeneous households' initial asset holdings.[29] Once an endogenous labour supply is introduced, growth starts to be influenced by redistribution.

Initial wealth determines households' permanent income, which in turn determines their labour supply, and ultimately the growth rate. The effect of redistribution on the rate of growth depends on the shape of the labour Engel curve (the static supply of labour as a function of static income). When the labour Engel curve is concave, redistributing wealth from the rich to the poor increases growth. Growth is maximized when wealth is equally distributed among the households. The rich suffer a loss of wealth, but benefits from increased growth. The opposite is true when the labour curve is convex.

Growth exhibits positive externalities, raising the real wage of all households. The welfare of each individual depends, via growth, on the wealth of others. Growth appears to exhibit the characteristics of a public good a la Musgrave. Obviously, such a model has room for Pareto improving redistribution.

The model can be extended to a two-sector model, where one of the sectors uses labour to produce a homogeneous good. The labour Engel curve would be replaced by the homogeneous good Engel curve. If it is concave, some redistribution would raise growth and be Pareto improving.

4.3 Empirical Studies

In the post–World War period many East Asian economies had relatively low levels of inequality[30] and grew at unprecedented rates. In contrast, many Latin

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[27] Palda, Filip (1999).
[28] Chou and Talmain (1996).
[29] Grossman and Helpman (1991).
[30] Relative to countries of comparable income levels.

American countries had significantly higher levels of inequality and grew at a fraction of the average East Asian rate.

Economists have attempted to measure the relationship between inequality and growth[31] by adding inequality as an independent variable to some variant of Barro's cross-country growth regression.[32] They generally found a negative and just-significant coefficient on inequality, indicating a negative impact on growth.[33]

In many of those models, the negative relationship depends on exogenous factors (aggregate wealth, political institutions, or the level of development). Many of them predict multiple equilibria, i.e., under certain initial conditions, inequality could have a positive effect on economic growth.

Several recent papers have developed models predicting a positive relationship between inequality and growth. However, they received less attention because all recent empirical work has reported a negative relationship between these variables.[34]

There are, however, three potential problems with this empirical work. First, many of the estimates of a significant negative effect of inequality on growth are not robust.[35] Second, all of empirical studies suffer from two problems: measurement error either random or systematic in inequality and omitted-variable bias.[36] A third problem is that empirical work does not directly address the important policy question of how a change in a country's level of inequality will affect growth within that country.

Recently, economists addressed the above problems by using more consistent data to control for any measurement error and panel estimation to control for any time-invariant omitted variables.[37] A generalized method of moments technique was used for estimation.[38] Results suggest that in the short and medium term, an

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[31] Alesina and Perotti (1994), Alesina and Rodrik (1994), Birdsall et al. (1995), Clarke (1995), Deininger and Squire (1998),Persson and Tabellini (1994).

[32] Barro and Sala-i-Martin (1995).

[33] Benabou (1996b) and Perotti (1996).

[34] Benabou (1996a), Galor and Tsiddon (1997a, b) and Saint-Paul and Verdier (1993).

[35] During sensitivity analysis (e., g., when additional explanatory variables or regional dummy variables are included) the coefficient on inequality often becomes insignificant, but remains negative(Deininger and Squire, 1998).

[36] Random measurement error could lead to an attenuation bias and reduce the significance of results. Systematic measurement error could lead to either a positive or negative bias, depending on the correlation between the measurement error and the other variables in the regression. Omitted-variable bias could be equally problematic, although it is impossible to predict the direction of this bias in a multivariate context.

[37] Forbes, Kristin J. A (2000).

[38] Manuel Arellano and Stephen R. Bond (1991).

increase in a country's level of income inequality has a strong positive correlation with subsequent economic growth.

The sharp contrast between this significant positive relationship and the negative relationship reported in the cross-country literature, is due to data quality, period length, and estimation techniques. Sensitivity analysis confirms that the positive relationship is highly robust to many permutations of the original sample and model. The one caveat is that these results may not apply to very poor countries, since inequality data for these nations are still limited.

5. Redistribution in Islam

5.1 Moral Bases, Significance and Limitations

Let us now take a brief look at the moral bases for redistribution as seen by some of the schools of thought reviewed above. We follow a sympathetic methodology that tries to discover from a Sharīʿah point of view the merits of each view.

5.1.1 Utilitarianism

The Utilitarian motto "Promoting the Greatest Good for the Greatest Number of people", as a social decision criterion, is Sharīʿah Compatible. Needless to say "good" or "utility" is taken to be within the limits of *ḥalāl*. In fact, the improvement of the human lot and the increase in human utility is perhaps the major economic goal of Sharīʿah.[39]

Utilitarianism , when combined with the assumption of diminishing marginal utility of income, produces the result that maximum utility in society is achieved by complete equality. However, complete equality runs the risk of complete destruction of incentives, i.e. Killing the goose that lays the golden eggs. So, sensible Utilitarians call for more not complete equality.

Sharīʿah of course never calls for complete equality as a general goal, and explicitly states that inequalities are part of the test of life.[40] Nonetheless, Sharīʿah did commend, not ordain, complete equality in emergencies, as in a life threatening food shortage. Such emergencies are random and non-repetitive, so the negative incentive effect of complete equality does not apply here.

5.1.2 Atonement for Sins as Basis of Redistribution

It seems strange that this basis is relevant to both the libertarian stance and its polar opposite: Marxism. Libertarians focus on the process by which distribution is generated rather than the outcome or resulting distribution. If the process (say

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[39] (The Qur'ān, 17:70).
[40] (the Qur'ān, 6:165).

market activities) were fair, no interference would be justified, for the outcomes are justified. The implication is that prior sin is the basis for redistribution, and to libertarians' capitalists are not sinners! Nevertheless, Marx said they were. To him their original sin is exploitation of workers, and the only possible atonement is for the tools of sinning (means of production) to be confiscated and redistributed to workers.

We have indicated earlier in the Introduction, Islam's position on this. It is interesting to note Islamic Sharīʿah and earlier religious traditions, did accept atonement for sins as one basis for some redistributions. This is explicitly stated in several verses of the Holy Qur'ān and the traditions of the Prophet (pbuh).[41] One consequence of this is to reduce or eliminate the disincentive effect of redistribution on the givers, as they feel that by giving they are also helping themselves .

5.1.3 Redistribution as a Concession to the Disadvantaged

Rawls' result focuses on the welfare of the least advantaged. This is welcome morally and resonates with the Prophet's (PBH) injunction "Seek for me the weak, for sustenance ( ) and succour is bestowed on you because of [your caring for] the weak". This result is also intellectually admirable as it snatches a concession to redistribution from the jaws of selfishness that is assumed in all participants in Rawls' hypothetical game.

5.1.4 Exchange as an Islamic Basis for Redistribution

Redistribution is based squarely on Islam's worldview. God alone is the Creator and true owner of everything. Individual income and wealth are truly a trust and a test from God, even when it is seemingly earned with one's expert knowledge or the "sweat of one's brow." This is because one's own body, mind and faculties are themselves gifts from God. So are the natural resources, free or scarce, that man works with to produce wealth.

As a token of gratefulness, it is a duty of the well to do, accountable before God on the Day of Judgement, to moderately share with the needy and to help support public duties. Failure to do so individually and collectively has been described in the Qur'ān as transgression ( ) and a corollary to disbelief in God and the Day of Judgement.[42] Rejecting Qaroon's argument that wealth acquired for good reason (such as superior knowledge) absolves its owner from obligations, the Qur'ān puts forward a different justification: "…And do good unto others as God has done good unto thee.[43]"

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[41] See for instance the Qur'ān 9:103.
[42] (the Qur'ān, 36:47, 68:16-31, 74:44, 89:17-18).
[43] (Al Qassass, 28:77-8).

Redistribution, though seemingly a one-way transfer, is often expressed in Sharīʿah as an exchange. Gratefulness now, atonement for sins, and reward in the hereafter, are for sure not market exchanges, but are exchanges nonetheless between each believer and God. When this point of view is internalized by economic agents, their motive for redistribution is stronger and their disincentives weaker.

5.2 Significance and Limitations

Islamic Sharīʿah emphasis on distributive justice, surprisingly evident from earliest Makkan Surahs, is a culmination of earlier Divine revelations, only more comprehensive, realistic and clear. Distribution ranks quite high in Sharīʿah hierarchy of values, and is an explicit Qur'ānic criterion for evaluating an economic system.[as evident in Qur'ān 69:34, 89:18]. Refusal to share with the needy is considered transgression " ."[44]

In Sharīʿah, redistribution is intended to serve three goals:

- Combating poverty, or need Fulfilment. This is the primary goal of re-distribution in Islam and is one expression of the Divine verdict to Honour the children of Adam.[45]
- Payment of *zakāh* and other charities is a purification to the donor.
- Reduction of inequality, is a secondary goal of redistribution. Islam is probably the only religion which has explicitly stated this goal and given it clear institutional backing [46] through transfers from the public treasury in addition to the payment of *zakāh*.

There are three significant constraints on redistribution that are often present and may be called redistribution dilemmas. They must always be considered in any feasible scheme for redistribution:

- Resources available for redistribution are never enough, because they are given free; there is always an excess demand for them.
- Redistribution could have a potential negative impact on work incentives on both donors and recipients. This may reduce future output (the size-of-the-cake problem. Economists traditionally emphasize this.
- The Qur'ān calls attention to another potential negative impact of redistribution on social cohesion and goodwill that is caused by: (1) abuse

[44] (Al Qalam, 68:16-31].
[45] Al-Israa 17:70 : "We have dignified Adam's offspring"
[46] (Surah Al Hashr 59:7).

of receivers by donors in words or deeds,[47] or (2) excessive redistribution. Both may create animosity and ill will.[48]

We should keep the above constraints in mind while reviewing below how Sharīʿah handles them in its redistribution strategy.

5.3 Strategy

Utmost Concern with Redistribution

This is especially true of the first objective for redistribution, which is combating poverty. Sharīʿah installed four major safety nets to relieve those who cannot fully support themselves of poverty: (a) intra-family maintenance, (b) *zakāh,* (c) public treasury (   ) and (d) ad hoc taxation, in that order. A lower level safety net such as (c) is activated only when a higher-level one such as (a) or (b) is insufficient or inapplicable. This concern is also manifested in the multiplicity and comprehensiveness of the redistributive measures used.

Moral and Religious Suasion

Islamic teachings inform and educate people to the moral superiority, rationality and justice of sharing with the needy some of the bounties that God granted to the wealthy as a trust and a test. When people are convinced of the fairness of redistribution measures and objectives, the negative impact on incentives, and evasion are both minimized. Otherwise, enforcement costs eat up a large chunk of transfer payments.

Realism

Sharīʿah recognizes as legitimate, the selfish motives (preference of self over others, insatiable love for property and wealth) and tries to deflect rather than stifle them. Repeated reminders are made in the Qur'ān and *Sunnah* that life on earth is transient, and that givers will be amply compensated in the Hereafter.

Moderation

Mandatory transfers are moderate. (For instance, *zakāh* is a flat rate of 2.5% on liquid and productive wealth), and needy relatives and the local poor have priority, thus reducing giver's disincentives. Heroic philanthropy even to worthy causes is generally not required. The Qur'ān explicitly states that excessive mandatory transfers were not ordained for they would have uncovered latent animosities.[49]

Increasing and Managing the Supply of Redistributable Resources

This is achieved by inducing people through faith, reward in the life hereafter, training and the authority of the state, to increase the grant of assistance. In fact, all

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[47] (Surah 2: 263-4).
[48] (Surah 47:36-37).
[49] (The Qur'ān, 47:36-37).

schemes of redistribution in Sharīʿah have as their objective either to increase or to manage the supply of distributable resources.

Decreasing and Managing the Demand for Redistributable Resources

There are numerous texts of Sharīʿah, which make it obligatory for the individual to become self-sufficient through his own efforts and to make his family independent from assistance from others, especially through seeking *zakāh* and charity ( ). The best known of these texts are the words of the Prophet (PBH) about *zakāh*: "There is no share in it for the wealthy or the able-bodied," and "The hand that gives is better than one that is extended." It was a part of the pledge ( ) to the Prophet (PBH) of some of the Companions that they would not ask others for anything. He also described charity as "the filth of the people" to be shunned unless there is no way to avoid it.

The management of assistance is a matter of great importance. We have in the Tradition examples of objective and clear determination of the circumstances under which an individual is permitted to ask others for assistance.[50]

Multiplicity of Transfer Instruments

Sharīʿah uses a combination of redistributive tools to maintain flexibility and effectiveness. Multiplicity of instruments brings flexibility into the system, because each instrument has different economic, psychological and social effects.

i. Voluntary, including *waqf* general charity, temporary donation of usufruct of real assets ( ), and the like
ii. Compulsory and permanent, such as *zakāh* and the Islamic inheritance system.
iii. Compulsory and temporary , such as support of needy relatives.
iv. Occasional, including sacrifice at the time of pilgrimage, and on breaking the Ramadan fast, marriage, childbirth; atonement for sins, etc. Several of such transfers are not only for the needy but also for friends and Neighbours.

[50] Muslim narrates from Qabisah that the Prophet (PBH) said:
"Asking (charity) is not permitted to anyone but three: one who is burdened (with a debt) is permitted to ask till he meets it then refrains; one who is struck by a calamity which destroys his wealth is permitted to ask till he finds a support for sustenance, and one who faces dire poverty to the extent that three reliable persons of his clan vouchsafe that so and so is facing poverty. Such a person is permitted to ask till he finds enough sustenance. As for others besides them, 0, Qabisah! It is illegal to ask; if one does so, he devours money unlawfully." (Sahih Muslim, III, Tradition No. 113).

v. From private wealth as all the above, or from the public treasury which is obliged to be the final safety net for need Fulfilment of individuals after *zakāh* fund is exhausted .

vi. From private property as all above, or from certain forms of natural wealth that Sharīʿah designated as jointly owned.

Following the Course of Least Resistance

Voluntary transfers are very much encouraged by Sharīʿah because they have no negative side effects on donor's work efforts. Several Islamic instruments share partially this desirable property even though they are mandatory. Examples include (a) Sharīʿah guaranteed free access of all citizens to certain natural resources before private property is established on them, thus achieving distributive objectives in a way that meets little disincentive effects; (b) transfers after death through inheritance system, (c) the priority of the poor on certain non-tax revenues of the public treasury ( )

A. Natural Resources

In an Islamic society, all citizens share certain resources, which are not supposed to be placed under private property. The first type that should be owned publicly is infrastructure, , including roads, bridges, land left for animal grazing, see and river shores. The second kind is natural resources, , including (sea , river, rain and spring) water, pastures (growing in public land), and all mineral wealth (according to the Malikis) and fire fuel, like fire wood and coal. The extraction of such resources can be franchised to private concerns in return for a share. Exclusive reservations on public land to individuals or groups (enclosures) is unlawful, however.

Individuals are allowed to reclaim land, that is not currently owned or used by private or public entities, . Such land can also be franchised by the government to individuals, to reclaim and utilize for a specific period.

B. Indirect Redistribution Policies

Indirect distribution includes a variety of actions that promote wealth sharing among citizens. Those include:

allowing others to use ones utensils, tools and jewellery for limited periods, loaning animals to others to use their services mutual permission of certain services and facilities to next-door Neighbours of land and residential housing.

C. Direct Redistribution: *Zakāh*

Transfers to the poor are probably as old as human community life. It is clearly present in Judaism and Christianity and has been mentioned as such in The Holy

Qur'ān.[51] Nonetheless, *zakāh* system in Islam has several advanced and unique features that are the more unusual if juxtaposed against prevalent religious thought and Practise at the time of the Prophet (570-632 CE)

Zakāh in Islam is an annual levy for the poor, obligatory on every Muslim who has a minimum of wealth. It has been counted by Prophet Muhammad (pbuh) among the five pillars of Islam.[52]

Perhaps the first civil war in history to be waged specifically to assert the duty of the rich to pay transfers to the poor is the one that occurred in early Muslim history. Shortly after the Prophet's death, many tribes declared their refusal to pay *zakāh*. Abu Baker the first Caliph simply refused and waged a very risky war against them. That war was not waged by the penniless against the rich, but by the believers, that *zakāh* was a mandatory part of Islam against those denying this fact .

In most religious traditions we know of, religiously ordained charitable giving is expended on religious intermediaries (clergy), establishment and maintenance of places of worship, and on the poor and needy. *Zakāh* in contrast is strictly and explicitly earmarked in the Qur'ān primarily for the poor and secondarily for specific public needs.[53] All four schools of *fiqh* agree that *zakāh* may not be spent on building or maintaining mosques.

Islam eliminated religious intermediation completely and empowered each individual Muslim with authority to perform any religious or mundane task (Slaughtering animals for food, leading congregational prayers, performing marriages, preparing a dead person for burial, etc.) The only intermediary perforce had been Prophet Muhammad (peace be on him), as he has to receive Divine revelation and convey it to people. Even here, Sharīʿah strictly prohibited the Prophet, his relatives and decedents from taking *zakāh* or charity.

Zakāh proceeds have to be strictly separated from the state treasury, which is not earmarked. In major contrast to debt slavery, which was Practised in many societies at the time, Sharīʿah prevented imprisonment of a penniless debtor, and the Qur'ān designated those in bondage and in debt as two of the eight types of recipients of *zakāh*.

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[51] The Qur'an explicitly quotes Jesus first public utterance while still a baby cuddled in Mary's arms (Peace be on both of them), miraculously announcing to the public: " I am a servant of God, He gave me the Book, made me a Prophet, blessed me wherever I may be, and enjoined me to pray and to [pay] *Zakāt* throughout my life." See also The Qur'ān, 19: 30-31, and 98:5.

[52] "To establish prayer and pay *Zakāt*…" is an phrase repeated numerous times in the Qur'ān.

[53] (Surah 9:60).

Zakāh collection and disbursement are state functions in Islam, as implied by the Qur'ān and actually Practised during the Prophet's time and the four Caliphs after him. The state may wish to delegate to property owners the right to estimate their own *zakāh* dues and dispense them in whole or in part (as was done by the third Caliph Othman Ibn 'Affan). A Muslim is held responsible to God to pay his/her *zakāh* dues in full whether or not the state collects it.

Zakāh is a complete and unique system of redistribution. Its importance to Muslims is reflected in its being one of the pillars of Islam, whose denial would be tantamount to apostasy.

Zakāh System

1. The system of *zakāh* contains the following elements:
2. At the end of each year, a certain percentage is collected from all wealth including real and financial assets. The percentage is set either as a ratio to the asset value (like cash, jewellery, animal wealth) or its yield (buildings, except used by *zakāh* payers for their own residence, factories, titles to real assets.
3. The government sets two wealth limits. The first is considered the sufficiency line ( ) which would be enough to provide for a satisfactory standard of living. The second is called the subsistence line ( ), which would be sufficient to provide an individual with his basic needs. Both limits would be set in light of the general economic conditions in the country as well as generally accepted conventions.
4. *Zakāh* would be levied on wealth over and above the sufficiency line, otherwise known to *fiqh* scholars as *niṣāb*.
5. Obviously, this requires a yearly account of the possessions of every Muslim to be used as a basis for *zakāh* calculation.
6. *Zakāh* can be collected either privately or by government, as will be detailed later on.
7. *Zakāh* proceeds are allocated with first priority given to the poor ( ), according to two principles: wealth maintenance and income maintenance.

Zakāh and Social Justice

The modern application of *zakāh* has drawn new opinions from scholars. Kahf quotes several of those who propose varying degrees of reform.[54] Sheikh Mustafa Al-Zarqa called in 1984 for a review of certain aspects of the modern application of *zakāh*. He points out that the modern economic structure gave rise to new kinds of wealth not present when *zakāh* was originally decreed. He concludes that the texts

[54] (Kahf, No Date 4).

of Qur'ān and *Ḥadīth* related to *zakāh* require a new interpretation and *ijtihād* in light of changing circumstances.[55] Sheikh Al-Zarqa concludes that all new types of wealth must be subjected to *zakāh* to keep consistency and justice in modern application.

Some economists proposed an all-inclusive system of *zakāh* where all wealth are included and where *zakāh* rates can be determined through the political process.[56] Others stress the need to review the *zakāh* system, especially that the way it is applied in Malaysia place most of its burden on Padi producers while property owners and high-salaried people escape it completely.[57] Others call for levying *zakāh* on all fixed assets used for business purposes.[58] Others call for a revamp of the concept of *niṣāb* and radical change in the coverage of *zakāh.*[59] Others call for nullifying the exemption of business fixed assets from *zakāh.*[60]. Finally, Kahf quotes Al-Qaradawi proposing to impose *zakāh* on salaries and professional income.[61]

The list of scholars calling for new *ijtihād* for the modern application of *zakāh* is long and includes several distinguished names from both *fiqh* and Islamic economics. The main drive behind most comments in this regard is that the balance of justice has been tilted in Favour of owners of new kinds of wealth and against owners of traditional wealth. This also mars the measure of consistency in applying such an important economic tool.

As to the nature of *zakāh*, several quotations and Practises from Prophetic traditions clearly indicate its redistributive nature. It is a tool that aims mainly and most of all at narrowing the differences of wealth among the citizens of the Islamic State. This characterization has the consensus of many scholars.[62] Yet, *zakāh* Fulfils other objectives too. It discourages keeping wealth idle, as well as holding monetary balances over and above transactions requirements. Such objectives come second to the objective of social justice. The following proposals regarding the scope and rates of *zakāh* present an attempt to pay attention to changing circumstances in modern times, while keeping in mind its main objective.

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[55] Al-Zarqa, Sheikh Mustafa (1984).
[56] (Raquibuzzaman, 1987).
[57] (Salleh and Najah, 1980).
[58] (Al-Misri, 1986).
[59] (Abu Saud).
[60] (Al-Amin, 1988).
[61] (Al-Qaradawi, 1973).
[62] (Kahf, No Date 4).

Scope of Zakātable Assets

One detail we need to discuss is the scope of *zakāh*, or the assets and incomes that should be subject to *zakāh*. We can distinguish between three opinions in this regard:[63]

The narrow opinion limits *zakātable* assets to agricultural products, livestock, mobile assets purchased for the purpose of resale, gold, silver, short term net receivables and money on hand.

The middle opinion adds earnings on fixed assets as well as on human capital, like wages, salaries and professional income.

The expansive opinion adds fixed asset themselves to the list.

We put forward for serious consideration the following twofold-opinion. First, all assets and incomes beyond the sufficiency line or *niṣāb* must be subjected to *zakāh*. Second, we cannot subject both an asset and its own income to *zakāh* simultaneously. Economists would agree that income on assets is growth by itself. They would also agree that all assets are potentially subject to growth. Therefore, all assets and their incomes satisfy the condition of growth. In addition, *fiqh* scholars provided two opinions regarding ownership. One says that *zakāh* is levied on "ownership ( )" while the other says that *zakāh* is levied on property itself, or assets and incomes. The latter opinion justifies levying *zakāh* on public sector properties. Publicly owned assets are owned by all citizens, rich and poor. Their proceeds are also used for the benefits of all, and not exclusively for the poor. The rich have a nominal share in the public sector, which can be estimated and be subjected to *zakāh*. Therefore, we would call to subject all assets or their incomes to *zakāh*.

A further point in this regard is related to monetary assets that include debt and cash. Such assets in an Islamic economy are barren, i.e., they do not earn income.[64] However, they are potentially growing assets, if turned into income-earning resources. In contrast, all other financial assets are real assets, as they represent titles to shares in real assets. Investment deposits with Islamic banks, e.g., entitle their holders to shares in the return of an investment pool that contains real assets. All marketable *ṣukūk* are of the same nature.

Rates of zakāh

We can therefore classify all assets in an Islamic economy into three categories. The first includes barren but potentially income earning assets. Conventionally, this

[63](Kahf, No Date 4).

[64] *Murābaḥah* debt would include the profit margin or the markup of *murābaḥah*. But, once the debt instrument is created, it does not earn any further income and becomes a barren monetary asset.

category is limited to monetary assets but we would like to expand it to include jewellery, precious metals and stones as well as artwork. The second category includes the rest of financial assets as well as all real assets. The first category is by consensus subject to 2.5 percent *zakāh* rate. *Zakāh* on the second category requires further explanation. The third category is human capital.

We remember that *zakāh* on products of agricultural land was originally set at 10 percent for rain-fed and 5 percent for irrigated land. Notice here that the difference in tax rate reflects the difference in production techniques and cost. Techniques and costs change from time to time depending on technological changes. We can therefore interpret the *zakāh* rates originally set as an application of the neutrality principle, meaning that *zakāh* payment should not Favour the use of rain land to irrigated land and should have allocative neutrality. This intention is further supported by the fact that the *zakāh* rate on mining is 20 percent. In order to keep allocative neutrality, we propose that *zakāh* would be levied on all assets in the second category at 2.5 percent to keep them at par with each other and with assets in the first group. Others call for extending *zakāh* collection to income emanating from such assets.

As to human capital, we can levy *zakāh* on its income only, that is on wages, salaries and professional income. Some call for the application of 2.5 percent rate on such income as soon as received. Others consider such payment provisional until the final account is made at the end of the year. Still others prefer payment of *zakāh* on what is left unspent at the end of the year, implying that *zakāh* would eventually collected on savings from such income in the form of monetary, financial and real assets.[65]

Zakāh Collection

Some countries establish a system of collecting *zakāh* through government agencies. Some others allow non-government institutions to collect *zakāh*. In addition, individual efforts to collect and distribute *zakāh* could be found in all Muslim countries.

In developing countries, where *shūrā* or democracy is still an infant, or at best an endangered specie, people have little recourse to monitoring and controlling government actions. Besides, governments in developing countries maintain low levels of transparency. This could lead citizens to hesitate a lot before paying *zakāh* to government agencies. *Zakāh* evasion would be expected in this case to be as rampant as tax evasion in developing countries.

Zakāh, meanwhile, requires a sophisticated system of collection that would deserve the trust of both *zakāh* payers and receivers. We propose that such a system would include a government agency to which citizens would pay their

[65] Compare with Kahf, No Date 2.

zakāh on a voluntary basis. In addition, a network of community-based non-government organizations, which would be managed by *zakāh* payers themselves under strict rule transparency, and external auditing would collect *zakāh* on voluntary basis too. Competition would be expected between government and non-government agencies in terms of providing better service to the poor and more transparency to *zakāh* payers.

Such a system would gradually evolve with the development of *shūrā* into either a system that is fully managed by government or by non-government organizations. The system can change gradually form being voluntary into being obligatory, once *zakāh* payers are sufficiently assured of transparency.

In all cases, proceeds must be deposited in Islamic banks, to be provisionally invested, until they are disposed of by banks as income maintenance Cheques to the incapable or as financing of micro projects to be owned and managed by the capable poor. Rules must be set to govern such disposal whose application must be closely monitored.

How to Use Zakāh Proceeds

Zakāh is not a singly-policy system of tax and subsidy. It goes beyond the conventional concept of redistribution. There are two gaps that *zakāh* is designed to fill. The first is maintaining a minimum level of income to those incapable of working, or income maintenance. The second is maintaining a minimum level of wealth or wealth maintenance.

Rebecca Blank model defines such group as without individual agency. Because they have no capacity for response, they are mainly disabled individuals, the elderly or children and as well as the disadvantaged because of race, gender or ethnic discrimination as well as the orphans who are socially isolated by definition. Additional income to those groups will not cause an offsetting change in labour supply.

We can therefore support this group through direct and outright transfers to provide them with their basic needs. In addition, the provision of services that improve the quality of their human capital sufficiently to make them capable of working should also be included in the income maintenance scheme.

The remaining citizens in the community should be able to work. In other words, they have sufficient human capital but they lack physical capital to make them productive. They need productive assets or more training, which they can use to produce enough income to support themselves as well as their dependents.

However, this group is not expected to understand the life of business and self-employment. If given productive assets, they may sell them and spend their value on consumption. We must therefore manage increasing their wealth in a way that guards against their retrogression into poverty.

One way to do this is to charge Islamic banks to identify micro projects for the poor and finance them with an earmarked portion of *zakāh* proceeds. The poor can own each project only provisionally until the project proves successful and starts to draw a flow of net income that enable the poor to support a reasonable level of consumption and save at least sufficiently to maintain the project. Ownership would remain under probation until a new behavioural pattern is ascertained so that ownership could be turned permanent.

Impact on Poverty

Numerous studies have estimated potential *zakāh* proceedings in several countries. Estimates range from just under 2 to 8 percent of GDP. Actual proceeds, however, are much lower; they are generally less than 1 percent of GDP.[66]

Table 1: Potential zakāh proceeds

Year	Author	Countries	% to GDP	
			Low	High
1973	Sami Ramadan Sulaiman	Egypt		6.1
1982	Muhammed. Hashim Awad	Sudan	3	6
1971	Muhammad Anas Zarqa	Syria	3	
1986	Monzer Kahf	11 countries	3.2	6.2
	Muqbil Zuqir	Saudi Arabia	2.7	
	Fuad Al Omer	Kuwait	2.1	
2004	Mabid Al-Jarhi	Egypt	1.8	8

Obviously, the actual proceeds are disappointingly low. Al-Jarhi's estimate assumes *zakāh* evasion ranging between 10 and 35 percent of the wealth of the rich. Nonetheless, the lower range estimate far exceeds actual collection through official channels of .02 percent of GDP.

Reasons for disappointing performance include strong adherence to the narrow scope of *zakātable* assets in *fiqh* opinions, tendency to avoid *zakāh* payments through official channels, lack of awareness of the general public on the importance of *zakāh* and how it should be calculated and inefficiency on the side of *zakāh*-collecting agencies. Another important reason for low proceeds is that collection is officially confined to part of *zakāh* due. Once those problems are properly addressed, *zakāh* could play a much bigger role in narrowing wealth differences, reducing poverty and enhancing human capital. All such results would finally reflect on better and faster economic development.

[66] (Kahf, 1999 and Al-Jarhi, 2004).

6. Conclusions

The economics of redistribution has drastically changed during the last three decades. The ad hoc treatment of equity in welfare economics is no longer acceptable. Meanwhile, the main body of economic theory that is based on the self-interest hypothesis is giving way to alternative hypothesis, including motivation by other-regarding preferences. Experimental economics has finally become in vogue and it is expected to introduce new and interesting developments into economic theory.

Fairness and justice models have proven capable of showing that redistribution can increase efficiency. The traditional equity-efficiency trade-off is becoming valid only as a special case. The positive relationship between equity and efficiency continues to gain theoretical support in the literature.

Models of impartiality, solidarity and priority have shown that Islamic values including justice, solidarity, fraternity and reciprocity are keys to efficiency when included in theoretical analysis. Such models cannot be attacked for being morally loaded, as they are considered within the acceptable limits of positive analysis. This goes a long way to exonerate Islamic economics from value bias. Islamic economists should no longer fear from being criticized by mixing religion with economics.

In this regard, we have always maintained that economics has never been value free. We can now claim that we are introducing the right values into economic analysis, as such values point to shorter and more direct paths to efficiency.

Theory has been able to use the new advances in clarifying the positive relationship between equity and efficiency to explain the positive relationship between equity and growth. This is an important conclusion for developing countries. Such countries can be more successful in their development efforts if they can improve the wealth distribution among their own citizens.

Empirically, the positive relationship between redistribution and growth is both significant and robust. Once data and Modelling problems are corrected for, the old suspicion that redistribution could be inimical to growth is no longer acceptable.

In the field of policy, redistribution is not just tax and transfer. It includes policies that improve the quality of human capital, especially through health and education improvements. A combination of policies is always better than one lonely policy.

Zakāh provides a combination of income maintenance and wealth maintenance policies to improve human capital and supplement it with physical capital so that the poor becomes productive. Undoubtedly, this improves productivity for the whole economy and accelerates the speed of development.

Theoretically, *zakāh* proceeds appear to be sufficient for carrying out such a job. However, actual Practise points to the opposite. The reason lies behind the insistence of policy makers in Muslim countries to apply a narrow scope of *zakātable* assets. In addition, the lack of a complete system of tax collection where both official and non-government channels can be effectively exploited is also a culprit.

Low *zakāh* proceeds can also be blamed for the lack of credible tax collecting system. Our proposals in this regard include establishing a government agency that competes with a network of NGO's in collecting *zakāh*. Proceeds must be given to Islamic banks for use in supporting the poor under strict rules and close monitoring.

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4

Islamic Economics and Finance Where Do They Stand?

Masudul Alam Choudhury*

A critique of Islamic economics and finance is launched against the backdrop of what otherwise is essentially the epistemological understanding of all theories and application relating to human volition. The epistemological principle is that of Unity of Divine Knowledge, which in the Qur'ān is referred to as Tawḥīd, Oneness of Allah (God). It is a systemic concept of pervasive learning by complementarities and participation in and across the grand relational world-systems. The proponents of Islamic economics and finance have forever forgotten how to treat this central and immutable praxis from the truly Qur'ānic standpoint. Hence this paper argues that Islamic economics, finance, Islamic banking, Islamic development organizations, methods and thought, for ever have been trapped in a feigned kind of neo-liberal and neoclassical doctrinaire, from which they cannot liberate themselves with out a fundamental change of praxis in place. No wellbeing and uplift for the Ummah (the conscious and pious world nation of Islam) is possible in these prevailing mechanisms that serve as link to the world capitalist globalization process of economics, finance and neoclassical socioeconomic thinking.

Arguments

This paper argues that the submissive attitude and advice on equating the Islamic and Western *methodologies* and even empiricism, thereby calling for adopting Western *methods* of analysis, constitutes a flawed reasoning. Note here that I have made a major difference between the concepts of Methods and Methodology as shown by italics. Choudhury (1999) explains that methodology

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and methods are interrelated scientific primitives together used for understanding praxis and applying it to inferential consequences of the methodological premise by the corresponding analytical methods. The original praxis is invariably epistemological in nature. Epistemology is subsequently integrated by a scientific discursive approach with ontology, and thereafter, with the ontic (evidential) domain of analysis, application and policy. Methods belong to the ontological and ontic domains, when the analysis and application of the original methodological premise is to be formulated and applied for understanding reality.

Yet, in the absence of the epistemological methodology it is possible for methods to be used independently of the ontological and ontic understanding. When this is the case, methods fail to have substantive relevance in the light of methodology. They exist merely as procedural artifacts of an analysis but not the true and relevant one. Choudhury (1999, op cit, p. 348) writes, "Methods can exist without methodology as was explained in the case of the reductionist design of rationalism. But methodology cannot exist without self-determined methods. Such methods must be derived from the essence of the methodology itself. They must be such instruments that mobilize the ontological-epistemological nature of divinely unified systems into explanatory relations." We will explain the difficulties that are encountered in such academic ventures from the Islamic side.

Contrary to the Islamic mainstream economic assertion is the distance of the prevailing Islamic socio-scientists from any substantive reference to the Qur'ānic worldview, it's epistemology of Oneness of the Divine Laws (*Tawḥīd*), the causal understanding of unification of knowledge in world-systems by the epistemological methodology embedded in ontology and ontic learning domains. Consequently, there remains an utter vacuum in the construction of the Islamic phenomena vis-à-vis its epistemology, the world, and the ontological reconstruction of a socio-scientific normative thought, which can then convert itself into positivism (Choudhury 1998). See Appendix 1 for a formal explanation of the *Tawḥīdi* phenomenological model.

1.1. The Epistemological Problematique

Analytical problems arise both with the arguments and with the general body of literature presently existing in the Islamic socio-scientific field. Such problems manifest themselves as failure to comprehend the essentially epistemological origin of an ontological construction of theory and application. The Islamic inquiry has remained ambivalent to such profound questions that underlie the construction of any revolutionary theory and its worldview. Bohr (1985) mentions about Einstein's remark, that there is no Science without Epistemology.

If the Islamic worldview is premised on its distinctive epistemology, ontology and the unified ontic (evidential) way of organizing the world-system, then such a revolutionary doctrine cannot be accumulative in thought as normal science. It must be distinctive and out of the ordinary lineage of normal thinking. In this

regard Kuhn writes (Kuhn, 1970, p. 152), "… scientific revolutions are here taken to be those non-cumulative developmental episodes in which an older paradigm is replaced in whole or in part by an incompatible new one". The Islamic worldview shares this attribute of scientific revolution. Without fundamental invocation, there cannot be a substantive theory and premise for Islamic economics and finance, and thereby, the construction of the Islamic worldview and world-system.

Islamic economics and finance have thus far remained ambivalent to these essential and fundamental blocs of ideas. Instead, they have used axiomatic inferences that do not comply with the otherwise pervasively learning world-system that the Qur'ān presents. It is therefore incorrect to exhort on Islamic economics and finance to emulate the models and quantitative applications of the Western genre of formalism and empiricism. They remain incapable of comprehending the nature and logic of the *Tawḥīdi* (Oneness of God = unity of divine knowledge) dynamics. Even the idea of empiricism is differently presented, interpreted and applied in the Qur'ānic worldview in view of the interrelationship between methodology and methods, as was mentioned earlier. The Qur'ānic perspective of empiricism is contemplative and meaningfully contextual with respect to diverse problems of life and thought within a relational and unified world-system in the light of *Tawḥīd*.

The epistemological origins of the learning world-systems according to the immutable principle of unity of divine knowledge in the Qur'ān is the central point of departure that delineates the great divide between Occidentalism and Islam and within the prevailing structure of thought in the Islamic scientific community. Imitation and prolonged ambivalence to the 'originary' foundations have been the main cause for the demise of Islamic economics and finance, tied presently as it is to neo-liberal capitalist doctrinaire.

The problems and significant contrasts between the Islamic paradigm in *Tawḥīdi* perspective and that which is being practiced in Islamic economics and finance today commence from the distinct methodological approaches to the fundamental *problematique* of economic and financial theory, the nature of preference formation and the concept of aggregation. We will start from a critical examination of this central premise of economic, social and financial theorizing. The problem has escaped the attention of Islamic economics and finance in particular and Muslim scientists in general.

2. Knowledge-Induced Preference Aggregation in the Light of *Tawḥīdi* Episteme

Our critique of the present state of economic theory (Choudhury 2004a, 2004b) has revealed that the major problem of ethical irrelevance in economic theory in general and macroeconomics in particular arises due to the inability of explaining behaviour by a dynamic theory of endogenous preferences. These are preferences

that evolve dynamically under the force of learning by interaction and consensus between discursive agents and in response to the environing transformation.

Furthermore, the absence of dynamic preference formation theory results in the aggregation problem of macroeconomics in particular. In general, preferences are prescribed exogenously in all of economic and social behaviour a la mainstream thought, governed as these are by the coterminous assumptions of scarcity, rationality, steady-state equilibrium and optimization. These combine to deepen the postulate of neoclassical marginal rate of substitution that is one-to-one related with the existence of steady-state equilibrium and optimality in resource allocation throughout mainstream economics and finance.

The consequence of marginal rate of substitution and of the conjoint state of steady-state equilibrium and optimum is analytical independence of preferences of the agents at the point of optimal rational choice. The novelty of learning dies away at such steady state and optimal points of resource allocation (Shackle, 1972). Goods, and thereby individuals, cannot interact in such optimal points underlying which are the postulates of competition for scare resources and thereby competition. The idea of *process* of interactive learning is not analytically explainable at such steady-state equilibrium-optimal points (Whitehead, 1978). Exogenous shocks revive the steady-state equilibrium and optimal states. But the new sequences of steady-state equilibriums and optimal states once again die away. Such perpetual recurrence of the steady-state equilibrium and optimal points of resource allocation protract the axioms of economic rationality, scarcity and competition perpetually in the non-changing structure of choices, menus, resource allocation, and thereby behaviour and aggregate individual preferences underlying the theory of institutions and social contract (Hammond, 1987).

Preferences and menus at both the individual and aggregate level are formed of bundles of such independently and exogenously assigned states of economic behaviour. Such preferences remain devoid of learning, are exogenously assigned and aggregated linearly. The dynamic and complex nature of learning preferences remains foreign to economic and financial theory, as does the conception of *process*. Islamic economics and finance have inherited this central debility of avoiding learning as process in their formulations of conceptions and applications, when they borrowed heavily from mainstream economic and financial theory.

The *Tawḥīdi* epistemological, ontological and ontic methodology thoroughly replaces the missing issues of unity of knowledge in learning and process at the microeconomic and economy-wide levels. Learning by process and unity of knowledge embed choices and decision-making in endogenous preference formation. The characteristics of pervasive learning on unity of knowledge by discursive processes in and across embedded systems lead to the principle of pervasive complementarities among *possibilities* rather than *alternatives* as implicated by the postulate of marginal rate of substitution and its corollary, the opportunity cost of alternative.

Thus, like all great paradigms the birth of any of them is deeply epistemological in nature. So is also the Islamic methodological background of economic and financial reasoning when premised on the universal praxis of *Tawḥīd* as the sole and pervasive attribute of unity of knowledge and its ontologically constructed world-systems. In such embedded systems that learn by process, the postulate of marginal rate of substitution is fully replaced by the principle of pervasive complementarities between systems and their preferences, social contracts and explanatory variables.

With endogenous preferences, the process of learning between embedded systems and the embedding of the moral law (*Tawḥīd*) in all such learning systems and their components, the duality as between micro and macro- economics is annulled. Morality must exist in economy-wide explanations of institutionalism and social contract, policy and governance. Hence the analytics of learning and endogenously interactive, integrative and dynamic preferences replace the exogenously assigned ones of microeconomics. They also replace the preference-benign methodology of macroeconomics. Indeed, the separation between microeconomics and macroeconomics is a pronounced mark of duality as a continuing mark of the divided knowledge barriers that characterize all of occidental intellectual thought (Capra, 1983). In the *Tawḥīdi* worldview no such insulation and discontinuity between disciplines is possible on grounds of the unique praxis of systemic unity of knowledge. Yet diversity of problems of different systems remains. Systems are nonetheless interactively integrated and creatively evolutionary in the framework of unity of *Tawḥīdi* knowledge.

3. Questions Concerning Endogenous Preferences and Learning Process Under *Tawḥīdi* Worldview of Unity of Knowledge

How is dynamic aggregation of preferences, and thereby, state and policy variables realized in Islamic economic and financial studies as premised on *Tawḥīdi* methodology? How does the process model underlying learning emanate from and in turn explain the *Tawḥīdi* unity of knowledge? How are ethics and morality made endogenously complementary with the state and policy variables at the social, economic and institutional levels, thus resulting in ethicizing world-systems? Answers to these questions are investigated below.

An Islamic theory of endogenous preference formation in an ethico-economic general equilibrium system can be explained. To focus on a political economic issue we will focus on the *inter*relationship among money, price, output, spending as resource mobilization, factor utilization, technological change and the concomitant monetary and fiscal policies that revolve around a cogent set of Islamic development financing instruments. Such participatory instruments are the profit-loss sharing (*Muḍārabah*), equity financing (*Mushārakah*), cost-plus mark-

up (*Murābaḥah*) and deferred payments (*Bay*ʿ *Mu'ajjal*) as the primary ones. Secondary financial instruments revolve around these primary ones to further expand participation and co-operation in the framework of embedded systems and values in Islamic political economy.

We note below the methodological approach of mainstream economic theory on various critical issues. The current state of Islamic economics and finance has been thoroughly imbibed by such Western perspectives. Some comparative examination of the existing Islamic economic and financial approaches in the Western perspectives contrasting with the *Tawḥīdi* approach is mentioned below.

3.1. Problem of Preference Aggregation in Mainstream and Islamic Economics

In economic theory Adam Smith thought of introducing natural liberty within human behaviour in market exchange (Sen, 1990). But the Smithian transition from *The Theory of Moral Sentiments* to the *Wealth of Nations* could not sustain the endogenous role of human sentiments in preference formation, given the condition of laissez faire, within which the natural liberty was to work to make man free. Consequently, the moral law as an embedded dynamic process could not enter classical utilitarian preferences a la Jeremy Bentham (Coase, 1994).

Subsequently, the transmission of utilitarian ethics into institutionalism and social contract, as in neo-liberal institutionalism, caused lateral aggregation of individual preferences that are formed by self-interest and methodological individualism reflecting the aggregate preferences of institutions and governments. Today this is the perspective upheld by public choice theory (Buchanan & Tullock, 1999). Institutions in economic theory imitate the self-interested behaviour, which is explained by the lateral aggregation of groups and individuals. The meaning of utilitarian ethics in such a preference aggregation methodology is exogenously introduced and never changed except monotonically (Hammond, 1987).

Since time is an independent variable in neoclassical economic theory, preferences depend on time as datum. Thereby, ethical induction on preferences remains absent or is constant. This underlying assumption of preferences is to establish the long-term steady-state nature of neoclassical equilibrium and optimization methodology. On the other hand, complex preference behaviour caused by interaction lead to evolutionary equilibrium states that distort price relatives to the extent that no predictability in the neoclassical sense can exist. See Appendix 2 for a formalization of evolutionary learning equilibriums. On the side of production menus and factor resource allocation indeterminate production possibility curves and production isoquants result due to the complexity and fuzzy domains of learning processes affecting surfaces of production menus, factor allocations, decision-making preferences, state variables and policy variables. Such disparate results are true of both perfect and imperfect competition in mainstream economics in the light of the learning universe of *Tawḥīdi* methodology.

Next, at the level of classical and neoclassical macroeconomic theories the aggregation of utilitarian preferences using utility functions becomes non-functional. Yet the marginal substitution principle between competing alternatives prevails in the aggregate production function for factor inputs that are aggregates not in the sense of firm-specific lateral aggregation. The demand functions of such aggregate factor inputs are generated either by surveys of firms or by estimation using derived factor demand functions. In the latter case, aggregate wage/rental ratio and the demand for capital function are estimated *ad-hoc*.

From the above two kinds of approaches to preference aggregation we note the following nature of any ethical induction in economic theory:

Firstly, the predetermined or monotonic nature of preferences in neoclassical economic theory causes insensitivity of state variables to ethics. That is, the question as to how ethics are derived from the moral law and affect ethical preferences and transform them into a pervasively complementary nature of resource allocation cannot be answered in neoclassical economics and its roots in financial theory. Likewise, attained values of the state variables cannot change behaviour relating to the ethics of relationally complementary goods, factors, agents and resource relations. Only the principle of marginal substitution prevails, defining the intrinsic nature of competition between alternatives and scarcity of resource allocation under the axiom of economic rationality governing choices and perceptions. Without the key postulate of marginal substitution and opportunity cost in resource allocation it is impossible for neoclassical formation of relative prices in economic theory.

Secondly, the aggregate nature of productive factors based on survey and estimation as mentioned above, cause ethics to remain mute in macroeconomics. They remain as datum in microeconomics Thus no fresh demand is made on reframing the role of endogenous or systemically interactive ethics in the neoclassical economic system, except by means of perpetuating at large the singular assumption of marginal substitution principle and opportunity cost between competing alternatives. This is also the underlying assumption for the neoclassical economic states of steady state equilibrium, optimality and non-complex stability in resource allocation.

The uniqueness of marginal substitution between competing alternatives in the state of optimal resource allocation remains permanent in economic theory. In Keynesian macroeconomics the same postulate enters from the side of competition between savings and spending, and hence between capital and output, money and the real economy. Let us explain these points briefly.

4. The Austrian School of Economics and Professor Fredrick Hayek on Interest, Resource Mobilization and Entrepreneurship

Hayek's *Good Money* Parts I and II (1999) present two kinds of economic dynamics. With respect to the allocation of money as resource over time he modifies the neoclassical idea of marginal rate of commodity substitution. Hayek (Good Money Part I) writes (pg. 195)

> …. In a state of pure barter, the exchange between goods of the same kind available at different points in time will not as a rule take place at the ratio 1:1, but according to the circumstances can take place at any other ratio, and that what happens in this case follows precisely the same rules as does the formation of the prices of two different goods.

On the side of his process-oriented institutionalist theory, Hayek's idea impinges upon an entrepreneurial model of economic innovation characteristic of the Austrian legacy (Schumpeter 1961). By combining these two aspects of Hayek's thought we note that the entrepreneurial model is not altogether safe from the presence of interest rate that enters from the side of resource allocation.

The above argument is equivalent to the following one. The same argument can also be applied to the case of savings as net income after consumption and taxes. The issue is that such net income must be deposited or utilized in some financially rewarding way. There are two ways of accomplishing this. Firstly, the saving is held in interest bearing financial assets on the argument of mainstream economic theory that interest rates provide incentive to save in liquid funds that can be utilized as capital for investment after a period of liquidity formation. The savings being held in liquidity for speculative purposes post-spending thus cause a withdrawal of funds. The accumulated amount of savings may flow into the real economy after a period of withdrawal of potential funds.

The second way of holding savings is to mobilize them continuously into the real economy through financial intermediaries. In such a case savings become resource mobilization and fail to have the meaning of macroeconomic savings as a function of income and interest rate. The subtle difference is in the Keynesian sense of savings = spending (investment) to occur continuously over time and not over a business cycle. Over the business cycle savings = investment occurs after a period of time as the economy nears a full-employment level of output. The continuous case is ruled out.

Thus entrepreneurial capital formed by savings remains a function of interest rates on such savings. Interest rates in such a case move between short- and long-run cycles. There is nothing in Hayek's thought to differentiate between the short and long run rates of interest. But from the nature of entrepreneurial economic transformation and the full role played out by the market process, on both of which

Hayek champions, it is logical to deduce that the focus was on long-run interest rates. Now if money were to be mobilized through savings as a long-run process then the neoclassical roots of Hayek's thought would permit the prevalence of long-run rates to tie up with the process of entrepreneurial change. A contradiction occurs between Hayek's market catalysis for economic progress and the presence of long-run rates of interest entering from the side of long-term savings and thus a long hold up of funds from potential mobilization.

Islamic economists and financial experts equate entrepreneurial activity in mainstream economic thinking with regimes of low interest rate, especially as vouched by the use of the participatory instruments, *Muḍārabah*, *Mushārakah*, *Murābaḥah* and secondary financing instruments. These instruments and the analysis concerning them in micro-enterprise development are treated exactly as in mainstream economics using the causality between savings and capital accumulation. Yet in mainstream economics capital formation occurs over a period of time of waiting through the route of interest rate either of the short or long run types earned on savings.

Mainstream economic theory of savings results from the underlying marginal rate of substitution and hence opportunity cost of the alternatives of holding resources in financial savings against injecting it into the real economy. Such a preference of choice is contrary to the Islamic view on the relationship between money, finance and the real economy. That is, in the form of a function of interest rate and disposable income accumulated savings forming capital comes into the economy as accumulated returns on savings after a period of resource withdrawal and waiting in the form of liquid savings.

In Islamic resource mobilization theory, contrary to the theory of capital via savings, money is not to be held in savings. It is mobilized in the real economy by participatory means and instruments in Sharīʿah compliant spending outlets. It is based precisely on such a well-defined circular causal relationship between money, finance and the real economy compliant with the Sharīʿah that interest rate can be phased out and replaced by productive effects of resource mobilization. Thereupon, the relationship of entrepreneurship to money, finance and real economy is established over a phased out regime of reduction leading to abolition of interest rates.

5. John Maynard Keynes and Capital Accumulation

Keynes recognized the social evil and retrogression to productivity caused by interest rate. He found financial interest to be deeply embedded in the destruction of human wellbeing. Keynes (1963, p. 369) wrote:

> The love of money as a possession – as distinguished from the love of money as a means to the enjoyments and realities of life – will be recognized

for what it is, a somewhat criminal, semi-pathological propensity which one hands over with a shudder to the specialists in mental disease.

Yet in Keynesian economic methodology there is no final liberation from the rate of interest. Keynes called the low-level interest rate as the low-level liquidity trap. At this level a maximum effect of the income multiplier is realized.

A substantial difference exists in Islamic thinking on the above issues. To begin with, the dichotomy between macroeconomics and microeconomics is untenable in Islamic economic ideas towards resolving the contentious problems. That is, no Islamic macroeconomics can be developed along lines of the Keynesian type with a liquidity trap. We cannot otherwise derive any Islamic meaning by applying the dynamics of Keynesian-Hicksian General Equilibrium Analysis to the Islamic General Equilibrium Analysis with endogenous ethics and morality and ethical preference formation as Sharīʿah-induced behaviour caused by continuous learning in such a system on the basis of *Tawḥīdi* unity of knowledge.

6. A Note on the Interactive Approach to Estimate GDP in *Tawḥīdi* Perspective

What then is the alternative procedure in measuring the Gross Domestic Product, and thereby measuring the aggregate variables in the economy-wide sense with ethical induction in such variables in reference to the microeconomic foundations of aggregate economy-wide perspectives? In answer, the National Income and Accounting Identity for measuring GDP must be replaced by the Input-Output approach with microeconomic disaggregations such as sectors and projects at community and sub-regional levels.

In such a case, project specific and sub-regional and community specific Total Outputs (GDPs) along with their inter-connected output flows (intermediary or inter-sectoral outputs) and value added as final demand of goods and services can be directly linked to knowledge-induced ethical decision making and Sharīʿah-driven preferences of agents. The input-output coefficients of such a knowledge-induced Input-Output Model become policy-induced when they remain to be simulated towards generating desired levels of 'inter-sectoral' linkages. Such inter-sectoral linkages are causally related with continuous augmentation of resource mobilization and structural changes in production menus as product-diversification, technological induction, risk-diversification and factor adaptation occur. Such conditions that are endogenously linked with policy-induced effects of inter-sectoral linkages as participatory effects together enable resource enhancing and 'inter-sectoral' linkages to be attained by policy selection (Choudhury & Hossain, 2005 forthcoming). The inter-sectoral linkages by means of learning and endogenous policy effects are the results of market-institutional learning dynamics. Thus the *Tawḥīdi* systemic unity of knowledge is invoked here as methodology and

policy in the midst of learning by unity of knowledge across systems, their agents, preferences, menus and variables.

Such an inter-sectoral linkage approach in measuring GDP by the learning methodology of *Tawḥīdi* unity of knowledge uses a simulation method, for optimization is contrary to continuous learning in state and policy variables. Consequently, the expected value, GDP' = GDP + ε. Here ε is that part of GDP that results from increasing returns to scale. The equilibriums of such a learning system are evolutionary in nature across processes of learning in the interactive, integrative and evolutionary processes (IIE-process or equivalently the Shuratic processes). Thus any measurement of the GDP by the Input-Output Model with learning variables and dynamic input-output coefficients remains only expectational. New processes of learning take over the older ones. Increasing returns to scale in production are realized in the *Tawḥīdi* system by the inherent complementary participation between factors and enterprise. It also would arise from the nature of dynamic basic needs regimes of development in the *Tawḥīdi* system, as by the Shatibi basket of Needs (Dururiyath), Comforts (Hajiyyath) and Refinements (Tahsanyyath). In such dynamic basic needs regimes of development, production diversification is combined with risk diversification, as the number of shareholders increase by the force of unity of knowledge in expanding participatory production menus inter-sectorally.

Therefore, while the mainstream GDP measurement is based on constant returns to scale with GDP (Q) = total factor payments, the *Tawḥīdi* case of GDP measurement using the knowledge-induced dynamic form of the Input-Output model yields GDP (Q'), such that $Q'(\theta) = Q + \varepsilon(\theta) > Q$, θ denotes learning in the *Tawḥīdi* IIE-processes (Shuratic processes). The output component $\varepsilon(\theta)$ coming from increasing returns to scale rather being distributed as current factor payments instead is accumulated in a contingency fund to be used for ameliorating factor needs in times of exigency.

Besides, in the above explanation respecting the measurement of GDP by the knowledge-induced Input-Output model of the *Tawḥīdi* IIE-process dynamics, *Zakāt* payment ($Z(\theta)$) enters as a circular causation variable. It is now seen as a causally interrelated 'sector' with its inevitable knowledge-induced attribute interlinking as unity of knowledge between the sectors in the light of the *Tawḥīdi* epistemology and ontology of systemic oneness. Contrarily, in the National Income and Accounting Identity the entry of the $Z(\theta)$-variables as a separate variable cannot explain the circular causation that *Zakāt* truly generates with all the other variables.

The dynamic coefficients and variables of the Input-Output Model explain the embedded system of IIE-processes that characterize the *Tawḥīdi* systemic worldview of unity of knowledge. Parsons and Smelser (1956) explain such an embedded social system of interrelationships as follows: A society needs

interaction between the following functions in order to carry on with its development: Social Adaptation (A), Goal Attainment (G), Integration (I), Pattern Maintenance (L). But within any of these functions there are discernable effects of each of the other sub-sectors. This yields a matrix disaggregation of {A,G,I,L} into each sub-sectoral disaggregations as, $\{A^a,A^g,A^i,A^l\}$, $\{G^a,G^g,G^i,G^l\}$, $\{I^a,I^g,I^i,I^l\}$, $\{L^a,L^g,L^i,L^l\}$, followed by still further levels of disaggregations.

7. The Supply Price of Capital

The context of duality between the two sectors and thus between multi-markets, namely the financial market with saving as the dominant factor formed by interest rate, and the real economy with spending as the dominant factor mobilized by productivity and profitability, now underlie the definition of the supply price of capital in such a dual, competing and dichotomous economy. The true present valuation of cash flows as the supply price of capital in macroeconomics ought to use the relative discount rate of (*r/i*, or *i/r*), where *r* denotes the rate of return in the real economic ventures; *i* denotes the rate of interest in savings. The relative movement between these signifies the transformation process towards or away from an interest ridden one as competition enhances between the savings and real sectors.

Due to the marginal substitution between these kinds of activities the same postulate can be reflected between two equivalent diagrams (not shown). In one diagram, the two axes would denote *r* and *i*, respectively. In the other diagram, *r* would correspond with the present value of cash flows generated by real economic activity represented along the corresponding axis. *i* would correspond with the present value of cash flows generated by savings represented along the corresponding axis. The present value of cash flows linked with *r* is discounted by the relative price (*r/i*), since these relative rates act as an opportunity cost for the real sector. The present value of cash flows linked with *i* is discounted by *i/r*. In both cases the discount factor denotes marginal substitution of the two competing alternatives, namely *i* and *r*, equivalently saving and spending or the financial sector versus real economic activity, respectively. Such a marginal substitution postulate is derived from the neoclassical foundation of Keynesian macroeconomics.

7.1. Some Quantitative Implications of the (*r/i, i/r*) Marginal Substitution Result

The principle of pervasive complementarities replaces the neoclassical postulate of marginal rate of substitution and thus destroys the entire neoclassical theory and thereby mainstream economic reasoning. Consequently, a different method replaces that of neoclassical resource valuation. I now carry on with the critique of the received valuation method, which has persisted in Islamic economics and finance with added fervour.

Let D_0 denote dividend payment on bonds at time t = 0, whose coupon yield is the rate of interest *i*. Let g_R denote the growth rate of dividends arising from real economic activity. Let g_F denote the growth rate of dividends arising from financial activity. These two sectors exist in competitive duality with each other.

According to our argument revolving around the (*r/i*) and (*i/r*) discount rates for the sectors dominated by real economic and financial activities, respectively, the present values of cash flows are given by,

1. $$PV = \int_0^\infty D_0 e^{-(i/r - g_F)} dt = D_0 /(g_F - i/r) > 0 \qquad (1)$$

with $g_F > (i/r)$, i.e., $i < g_F / r$ for cash flows arising from the financial economy. Expression (1) yields the following result,

$$dPV / di > 0 \quad ; \quad dPV / dr < 0 \qquad (2)$$

2. $$PV = \int_0^\infty D_0 e^{-(i/r - g_R)} dt = D_0 /(g_R - r/i) > 0 \qquad (3)$$

with $g_R > (r/i)$, i.e., $i > r / g_F$ for cash flows arising from the real economy.

Expression (3) yields the result,

$$dPV / di < 0 \quad ; \quad dPV / dr > 0 \qquad (4)$$

Expressions (1) and (2) show the trade-off between *i* and *r* in respect to resource allocation in the financial and real sector duality according to the postulate of marginal rate of substitution. This is yet another way of stating that in the neoclassical roots of macroeconomics, the financial sector and real sector remain competing rather than complementary. Thereby, such sectors have their own versions of prices and returns. Through the trade-off between *i* and *r* financial resources get withdrawn from the real sector into the financial sector and vice-versa.

Islamic economists with mainstream persuasion have for long now imitated and legitimized the use of the present-valuation of cash flows method, and thereby of the concept of time value of money. They have missed the understanding that the time valuation of money is simply the shadow price of interest rate. In this regard the argument runs as follows: Time value of money is the result of the postulate of marginal rate of substitution between the competing sectors of savings (*i*) and real economy (mobilization of resources through the financial sector continuously to generate profitability *r*). Marginal rate of substitution is rejected forever in the *Tawḥīdi* worldview of unity of knowledge between the two sectors that learn continuously in the IIE-processes. Besides, money pursues real goods and services in Sharīʿah compliant outlets with complementarities between them. In the future we are not sure under any circumstances about the existence of markets, the level of demand and changing human preferences under learning that is continuous and

unifying between money and real goods and between the good and services. Thus we cannot price a fruit before it is borne; we cannot price a fish before it is landed for market.

Besides, the uncertainties of the future over preference change and continuous learning cannot be estimated as datum by probabilistic expected values. I surmise that such probabilities would be Quantum Field Probabilities around the actual occurrence of multiple possibilities in a fuzzy topological field. Such probabilities would be like those relating to Heisenberg's Uncertainty Principle (1958). The determination of the true nature of probabilities in complex fields of events had defied Keynes as he pondered over it (O'Donnell, 1989).

Contrary to the present-valuation method and its prototypes such as internal rate of return, certainty equivalent and asset valuation of shareholders' wealth the *Tawḥīdi* methodology of systemic unity between money and real economy presents an alternative valuation method. This is the valuation method by means of the overlapping intergenerational model. In it valuation of assets and returns is carried out by the moment-to-moment terminal value of a stream of cash flows 'nearest' to the point of their occurrence. The estimation of such moment-to-moment cash flows is carried out by two combined approaches. Since an equilibrium point permanently remains as an 'expectational' point that can be only approximated to but never actually attained in the continuously learning model, therefore cash flows are expected values with a probabilistic correction for exigency by a factor as in our earlier case of the $\varepsilon(\theta)$-value. θ is the consensual assignment of a sequence of discoursed knowledge flows in the IIE-process of the Shura along with the abstraction of the ontology of understanding the dynamics of unity of knowledge for the particular problem at hand, that is valuation 'nearest' to a point of valuation. The second factor determining the probability measure of cash flows 'nearest' to the point of valuation is the institutionally guided discourse mechanism in the midst of the IIE-process. Valuation is thus explicitly a combination of market process and guidance according to the ethical rules of the Sharīʿah.

8. The Principle of Complementarities Versus the Postulate of Substitution in Human Capital Theory

What is all the more an unresolved problem is the role that endogenous human capital plays in the production function (Romer, 1986), even when diminishing returns to scale is not assumed in the aggregate production function. What results then is a trajectory spanned by substitutes (gross or imperfect) linked with the positive effect of human capital on the productive factors in generating and continuing this kind of the substitution history. Yet on each of the production possibility surfaces so induced by human capital, the combination of the productive factors lie along a particular form of surface (hence trajectory) that shows perpetual marginal substitution between the competing goods (services) and factors. The consequence is once again one of limited and not pervasive complementarities

between the competing variables. The reproduction of human capital in terms of its endogenous relationship with factors perpetuates the marginal rate of substitution between the factors and goods (services) (Turnovsky, 1995).

The central element of human resource development in every sphere of life is the instilling and functional understanding of the *Tawḥīdi* episteme in the systems framework of unity of knowledge. In the specific problems under examination the underlying principle of pervasive complementarities (the Qur'ānic principle of pairs in learning against the dissociate nature of rivalry as falsehood) must be functionally understood for applications and inferences based on this *Tawḥīdi* complemented worldview of unity of knowledge. Human resource development is thereby both a formal and vocational training as well as a matter of development in the learning-by-doing environment. In the educational system such a meaning of human resource development would go through the curriculum and training of the mind along the analytics of unity of knowledge in keeping with the *Tawḥīdi* principle of pervasive complementarities and the complexity dynamics that such educational development incurs. In the corporate world a similar human resource development will take place by the process of consensual discourse and interaction to understand and apply the principle of pervasive complementarities to particular problems, in keeping with the embedded precept of such problems within the embedded systems.

In all of the above directions and more the objective criterion of the simulation system of learning and organizing on the basis of the *Tawḥīdi* unity of knowledge is the social wellbeing criterion. It is simulated in connection with circular causation among the complementary variables of the social wellbeing criterion. On such a multidimensional perspective of problem solving in reference to the Interactive, Integrative and Evolutionary (IIE) process of the embedded systems in unity of knowledge, the view of Gunnar Myrdal (1968) is noteworthy. He remarked that there is no such thing as an economic problem, a social problem and the like. There are only problems.

Thus a complementary approach toward understanding and solving the complex problems of corporate governance and performance in the real world must be headed off by the instilling and analytical functionality of *Tawḥīd*i unity of knowledge worldview pertaining to the embedded nature of complexity in problem solving. In the world of entrepreneurship human resource development according to the *Tawḥīdi* worldview would proceed along the blueprint of interconnecting the various segments of the enterprise within it and across the community in the sense of sustainable development enabled by pervasive complementarities according to the Sharīʿah outlets with constructive discourse in and along the evolving IIE-processes.

At the community level projects for poverty alleviation human resource development will be understood as the application of the principle of pervasive complementarities in multidimensional ways of integrating the poor in discursive

forums and cooperative ventures by the Sharīʿah instruments of development financing. Multidimensional choices of ways and means result in multiple and evolutionary equilibriums in the light of learning along the IIE-processes 'nearest' to the points of occurrence of an event.

Such evolutionary equilibriums of simulated learning are considered in the entrepreneurial models of the Austrian school of economics. See Schumpeter (1961) and Hayek (1945). Kirzner (1997) has recently considered such an entrepreneurial model of learning in the light of the Austrian legacy. The contrast with the *Tawḥīdi* methodology though is that while the Austrian school of economics has nothing to say on unification of knowledge and systems, and Hayek openly claimed the legitimacy of marginal rate of substitution as a neoclassical postulate of resource mobilization, therefore this silence is logically and totally rejected by the *Tawḥīdi* methodology of unity of knowledge as explained by principle of pervasive complementarities as per the paired universe of the Qur'ān.

9. *Tawḥīdi* Approach to Resource Mobilization Theory

Be it any form of resources -- financial, physical or human -- the *Tawḥīdi* episteme of unity of knowledge and ethical preference formation in the midst of discursive learning must necessarily place an ethical preceptor in the system under examination. This fundamental premise transforms all of macroeconomics into a study on the microeconomic analysis of preference formation and institutional guidance. The issue was discussed earlier. In this light the resource mobilization problem of Islamic economics and finance would depend upon a microeconomic understanding of the relationship between money and project-specific financial mobilization using co-operative instruments as pronounced by the Sharīʿah. The aim is to establish systemic unification between money and the real economy (Choudhury 1997). In this kind of formalism it is impossible to construct a negative relationship between the rate of return and output, as must otherwise be the case if we adopted the Keynesian-Hicksian IS-curve of general equilibrium analysis to Islamic general equilibrium analysis without a deep questioning. Likewise, the relationship between the rate of return and output remains positive. Thereby, no Islamic equilibrium consequences in the sense of the Keynesian-Hicksian IS-LM methodology can be explained, as these curves remain positively sloped.

Likewise, no Islamic meaning can be attached to the relationship between saving and investment over the business cycle fluctuations in the light of the Keynesian general equilibrium analysis. Only in the instantaneous case of saving = investment can a resource mobilization be understood. That too is true for the static case only. Forced saving and inflationary pressure cause inequality between anticipated investment and actual saving over the course of business cycles. Now the rate of interest remains endemic in such phases of business-cycle fluctuations.

In the light of the above explanation of resource mobilization as unity of systems attained by IIE-processes between the real artefacts and their mutual

complementarities Islamic financial institutions assume a specific definition by function. Consider Islamic financial institutions such as the Islamic bank, Islamic insurance company, Islamic development institutions, Islamic trading house and Islamic institution of research and development. We examine a couple here.

In the *Tawḥīdi* methodological perspective an Islamic bank is an institution that mobilizes the resources of the community in Sharīʿah compliant ways and by Sharīʿah compliant instruments. Its objective is to attain desired levels of wellbeing for the community through participatory approaches in achieving such wellbeing. Such participatory approaches are derived from the foundational simulation problem of knowledge development that simultaneously establishes circular causation between the variables as relational ontology between all such state variables, policy variables, instruments and ethical preferences and possibilities instead of competing alternatives found in mainstream economics.

10. Resource Mobilization Through Islamic Insurance: *Takāful*

Islamic Insurance (*Takāful*) is a non-bank financial institution complementary to the Islamic bank. It helps in product- and risk- diversification as a risk-management and resource mobilization institution. The principle of complementarities is attained through *Takāful* by matching the flow of financial resources in Sharīʿah compliant outlets and by managing shareholders risk for the Islamic bank. Besides, the instruments used by *Takāful* revolve around the usual Islamic cooperative ones. Thereby, the use of such instruments is matched with those of the Islamic banks and performs participatory function for stakeholders and shareholders.

Insurance premiums cannot be fixed by distant future estimation of risk, as is being done by existing *Takāful*. This is tantamount to *Ribā* and is subject to all the conditions of the *Ribā* Rule on rejecting pricing of unknown futures. Only the 'nearest' estimation of expected events can be done with a margin, as we explained earlier, for increasing returns to scale of production in the *Tawḥīdi* embedded economic system. Indeed, there is no full information now, as the embedded system learns continuously and across continuums. The fixation of premiums is thereby tantamount to the actuarial valuation of future liabilities of the insured under assumed contingencies. This kind of formula valuation is no different from the conventional actuarial calculation of premiums under contingencies of future speculated risk. The premium cost is imputed by age, personal characteristics of the insured, the face value of policy and its time to maturity, all compounded by assigned rates of interest.

In the light of the *Tawḥīdi* unity of systemic knowledge, the alternative to premium-based financing of *Takāful* is the resource mobilization into diversified projects that are socially embedded in the Sharīʿah meaning of social wellbeing for

the mutual benefit of the insurance company and the insured. Such projects are product- and risk- diversified by the increase in opportunities and number of shareholders and stakeholders. The cooperative instruments that mobilize resources into Sharīʿah compliant directions help to attain such reduction in risk and increase in return as the learning process on unity of knowledge in the sense of embedded systems continues.

In all forms of *Takāful* a one-year term insurance with the option for renewal and optional conversion is recommended. In such a case annual valuation at a 'nearest' point of valuation and return by estimating risk and return can be possible by the overlapping-generations model, mentioned earlier. Socioeconomic development through the integrated networking of Islamic financial institutions becomes sustainable in the one-year renewable term insurance.

Two forces play their role here. Firstly, choices of new portfolios of investments properly diversified between short-, medium- and long- term investment outlets are realized. This is a market response. Secondly, ethical market transformation is guided by ethical transformation of preferences, menus and modes in cognizance of the institution-market circular causation affecting ethical formation. Thereby, socioeconomic choices in consumption, production, and technological and distributional menus are realized in reference to the social contract of the Sharīʿah. Thereby, markets are not systems of invisible exchange. Rather they are systems of social contracts.

11. An Explanation of the Islamic Money, Interest and Output Circular Causation Interrelationship

Carrying over from the discussion on money, resource mobilization and the real economy, it can now be deduced that there can be no emulation of the mainstream macroeconomic theory in the *Tawḥīdi* socio-scientific paradigm.

The difference between *Tawḥīdi* and mainstream economic and financial thinking is this: The knowledge dynamics underlying social productivity and ethical values in the *Tawḥīdi* episteme of unity of knowledge is unknown to mainstream economics. In fact, mainstream economics is not a study of a *process*-oriented world-system (Georgescu-Roegen 1971) that studies embedded systems and ethical behaviour. The role of r/i (r denotes the rate of return; i denotes the rate of interest) as an endogenous variable in relation to the evolving effect between M (money) and Q (output) under the impact of knowledge-flows by discourse, integration and creative evolution, as in the case of the *Tawḥīdi* epistemological and ontological construction, is unknown in mainstream economic, finance, social and institutional studies.

12. The Institutional Picture on Resource Allocation According to the Present State of Thinking in Islamic Economics and Finance

We note that it is not sufficient to merely distribute charity to the poor and needy as a proportion of the total charity in order to realize human development. Indeed financial performance indicators for a leading Islamic bank (anonymous) show a high percentage of spending in the poor and needy out of the total spent in charity, though the total in charity makes up a small percentage of net income. Contrarily, in improving human development it is necessary to use charity in productive and interlinked ways for uplifting the wellbeing of the poor and deprived. This is the ideal behind micro-entrepreneurial development. Micro-entrepreneurial development includes micro-enterprise credit but with the dynamic finance-real economy guided linkages, as explained above.

The bank appears to have done efficiently well by mobilizing funds in ways that indicate a Sharīʿah approach to investment funding is being followed. In such a case, against the social impact of the bank in poverty alleviation, human development and micro-enterprise development, the growing economic efficiency and profitability of the bank indicates that the wealth of shareholders is preserved. A trade-off thereby occurs between the economic and social goals of resource mobilization.

The message in general is clear now. Islamic financial institutions are evolving along a line of activities based on a mechanistic understanding of the Sharīʿah. In fact, the Sharīʿah conception based on learning dynamics did not evolve by a participatory discourse of the learned with diverse agencies of the Muslim community. There is no effective process in place in the Islamic institutions like the IIE-process of the Qur'ānic Tasbih-Shura experience.

13. Conclusion True Nature of Islamic Economic and Financial Studies

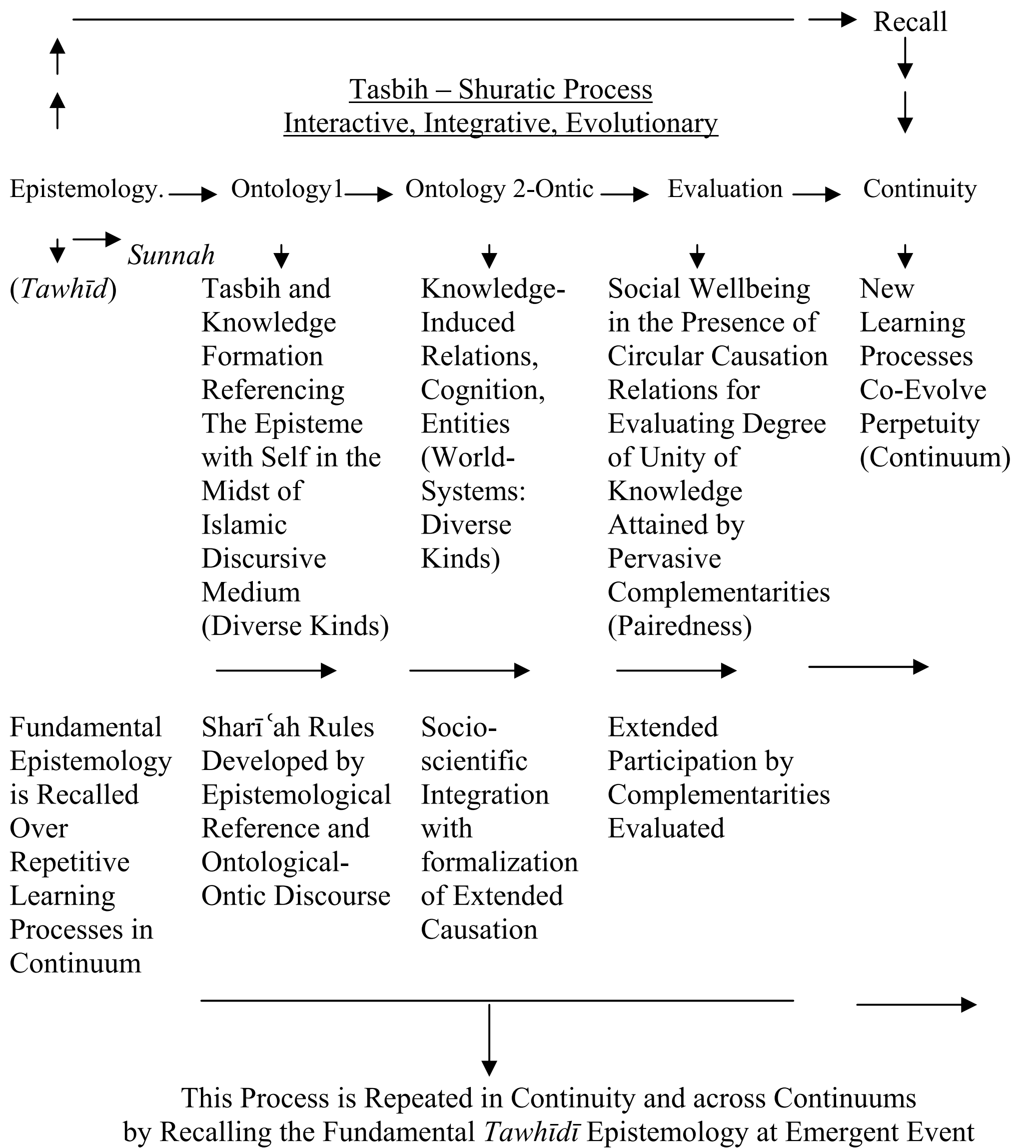
The above set of arguments is an illustrative example, not meant to be exhaustive in so many details that can be critically launched against the present state of Islamic economics and finance. This leads to a critical review. We reiterate here the nature of Islamic economic and financial studies in a different light in reference to the Qur'ān and the Sunnah as the basis of the *Tawḥīdi* epistemological methodology.

The substantive question of interaction, integration and creative evolution between diverse issues of embedded social, economic and scientific systems in accordance with the epistemology of *Tawḥīd* (Oneness of God = unity of divine knowledge), which is particular to the Islamic worldview, is fundamental in

understanding the nature and logic of economic behaviour and Islamic transformation in embedded systems with endogenous circular causations. Such a knowledge-cantered process model transcends from the level of the individual and family to society, markets, institutions and the global order (Choudhury, Umar and Al-Ghamdi, 2003).

Appendix 1

Tawhīdī Phenomenological Model



Appendix 2

Evolutionary Equilibrium in Learning Spaces of *Tawḥīdi* Unity of Knowledge

The existence of learning on unity of knowledge (*Tawḥīdi* dynamics as expressed by the IIE-process) together with the nature of learning evolutionary equilibriums realized in such systems cause perturbations in the attainment of such equilibriums. In the case of market equilibrium for instance, an equilibrium is not actually attained but only approximated to by learning, which then disturbs the equilibrium point to a higher (or lower) plane of unity of knowledge in the market order. Such market equilibrium is the logical consequence of relational epistemology among a vast spectrum of embedded variables and their systems that influence movements in the market exchange mechanism.

Consider the market equilibrium, $E = (x^*,p^*)$ in market clearance quantity q^* and corresponding equilibrium price p^*. Note that each of these is influenced by learning as per the epistemology of unity of knowledge. We denote this factor by $\{\theta\}$-values attaining a probability limiting value of θ^* at (x^*,p^*). Such a probability limit occurs over a given N1 rounds of IIE-processes that characterize a given major learning juncture, although learning occurs continuously in continuum of markets and embedded systems. We write a continuum of exchange points by $\{(x,p)[\theta]\}$.

However, note that in evolutionary fields of θ-values there is no unravelling of facts either in the θ-field or in the $\mathbf{y}(\theta) = ((x(\theta),p(\theta))$-values. In other words, while θ-values evolve, along with these the knowledge-induced $\{(x,p)[\theta]\}$-values evolve as well in their domains.

Consider for example, $\theta \in \{\theta_1\}\cap\{\theta_2\} \neq \phi$, for two intersecting sets 1 and 2 of θ-values. According to the evolutionary character of θ-values in this intersecting and expanding region,

$d[\{\theta_1\}\cap\{\theta_2\}]/d\theta > 0$, and (1)

$\text{plim}_{[\text{numbered interactions}]} \{\theta\} = \theta^* + \varepsilon(\theta)$.

That is, $\text{Prob}(|\theta-\theta^*|) = \varepsilon(\theta) > 0$, for every $\{\theta\} \subset \Omega$, and $\text{Prob}[\Omega \to \Omega] = 1$

Consequently,

$d\mathbf{y}(\theta)/d\theta > 0$, subject to the above conditions. From this we can define $y^*(\theta^*)$ in a way similar to θ^*. (2)

Next define an equilibrium point in an evolutionary field of $(\theta, y(\theta))$-values as $((\theta^*, y^*(\theta^*))$, such that all the conditions of (1) ↔ (2) as a reflexive relationship. A description of the evolutionary space of $\{\theta^*, y^*(\theta^*)\}$ is thus generated as a system of relational processes.

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Comments

on "Redistributive Justice in a Developed Economy: An Islamic Perspective" by Mabid Ali Al-Jarhi and Muhammad Anas Zarqa

Mohamed Ariff [*]

The paper by Dr. Mabid Al-Jarhi and Dr Anas Zarqa represents a valuable addition to the literature on the subject. It tries to make a clear demarcation between the conventional approach and the Islamic one on the issue of redistribution of income and wealth.

However, I am not at ease with the title of the paper which speaks of redistributive justice in a "developed economy". On the one hand, the title renders the paper somewhat irrelevant, as there is not a single country in the Islamic world belonging to the category of developed economies. On the other hand, the issues addressed in the paper are by no means specific to the developed economy status. That said, I must hasten to add that the paper is fairly well balanced both in terms of theoretical and empirical observations and in terms of pros and cons. The survey of the literature on redistribution, especially fairness models, is indeed commendable.

The authors have taken pains to debunk the notion that equity and efficiency cannot coexist. In this regard, the Malaysian experience with the New Economic Policy 1970-90 is instructive. Contrary to the common perception that bigger slices for some must mean smaller slices for others, Malaysia was able to demonstrate that it is possible for some to have bigger slice without others having smaller ones. The Malaysian affirmative policy was based not on the principle of disruptive redistribution of the existing pie but premised on active engagement of the disadvantaged in the expansion of the pie, so that everyone is better off and no one is worse off. This is clearly a case of greater equity in a growing economy. Quality growth is one that comes with equitable distribution.

The discussion of Pareto optimality is somewhat intriguing. It is argued that in a perfectly competitive economy redistribution from the rich to the poor would improve aggregate efficiency, provided the rich spend more on goods with relatively inelastic supply and the poor spend more on goods with relatively elastic supply. The logic is that income redistribution raises aggregate demand, which in

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turn raises aggregate supply. Much obviously would hinge on income-elasticity of demand and price-elasticity of supply. The authors stop short of questioning the Pareto optimality itself.

The notion of Islamic brotherhood (where one wishes for his brother what he wishes for himself) opens up new avenues in welfare economic analysis. Much would, of course, depend on the degree of benevolence one assumes. The degree of benevolence refers to how an individual equates his personal welfare with that of another. If A regards a dollar increase in B's welfare as being equivalent to a dollar increase in his own welfare, there is 100 per cent benevolence, so that A's benevolence coefficient reaches unity on the benevolence scale, implying that A is completely unselfish. Conversely, if B's improved welfare means nothing to A, the benevolence coefficient of A is zero, implying that A is totally selfish. Worse still, if B's improved welfare causes A to be unhappy, the latter's benevolence coefficient is negative, implying that A is malevolent toward B.

The Pareto welfare criteria implicitly assume a zero benevolence coefficient. The said criteria would become less stringent if one permits benevolence, and more stringent if one admits malevolence, into the analysis. Thus, the Pareto condition that at least one person is better off without others being worse-off is valid, if and only if one assumes that others are not malevolent toward the individual who is now better off. Of course, Islam does not condone malevolence. But, the concept of welfare in Islamic economic system is different from conventional welfare economics. According to the latter, if A's gain exceeds B's loss so that A can profitably compensate B, the aggregate welfare of the community as a whole increases, even without A having to *actually* compensate B. In the Islamic sense, however, the change may signify a turn for the worse, if A is very rich and B is very poor, unless B is compensated *adequately*. Adequate compensation would depend on the relative position of A and B along the wealth distribution scale. This inevitably leads to the question of interpersonal comparisons which economists seek to avoid. But, social justice calls for interpersonal comparisons and economists can play a meaningful role as social scientists by positively responding to this call.

I find the section on redistribution in Islam most interesting. The authors have put forward a very persuasive argument for distribution in an Islamic framework. Their discussion of the institution of zakah in particular is quite extensive. However, the modalities and strategies considered in the paper can only help alleviate, but not eradicate, poverty. Redistribution of income from the rich to the poor would only amount to income transfers for consumptive purposes and will probably keep the poor in a state of poverty for ever. The use of zakah funds to equip the poor with new means of making a living and thereby generating income and creating wealth on their own would help convert zakah receivers into zakah payers over time.

As the authors have shown, actual zakah proceeds are way below potentials. This is largely because, zakah collection and distribution is yet to be properly institutionalized in the Muslim world. Although zakah bodies do exist in many countries, none is run like the way income tax revenue is organized. One of the reasons why so little zakah is collected in most countries is that many zakah payers prefer to distribute on the own, which in turn is due to the dismal record of many zakah collecting agencies which have failed to distribute the proceeds fully.

The paper falls short of discussing the international dimension of zakah collection and distribution. After all, Ummah is borderless. There is considerable economic disparity among the countries in the Muslim world. In some countries, more zakah can be collected than what is needed for redistribution. The reverse is true for many countries especially in Africa, where the "demand" for zakah funds far exceeds the "supply" of zakah funds. There is certainly a need for a supranational zakah institution to shift zakah funds from "surplus" countries to "deficit" countries under the auspices of the Organization of Islamic Conference (OIC)

All this notwithstanding the paper by Dr Al-Jarhi and Dr Anas Zarqa has given us much food for thought. I would like to thank them for an intellectually stimulating paper.

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Comments

on "Islamic Economics and Finance: Where Do They Stand?" by Masudul Alam Choudhury

Mohamed Ariff [*]

The paper by Prof. Masudul Alam Choudhury is not an easy paper to read. It is a highly philosophical and intellectually sophisticated piece of work that requires more than careful reading. It is even more difficult to comment on the paper, as it is tightly argued with hardly any space for serious criticisms. I find myself generally in tandem with the tenor and conclusions of the paper.

Prof. Choudhury raises highly pertinent questions and throws formidable challenges at economists who are re-inventing Western economic theories and empiricism ostensibly in the name of Islam. Arguably, most, if not all, of the contemporary writings in the realm of Islamic Economics are products of unimaginative application of analytical tools of conventional economics in the Islamic domain. The author argues very persuasively and convincingly that the Islamic worldview is premised on a distinctive epistemology and the Tawhidi dynamics of Islam call for an entirely different approach, while Islamic economics and finance have fallen unwittingly into the trap of neo-classical and neo-liberal doctrinaire.

The problem is glaringly conspicuous in the case of Islamic finance which is now in the danger of being completely absorbed if not hijacked by the West. It has become fashionable for Western banks to have Islamic extensions, motivated purely by the desire to have a share in the growing market for Islamic funds. Islamic banking has devolved into yet another addition that contributes to the diversity of financial instruments in the global market. It now appears that as if the elimination of interest is the end-all and be-all of Islamic finance. It can also be argued that the elimination of interest is more apparent than real. Islamic finance is in the danger of seeking solace in the letter rather than the spirit of Islamic injunctions. Islamic financial instruments are overtly “interest-free” but remain covertly “interest-based” to the extent the cost of funds and returns on deposits are guided by the prevailing interest rate structure of conventional banking. Seen in such terms, it is readily obvious that Islamic banks have been unwittingly admitting interest rates through the back door.

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The Islamic economic system differs sharply from other contemporary economic system so much so that Western concepts, notions, ideas and instruments are inapplicable without radical modifications. The moral values and the ethical norms of Islam do significantly influence the mode of economic behaviour of Muslims in an Islamic society. To the extent that economics is a behavioural science, it must reflect such behaviour. What makes an Islamic economy different from other economies is its value system which influences its consumption, production, saving, investment and redistribution decisions.

Does all this provide a valid basis for rejecting all conventional tools of analysis as irrelevant or inappropriate for Islamic economics and finance? I am not so sure. This is not to deny that there are many concepts in conventional economics that are steeped in Protestant values such as the notion of profit maximization. But, how about concepts and terms that are neutral or value-free, such as elasticity and equilibrium, which are borrowed from Physics? Care must however be taken to be wary of seemingly benign concepts such as "optimality". For what may constitute an optimal solution in one situation may well be sub-optimal in another, depending on the set of criteria which are not necessarily value-free. Thus, for instance, Pareto optimality is based on a distributive justice according to which no one should be made worse-off, so as to avoid inter-personal comparisons. Pareto optimality is thus too restrictive to be a guide for redistribution in an Islamic economy, which is far more egalitarian in both letter and spirit.

Prof. Choudhury's concerns are not about just concepts and terms per se, but about relationships and interactions among them (methods and methodology) in the Islamic framework, in contrast to the mainstream economics. He is certainly breaking new grounds. He shows that preference aggregation in mainstream economics differs from that in Islamic economics. He differentiates financial savings (a return on which is interest) in the mainstream context (where the financial sector is separated from the real sector of the economy) from participatory injection of capital into the real economy in the Islamic mode. He thus demonstrates the uniqueness of the Tawhidi approach, which is premised on inherent complementary participation of factors and enterprise. This leads him to argue that the dichotomy between macroeconomics and microeconomics is untenable in the Islamic framework. What is more, he questions the use of the present-valuation of cash flows method and the time value of money by Islamic economists and shows that the time valuation of money is no more than the shadow price of interest rate.

Given the Tawhidi principle of pervasive complementarities, there is unity between money and real economy and consequently there is only positive relationship between the rate of return and output. This is in sharp contrast to the Keynesian-Hicksian IS-curve of general equilibrium analysis.

Finally, the author looks critically at Islamic banking and insurance in practice. He takes existing Takaful to task for fixing insurance premium by distant future estimation of risk, which is tantamount to interest or *riba* as it smacks of pricing of unknown futures. On Islamic banking, his main criticism is that their activities are based on mechanistic understanding of the sharīʿah. He stops short of scrutinizing the extent to which these institutions have distanced themselves from the institution of interest in both letter and spirit.

I have learned much from the paper, which I found very refreshing. I wish to congratulate the author on a job well done.

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Comments

on "Islamic Economics and Finance: Where Do They Stand?" by Masudul Alam Choudhury

M. Umer Chapra*

It is a source of great pleasure and honour for me to be a discussant of the paper written by Prof. Masudul Alam Choudhury, whom I respect greatly for the several valuable contributions he has made to Islamic economics and finance.

Islamic economics, as you all know, is not a new discipline. It represents the revival and further development in the Twentieth and Twenty-first centuries of ideas on economics that had evolved in the writings of a large number of prominent Muslim scholars like Abu Yusuf (d.798), al-Mawardi (d.1058), Ibn Hazm (d.1064), al-Sarakhsi (d.1090), al-Tusi (d.1093), al-Ghazali (d.1111), al-Dimashqi (d. After 1175), Ibn Rushd (d.1198), Ibn Taymiyyah (d.1328), al-Shatibi (d.1388), and Ibn Khaldun (d.1406).[1]

Similarly, the Islamic financial system, which is trying to get rid of the role of interest in financial intermediation, is also not something new. It worked quite effectively during the heyday of Muslim civilization and for centuries thereafter. According to Udovitch, the *muḍārabah* and *mushārakah* modes of Islamic finance were able to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, and long-distance trade (1970, pp. 180 and 261). These modes were used by not only Muslims but also Jews and Christians to the extent that interest-bearing loans and other overly usurious practises were not in common use (Udovitch, 1981, p. 257, see also p. 268). According to Goitein, breach of the Jewish, Christian and Islamic law against interest was found in the "Geniza documents only once in the record of a judgement", even though "an unusually large amount of Geniza documents deal with credit" (Goitein, 1967, pp. 255 and 250, see also Goitein, 1966, pp. 271-4). By the time of the Abbasid Caliph al-Muqtadir (908-932), sarrafs, who performed the role of bankers in Muslim history, had started performing most of the basic

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[1] For some of these contributions see Spengler, 1964; DeSmogyi, 1945; Mirakhor, 1987; Siddiqi, 1992; Essid, 1995; Islahi, 1996; Chapra, 200; and S. Ghazanfar, 2003.

functions of modern banks (See Fischel, 1992). They had their own markets, something akin to the Wall Street in New York and the Lombard Street in London, and fulfilled all the banking needs of agriculture, industry and commerce (Duri, 1986, p. 898) within the constraints of the then-prevailing technological environment. `

However, as a result of the Muslim decline over the last few centuries, further development of Islamic economics did not continue except by a few luminaries like al-Maqrizi (d.1442), al-Dawwani (d.1501), and Shah Waliyullah (d.1762). This was to be expected because, as rightly predicted by Ibn Khaldun, sciences progress only when a society is itself progressing (*Muqaddimah*, n.d., p.434). Even Islamic finance got displaced, like many other Islamic institutions, by the conventional financial system after the colonization of Muslim countries.

It is heartening that Islamic economics and finance have both been reviving after the independence of Muslim countries from foreign domination. A number of prominent scholars, Prof. Choudhury being one of them, are striving to give it a shape that would enable Muslims to respond successfully to the challenges they are facing. However, while conventional economics and finance have gone through a long process of development over the last two centuries, it would be unrealistic to expect Islamic economics and finance to become mature over a short period of just three or four decades. Both these are in the initial phase of their development and it will be quite a while before they become mature.

Prof. Choudury's paper is a critique of both Islamic economics and finance. This is, of course, welcome because it is the only way in which the failings of both these disciplines can be brought into the limelight and efforts made to remove them. It is better for these disciplines to be subjected to criticism in their early stage of development so that the failings may be corrected before it is too late. Prof. Choudhury needs to be complimented for being one of the several scholars who are performing this task.

However, while complimenting him for his critique, I take the liberty to point out that all his criticisms are not necessarily right. He does not seem to me to be right in his critique of Dar and Presley's advice to Islamic economists to "exploit the wealth of supportive arguments in Western literature." Their advice is in keeping with the historical record of Muslims who have never in their history adopted a policy of living in isolation of other civilizations. They actively interacted with the Chinese, Indian, Egyptian, Greek and Sassainan civilizations and borrowed from them what they thought was good and useful and, after improving upon it and adding to it immensely through their own creative genius, passed it on to the Western civilization. It would be naïve not to acknowledge the fact that the West has kept the torch it bequeathed from the Muslims with even greater brightness. Muslims need to benefit from what the West has done instead of trying to reinvent the wheel. Islam believes in the unity of mankind which is an essential corollary of the Islamic belief in the unity of God. According to the

Qur'ān, mankind was created as one, but became divided because of their differences and transgressions against each other (al-Qur'ān 10:19, 2:213 and 3:19). The ultimate objective of Islam is to unite mankind. Without such unity, its teaching of the brotherhood of mankind will not be able to materialize. How can we succeed in uniting mankind if we do not believe in the cross-fertilization of ideas put forward by different civilizations?

It would be a mistake to assume that everything in conventional economics is wrong, and that we should not borrow from its "methods and models" as Prof. Choudhury would like us to do. It is true that conventional economics did take a wrong turn after the Enlightenment Movement of the 17th and 18th centuries. This did not, however, strip it totally of the moral basis of society emphasized by the Aristotelian and Judo-Christian philosophies. All conventional economists did not necessarily become secular in their lives and many of them continue to be attached to their religious worldviews. Consequently the pre-Enlightenment tradition never disappeared completely in conventional economics (Baeck, 1994, pp.11). Protests have been, and continue to be, made by prominent scholars against the Enlightenment worldview. Thomas Carlyle went to the extent of calling economics a "dismal science" and rejected the idea that free and uncontrolled private interests will work in harmony to promote public welfare (See Jay and Jay, 1986). Henry George ridiculed the dominant doctrine of laissez-faire with its emphasis on self-interest (Progress and Poverty, 1879/1955).

A number of conventional economists have also been arguing in favour of the need to give a human face to capitalism (Brittan, 1995). Others have been emphasizing the injection of a moral dimension into economics. Hausman and McPherson have concluded in their survey article in the Journal of Economic Literature on "Economics and Contemporary Moral Philosophy" that "An economy that is engaged actively and self-critically with the moral aspects of its subject matter cannot help but be more interesting, more illuminating and, ultimately, more useful than the one that tries not to be" (1993, p. 723). It is, therefore, possible that, as a result of continued increase in the expression of such views in conventional economics, Islamic economics and conventional economics may draw closer to each other and that, after a lapse of time, the distinction between them may almost disappear. I, therefore, see no harm in benefiting from the writings of conventional economists, particularly those among them who wish to return to the pre-Enlightenment worldview. This would greatly benefit Islamic economics.

The above discussion has indicated one of the points where I disagree with Prof. Choudhury. However, I wish to compliment him for his effort to inject a multidisciplinary and circular causation analysis into Islamic economics. This is the need of the hour and a number of other scholars have also emphasized this. This is, however, not something new in Islamic economics. Ibn Khaldun and his predecessors had also adopted such an approach. They tried to show the closely

interrelated role of moral, psychological, political, economic, social, demographic, and historical factors in the rise and fall of human societies. None of these factors can by itself make an optimum contribution to development without the support of the others. It may have been better if Prof. Choudhury had at least made the mention of the contributions made by classical Muslim scholars to multidisciplinary and circular causation analysis.

In their multidisciplinary analysis Classical Muslim scholars laid a great deal of emphasis on the key role of human beings in the socio-economic and political development of human societies. This is because human beings are the end and means of development. It is their well-being which is desired. If they are the end of development, then they will not be motivated to render their best unless their well-being is ensured; everything that prevents them from receiving the fruits of their labour needs to be reformed. If they are the means, then they will not be able to render their best unless they have the ability to do so. This requires their moral as well as intellectual uplift. Reform and education of human beings is, therefore, indispensable. This is the reason why the Qur'ān says: "God does not change the condition of a people until they change their own inner selves (13:11). Accordingly, all the Prophets of God gave a central place in their massage to the reform of human beings and the institutions that affect their behaviour. The human being should, thus, occupy a central place in any development philosophy as well as multidisciplinary and circular causation analysis.

However, when we talk of the role of human beings in development, we need to bear in mind that the institution that has a maximum impact on human attitudes and behaviour is justice. Islam has, therefore, given a central place to the establishment of justice in human societies. To ensure justice, it is necessary to have rules of behaviour. These are called moral values in religions paradigms and institutions in institutional economics. These rules of behaviour may not be meaningful unless they are enforced. This is where both the society and the government have an important role to play. Thus the individual human beings, the society, the government, and values and intuitions all interact with each other in development. The manner in which lack of justice triggers the decline of a society has been spelt out with great clarity by Ibn Khaldun in his *Muqaddimah*.

As far as Islamic finance is concerned, I am in full agreement with Prof. Choudhury when he says that "Islamic financial institutions are evolving along a line of activities based on a mechanistic understanding of the Sharīʿah". It is, accordingly, not fulfilling its real purpose which is to "mobilize the resources of the community in Sharīʿah compliant ways and by Sharīʿah compliant instruments to attain the desired levels of well-being for the community" (p. 31). *Muḍārabah* and *mushārakah* modes of financing have not made a significant headway, and the conditions laid down by the Sharīʿah for the permissibility of a number of the debt-creating modes of finance are not being fulfilled earnestly as a result of the use of *ḥīlah* or legal contrivances. The result is that a number of critiques of Islamic

finance do not find any significant difference between Islamic and conventional finance. I am afraid that, if the course that the Islamic financial system has taken so far is not rectified, people will lose faith in the system and it will suffer a severe set back. It would have been worthwhile if Prof. Choudhury had tried to show how the system may be reformed to enable it to help realize the *maqāṣid* al-Sharīʿah.

On the whole I think Prof. Choudhury needs to be complimented for writing a thought-provoking paper. However, I would advise him to use less difficult language so that even commoners like me can easily understand the message that he is trying to convey. I wish to give below just a few examples of the difficult language used by him:

- "Imitation and prolonged ambivalence to the originary foundations" (p.7).
- "*Tawḥīdi* epistemological-ontological-ontic methodology" (p.10).
- Preference-benign methodology of microeconomics (p.11).
- *Tawḥīdi* episteme of unity of knowledge: (p.33).

He is a great scholar and a prolific writer and it should not be difficult for him to use language that is simple and easy for everyone to understand. Simpler language will enable him to convey his worth-while message to all more successfully.

Violation of Moral Values[2]

I now wish to come to a point which in general most Islamic economists tend to miss. It is, of course, important to emphasize the injection of a moral dimension into economics. This is what Prof. Choudhury has also done admiralty well. However, this leaves a very important question unanswered. Why is it that the observance of the same moral values fluctuates over history such that they are abided by faithfully during certain periods and violated during others in the same society? If the task of Islamic economics is not just to analyze 'what is', but also to lead to 'what ought to be', then assuming the prevalence of Islamic values, as has been done generally, cannot be helpful when the values are in fact generally being violated in most Muslim societies.

Moral values are not sufficient by themselves. Muslims have been listening to sermons for centuries during the period of their decline and yet the moral condition of their societies has not improved. There is perhaps greater corruption and injustice in the Muslim world than in the 'secular' West. Workers in the Muslim world are also perhaps less conscientious, hardworking, and punctual, and businessmen are probably less honest and scrupulous than what Islamic norms require. Many of the morally wrong practises like cheating, bribery, and other unfair means of earning have now become securely locked-in through the long-run operation of path dependence and self-reinforcing mechanisms. Everyone

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[2] This and the following sections have drawn heavily from Chapra, 2000, pp. 366-76.

condemns the practises but is unable to get rid of them even if he sincerely desires to do so, because the whole social environment has become corrupted. Hence, Muhammad Asad, one of the great Muslim scholars of this century, has rightly said: "To desire a return to an Islamic reality is one thing, but to visualize that reality in all its concrete aspects is another" (Asad, 1987, p. 3).

If Islamic economics is serious about introducing the role of moral values in economic performance, then it cannot avoid identifying the different factors that create divergence between the ideal and the actual behaviour in human societies. It must also try to find practical, down-to-earth ways of weakening these factors and reversing their effect to the extent possible, to enable Muslim countries to move towards the Islamic ideals of better moral-orientation and greater well-being. For example, one of the important factors responsible for the gap between the ideal and the actual is the lack of effective political accountability in clear violation of Islamic norms. There is hardly any Muslim country where there is real democracy, where the press is genuinely free, where the courts are truly independent, and where the law of the land is applied fairly and impartially to all, irrespective of their wealth and power. Hence, while the revelation of any instance of moral or financial corruption in the West creates a sensational expose in the news media and leads to the resignation of the minister concerned, it hardly finds mention in the local news media of many Muslim countries and, if it does so in countries where the press is relatively free, it fails to create any ripples in the echelons of power. No minister or official feels the necessity to resign because of the revelation of his corruption or moral laxity. He may even be ‘reappointed’ or 're-elected' with great ease. In such an environment where it is possible for the wealthy and the powerful to get away with corruption, inequities, and incompetence, there is bound to be a lack of serious political commitment for reform and general well-being.

What Islamic economics needs to show Muslim countries, therefore, is how to have the Islamic values reflected in the legal, social, political and economic institutions of Muslim countries. Other societies have done this in spite of an external secularist and value-neutral stance ((OECD, 1996). They have formulated a legal framework and a proper code of conduct for government officials, and put in place mechanisms for transparency, rule of law, public accountability, and the protection of whistle blowers. They have also created sufficient checks and balances, and adopted measures that make it difficult for violators to get away unscathed. Muslims have lagged behind here. This is not because of Islam, but rather in spite of Islam.

Solutions to Crucial Problems

In addition, there is a glaring omission in Islamic economics of a scientific analysis of some of the crucial problems that are plaguing Muslim countries. These include: corruption, extravagance and wastefulness, budgetary and balance of payments deficits, a high debt-servicing burden, low levels of saving and investment, high rates of inflation and unemployment, extreme inequalities of

income and wealth, poverty and miserable socio-economic condition of the poor. The immediate need is to find remedies to all these problems. Some non-Muslim countries have admirably solved a number of such problems by adopting certain standard remedies, which are easier to adopt and more effective in the short-term. A discussion of these remedies does not seem to get a fair share in Islamic economics. A complete package of reforms, some of the elements of which may be common to both Islamic and other moral or even secular systems, has yet to be discussed by Islamic economics.

This makes Islamic economics appear unrealistic to the critics as well as policy makers. Even those who are favourably inclined towards Islam, and there is a large number of these, feel that while most of the policy instruments discussed by Islamic economics are essential for ensuring justice and the long-term health of Muslim societies and economies, they will take a longer time to implement and bear results. In contrast, the prevailing problems need immediate attention and solutions. If this were done, it would automatically become clear that, while the greater emphasis on justice, brotherhood, moral reform, family and social solidarity, and some specifically Islamic institutions would continue to be the distinguishing feature of Islamic economics, there would be a great deal that overlaps between Islamic and conventional economics. This is because, as already pointed out, conventional economics has not been as secular and value-neutral as the economics profession would have liked it to be. It has not refrained from making value judgements, suggesting policies, and analyzing their impact. Conventional economists are human beings with a throbbing heart. They live in democratic societies and it is not possible for them to ignore their societies' values and aspirations, many of which have their roots in religion and not in secularism or materialism and hedonism.

The Future Course of Action

It is high time that Islamic economics started concentrating on the existing problems of Muslim countries and proposing remedies which are Islamically preferable as well as politically and economically feasible.[3] Such an approach would not only help enhance its popularity and general acceptance but also create a better environment for the introduction of specifically Islamic measures. A change of this nature in its approach would, however, require individual country analysis. The intensity of the problems is different in different countries. In addition, the historical backgrounds, institutional frameworks, and 'prevailing' social mores are also different. Each country may, therefore, need a specifically tailored reform programme. The blanket approach of considering all Muslim countries together

[3] Homa Katouzian has rightly pointed out that “the economists and other social scientists would be able to make much more useful contributions if they concentrated their efforts on the social and economics problems these countries face” (Katouzian, 1985, p. 391).

may perhaps not be suitable except for a general discussion of the Islamic economic system to elucidate its objectives, principles, rationale and operation.

Islamic economics would also have to collect reliable data on a number of important economic variables. Without knowing the actual position and the reasons for it, it is not possible to prepare a well-conceived programme for social, economic and political reforms. Data creates transparency and reveals the true picture, which some governments do not welcome because of the adverse impact this has on their vested interests. Hence, one of the essential prerequisites of the Islamization process is transparency through the collection and publication of all necessary data and their scientific analysis. Missing in particular are data on the distribution of income and wealth, the extent of need-fulfilment, and the nature and quality of life, particularly of the downtrodden. Without such data, it is not possible to know the degree of equity prevailing in the allocation and distribution of resources, which is the most crucial criterion for judging the Islamization of a Muslim economy. There are also inadequate data about government revenues and expenditures, consumption, the savings and investment behaviour of individuals and different sectors of the population, employment and unemployment, bonded female and child labour, wages and salaries, working conditions, work habits, and productivity, along with a rational explanation for the deviation from Islamic norms. Once this is done, it may be possible for Islamic economics to do a more meaningful job of analyzing the impact that the introduction of Islamic values and institutions may have on aggregate consumption, savings and investment, economic growth and stability, and income distribution.

A Task Far More Difficult than Conventional Economics

The task of Islamic economics is, thus, broader and far more difficult than that of conventional economics. The nature of its paradigm does not allow it to confine itself merely to a discussion of just 'what is'. Its primary task needs to be to transform Muslim societies and to take them to 'what ought to be'. To accomplish this, it must identify all the major factors that influence the behaviour of economic agents. None of these can be taken in isolation because, as Ibn Khaldun rightly observed, all of them tend to interact with each other over time in a circular manner. A theory of socio-economic dynamics comparable to general equilibrium theory may make it possible to study the interaction of all major values and institutions with economic variables over time in a way that helps realize the desired allocation and distribution of resources that is in conformity with the vision of Islam. By adopting such a goal-oriented, dynamic and inter-disciplinary approach, Islamic economics may be able to explain not only the growth and stagnation of Muslim economies in the past but also the sources of their current problems. It may be able to predict relatively more confidently the behaviour of economic agents and influence more effectively the future course of events.

The practical wisdom of Islamic economics has been unable to come anywhere near this goal so far. It has not been able to come to grips with the task of explaining the rise and fall of Muslim economies in the past, the gap between Islamic norms and the actual behaviour of economic agents, and the causes of the problems faced by Muslim countries. It has been unable to suggest a balanced package of policy proposals in the light of Islamic teachings, to enable Muslim countries to perform the difficult task of reducing their imbalances and simultaneously actualizing the *maqāṣid*, particularly justice and general well-being.

The expectations for the near future should not, therefore, be pitched at a very high level. It may not be possible to raise Muslim societies, at least in the near future, to the high spiritual level that Islam demands and that Muslim economists assume in their analyses. Moreover, the performance of all the functions that are expected from Islamic economics may not be immediately feasible because of the lack of resources and political support, the non-availability of data, and the difficulty of measuring a number of the socio-economic and political variables that need to be incorporated into the models. Hence, while it should not lose sight of its ultimate goal, it should be realistic about the immediate possibilities. It is possible that even after a great deal of effort, its achievements may not be significantly great in the immediate future. The effort should, however, continue, because, as Nasr has put it: "Islamic economics and the institutions which are predicated upon it have tremendous unfulfilled potential yet to be realized" (Nasr, 1991, p. 392).

Islamic economics fortunately has the advantage of drawing strength from the renaissance which is steadily gaining momentum in the Muslim world after centuries of decline and disintegration. It also has the advantage of getting support from the foundation of multidisciplinary dynamics laid down by Ibn Khaldun (d. 1406) and of the tools of analysis developed by conventional, social, humanitarian and institutional economics as well as other social sciences. It is hoped that the development of this new discipline with its explicit commitment to the satisfaction of the material as well as the spiritual needs of the human personality, and to moral values, socio-economic justice, and family and social solidarity, will not only help the Muslim world but also provide a new impetus to economics in general.

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Part-II

Needs and Implications of Transparency and Risk Management

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Risk Measurement and Disclosure in Islamic Finance and the Implications of Profit Sharing Investment Accounts

V. Sundararajan*

The paper discusses key issues in the measurement and control of risks in Islamic Financial Services Institutions, particularly the implications of profit sharing investment accounts (PSIA) for risk measurement, risk management, capital adequacy and supervision. Cross country data on a sample of banks reveal a considerable smoothing of returns paid to PSIA, despite wide divergences in risk. This suggests that the sharing of risks with PSIA is fairly limited in practice, although, in principle, well-designed risk (and return) sharing arrangements with PSIA can serve as a powerful risk mitigant in Islamic finance. Supervisory authorities can provide strong incentives for effective and transparent risk sharing and the associated product innovations, by linking the extent of capital relief on account of PSIA with appropriate supervisory review of the risks borne by the PSIA (equivalently the extent of displaced commercial risk assumed by the shareholders), and by requiring adequate disclosure of these risks. A value-at risk (VAR) methodology is proposed for measuring these risks.

Introduction and Summary

Globalization, changes in regulatory environment, and the growth in Islamic financial institutions and markets, together call for strengthened risk management in Islamic Financial Services Institutions (IFSIs), in order to enable them to compete effectively and remain sound and stable. This is because, the IFSIs face a unique mix of risks that arise both from the contractual design of instruments based on shar ah principles, and the overall legal, governance, and liquidity infrastructure governing Islamic Finance.

Fundamental to effective risk management, however, is a process of appropriate risk measurement that recognizes the specific mix of risk factors in Islamic

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Financial Contracts. The issues of risk measurement and disclosure are central to adapting the New Basel Capital Accord (Base II) for both conventional and Islamic banks. Risk measurement is also crucial to an effective disclosure regime that can harness market forces to reinforce official supervision.

The purpose of this paper is to review selected issues in the measurement of risks in IFSIs, and consider, in particular, the implications of profit sharing investment accounts (PSIA or investment account for short) for risk measurement, risk management, capital adequacy and supervision. The paper examines, using cross section data on a sample of banks, the relationship among the returns on PSIA , the returns on bank deposits generally in the banking system, the return on assets and equity, and the level of risks. The analysis shows that in practice there is considerable smoothing of returns on investment accounts despite wide divergences in risk, and hence very little risk sharing with investment accounts. The paper proposes a specific approach to measure the actual sharing of risks between shareholders and investment accounts holders, based on value-at-risk (VAR) methodology. The main conclusions of the paper are as follows: 1) Appropriate management of PSIA, with proper measurement, control, and disclosure of the extent of risk sharing with investment accounts holders, can be a powerful risk mitigant in Islamic finance. 2) Supervisory authorities can provide strong incentives for effective overall risk management, and transparent risk sharing with PSIA, by linking the size of capital relief on account of PSIA to a supervisory review of bank policies for risk sharing, and by mandating the disclosure of risks borne by PSIA and of the displaced commercial risk borne by the shareholders, as part of the requirements for granting capital relief. The evolving standards for capital adequacy, supervisory review, and transparency and market discipline are consistent with these proposals.

Several key conclusions and policy messages can be highlighted at the outset.

- The unique mix of risks in Islamic Finance and the potential role of investment account holders in sharing some of the risks, call for a strong emphasis on proper risk measurement, and disclosure of both risks and risk management processes in IFSIs.
- Effective risk management in IFSIs (and a risk focused supervisory review process) requires that a high priority be given to proper measurement and disclosure of
    - Aggregate banking risks (to reflect the volatility of *muḍārabah* profits accruing to Investment account holders)
    - Specific types of risks (to control effectively the extent of credit, market, operational and liquidity risks)
    - Facility specific risks (to properly price individual facilities by measuring the full range of risks embedded in each facility)

- Progress in risk measurement, disclosure, and risk management will, however, require a multi-pronged effort:
  - To strengthen accounting standards and harmonize them with prudential standards;
  - To initiate a systematic data compilation process to enable proper risk measurement, including through developing central credit and equity registries suitable for Islamic finance
  - To build a robust governance and creditor/investor rights infrastructure that would foster Islamic money and capital markets—based on innovative uses of asset securitization-- as a foundation for effective on balance sheet risk management, including through transparent apportioning of risks to investment account holders.
  - To foster this transformation of investment accounts into an effective risk mitigant (in addition to collateral and guarantees) through product innovations supported by proper disclosure and reserving policies that makes transparent the extent of risk being borne by the Investment accounts, and the risk-return mix being offered.
  - To provide supervisory incentives for effective risk sharing with PSIA, by linking the capital relief on account of PSIA to the extent of actual risks shared with PSIA, and by requiring adequate disclosure of these risks as a basis for capital relief.

All this will set the stage for eventual adoption of more advanced capital measurement approaches envisaged in Basel II and their adaptations for Islamic finance as outlined in the relevant IFSB standards. The paper highlights some of the measurement issues and policy considerations in promoting effective risk sharing between owners and investment accounts holders, and proposes a value-at risk methodology for measuring and monitoring such risk sharing.

2. Background

Recent work on risk issues in Islamic finance has stressed that features of IFSIs, and the intermediation models that they follow, entail special risks that need to be recognized to help make risk management in Islamic Banking truly effective.[1] Hassan (2000) noted that the traditional approach to capital adequacy and supervision based on 1988 Basel Capital Accord – Basel I – did not adequately capture the varied risks in Islamic finance facilities. In a similar vein, recent studies in the Islamic Development Bank discuss the special risks in IFSIs (Chapra and Khan (2000) and Khan and Ahmed (2001)). These studies survey the risk

[1] In many documents, the term Institutions Offering Islamic Financial Services (IIFSs) is used rather than Islamic Financial Services Institutions (IFSIs); In this paper, the terms IFSIs, IIFSs , and Islamic Banks will be used interchangeably for convenience.

management practices of IFSIs, and note that the new Basel Capital Accord (Basel II) provides scope for proper recognition of risks in Islamic banking products – through a more risk sensitive system for risk weighting assets and stronger incentives for effective risk management. These studies also highlight a set of issues in Islamic Jurisprudence ("*fiqh*" Issues) that need to be resolved to facilitate effective supervision and risk management. Implications of risk sharing with PSIA for the governance, financial reporting and capital adequacy of Islamic Banks are discussed in Al-Deehani, Karim, and Murinde (1999) and Archer and Karim (2002, 2004). A recent World Bank study (El-Hawary and others (2004)) considered the appropriate balance of prudential supervision and market discipline in Islamic finance, and the related implications for the organization of the industry. In parallel, recent studies from the IMF focus on financial stability implications of Islamic banks (Sundararajan and Errico (2002), Marston and Sundararajan (2003), and V.Sundararajan (2004)). These studies also stress the importance of disclosure and market discipline in Islamic finance; they also note that in addition to the unique mix of risks, for a range of risks, Islamic Banks may be more vulnerable than conventional counterparts, owing in part to the inadequate financial infrastructure for Islamic Banks, including missing instruments and markets, and a weak insolvency and creditor rights regime, factors that limit effective risk mitigation.

Therefore, systemic stability in financial systems with Islamic Banks requires a multi-pronged strategy to bring about:

- Suitable regulation and disclosure framework for IFSIs;
- Robust financial system infrastructure and adequate macro-prudential surveillance in order to provide the preconditions for effective supervision and risk management; and
- Strengthened internal controls and risk management processes within IFSIs.

Accordingly a comprehensive risk-based supervision is needed for IFSIs, supported by a clear strategy to build up risk management processes at the individual institutions' level, and robust legal, governance and market infrastructure at the national and global levels. In recognition of this need, international community has established the Islamic Financial Services Board (IFSB), headquartered in Kuala, Lumpur, to foster good regulatory and supervisory practices, help develop uniform prudential standards, and support good practices in risk management. (See "IMF Facilitates Establishment of IFSB"; IMF news brief no.02/41, May, 2002. http://www.imf.org/external/mp/sec/nb/2002/nb241.htm)

IFSB has advanced the work on capital adequacy framework and risk management in IFSIs, through the issuance of draft consultative papers on these topics in 2005 (see IFSB 2005a and 2005b). In addition, work is underway (in various IFSB working groups and task forces) on corporate governance standards,

on disclosure standards to promote transparency and market discipline, on standards for supervisory review process and on additional guidelines on prudential and legal framework for Islamic banks. Recent discussions coordinated by the IFSB have again reinforced the importance of building a robust financial infrastructure for Islamic finance -- which constitutes the precondition – to support the sound functioning and effective supervision of Islamic Banks[2].

In particular, the effective supervision of Islamic Banks requires that the three - pillar framework of Basel II and the language of risks it introduces be adapted appropriately to its operational characteristics. Such adoption of Basel II would require a medium term effort involving: i) Strengthening existing supervisory framework to achieve full compliance with Basel Core Principles of Banking Supervision. (ii) Developing appropriate risk measurement and disclosure procedures supported by systematic efforts to build up data bases needed for risk measurement; (iii) in parallel, building up the core elements of financial infrastructure and risk management instruments to support sound development of Islamic finance. This will set the stage for adopting more advanced capital measurement approaches as envisaged in Basel II, but tailored to the specific operational characteristics of Islamic finance, including the role of investment accounts. Key issues in measurement and monitoring of specific risks in Islamic finance are first reviewed before considering disclosure and supervision issues

3. Measuring Risks in Islamic Finance

3.1. *Muḍārabah* Risk

The way risks are shared between investment account holders who invest on a *muḍārabah* basis, and the bank as a *muḍārib*, plays a crucial role in Islamic finance. The share of unrestricted investment accounts in the total deposits of Islamic Banks varies considerably from near zero (holding only demand and savings deposits) to over 80% in some banks (Appendix 1: Table 2). The implications of such profit & loss sharing deposits for risk measurement, disclosures, and bank governance generally has been a topic of several studies (See Clode Michael (2000) and AAOIFI (1999) and Archer and Karim (2004)). In this section, we will highlight specific risk measurement issues that need to be addressed in monitoring risk-return trade off in investment deposits. The focus is on the financial risks faced by the unrestricted investment accounts; for restricted investment accounts, the risks for banks & depositors are those attributable to the specific assets to which the investment account returns are linked, and the risk measurement issues discussed in this paper can be readily applied to the relevant asset portfolio. Both restricted and unrestricted investment account holders also face fiduciary risks—risks of negligence and misconduct—reflected in the quality

[2] See papers presented at the seminar on 10-year Master Plan for Islamic Financial Services Industry held in Putrajaya Malaysia, May 2005.

of internal controls, corporate governance, and risk management processes of the IFSIs acting as *muḍārib*.

In its most general form, risk is uncertainty associated with a future outcome or event. To an investment account holder in an Islamic bank the risk is the expected variance in the measure of profits that is shared with the depositor. This variance could arise from variety of both systemic and idiosyncratic (i.e. Bank specific) factors. Actual risk in the investment account is dampened in practice by profit equalization reserves (PER) and by variations in *muḍārib's* share. Such reserves are used to reduce or eliminate the variability of return on investment deposits, to redistribute income over time, and offer returns that are aligned to market rates of return on conventional deposits or other benchmarks. In addition, banks may use investment risk reserves to redistribute over time the incomes accrued to the investment accounts. Nevertheless, from an investor's point of view, the true risk of *muḍārabah* investment in a bank can be measured by a simple Profit – at - Risk (PAR) measure. For example, standard deviation of the monthly profit as a percentage of assets, σ_p, provides the basis for a simplest measure of risks of holding an investment account.

From a monthly time series of *muḍārabah* profits (as a share of assets), its variance (and the standard deviation σ_p) can be calculated, and assuming normality, Profit at Risk can be calculated as

$$PAR = Z_\alpha \, \sigma_p \, \sqrt{T}$$

where Z_α = is the constant that gives the appropriate one-tailed confidence interval with a probability of 1-α for the standard normal distribution (e.g. $Z_{.01}$ = 2.33 for 99% confidence interval).

T = holding period or maturity of investment account as a fraction of month.

Such aggregate PAR for a bank as a whole provides a first cut estimate of risks in unrestricted *muḍārabah* accounts. Such risk calculations could also be applied to individual business units within the bank (also for specific portfolios linked to restricted investment deposits). In addition, if specific risk factors that affect the variation in *muḍārabah* profits can be identified, this σ_p can be decomposed further in order to estimate the impact of individual risk factors, and this would help refine the PAR calculation. In practice, however, profit equalization reserves (PER) and investment risk reserves are actively used by IFSIs to smooth the return on investment accounts. As a result, risks in investment accounts are absorbed, in part, by banks themselves, insofar as profit equalization reserves is strongly positively correlated with net return on assets (gross return on assets minus provisions for loan losses), -- i.e. PER is raised or lowered when the return on assets rises or falls, and hence the investment accounts are insulated from both gains and losses. Banks can also adjust their share of profits to maintain adequate returns to shareholders. Such absorption of risks by bank capital is referred to as "displaced commercial risk" by AAOIFI (1999). The correlation between PER and the asset return could,

therefore, be viewed as an indicator of "displaced commercial risk". Thus, the precise relationship between the risk to investment account holders and the aggregate risk for the bank as a whole arising from the variability of net return on assets (gross return net of specific provisions) depends upon the policies toward profit equalization reserves, investment risk reserves, and *muḍārib*'*s* share. These policies determine, in effect, the extent of risk sharing between investment accounts and bank capital. These relationships and an empirical analysis of the determinants of return on investment accounts (RIA) are presented in Appendix 2, and further discussed in section 4.

Against this background, the true risks borne by investment account holders can be made transparent by disclosing the definition of *muḍārabah* profits, the level and variations in these profits and in profit equalization reserves, as well as policies toward establishing PER that will determine its variance as well as its correlation with the asset return. At the same time, transparency of internal controls and governance arrangements, including risk management processes, would also be important to provide assurances of integrity of IFSIs as a *muḍārib*. The measurement of such fiduciary risk could be subsumed under operational risk measurement discussed in section 3.6 below. For a discussion of appropriate practices in defining *muḍārabah* profits, see AAOIFI, Financial Accounting Standard No.6, and the Framework of the Rate of Return (October 2001, and revised 2004) issued by the Bank Negara Malaysia. For examples of estimation of such earnings and profits-at -risk measures for Islamic Banks, see Hakim (2003) and Hassan (2003).

3.2 Credit Risks in Sales Based Contract

Murābaḥah and other sales based facilities (*istiṣnāʿ*, *ijārah*, *salam*, etc.,) dominate the asset side of Islamic banks, ranging from 80% to 100% of total facilities. Equity type facilities still constitute a negligible proportion of assets in most banks. Thus, credit risk – the losses in the event of default of the borrower or in the event of a deterioration of borrower's repayment capacity – is the most dominant source of risks in an Islamic Bank as in conventional banks. The method of measurement of credit risks in conventional banks apply equally well to Islamic banks, with some allowance required to recognize the specific operational characteristics and risk sharing conventions of Islamic Financial Contracts.

Credit risk can be measured based on both the traditional approach that assigns each counter party into a rating class (each rating corresponds to a probability of default) as well as more advanced credit value-at-risk (Credit VAR) methods discussed later in the section. The basic measurement principle under both these approaches is to estimate the expected loss on an exposure (or a portfolio of exposures) owing to specified credit events (default, rating downgrade, some non-performance of specified covenant in the contract etc…) and also, to calibrate unexpected losses (deviations from the mean) that might occur at some probability level. Expected losses are provisioned and regarded as an expense that is deducted

from income, while unexpected losses (up to a tolerance level) are backed up by capital allocation. The risk weights attached to various exposures on the bank's asset side (in the New Basel Capital Accord, for example) in effect represent the banks' or supervisor's Judgement on the unexpected losses on the exposures that should be absorbed by capital. The calculation of loss – both expected and unexpected – in an individual loan will require estimates of:

- Probability of default (or probabilities of rating down grades from one rating class to another);
- Potential credit exposures at default (or at the time of rating transition);
- Loss given default (or reduction in the value of the asset following a rating transition).

Proper measurement of these three components of credit risk, and calculating unexpected losses are the fundamental requirements of the New Basel Capital Accord (Basel II). Measurement of these components for the case of sales-based contracts – *murābaḥah* and *salam* – is discussed below.

The default could be defined in the same way as for conventional Banks, based on financial condition of the borrower and the number of days the contract is overdue.[3] Estimation of the probability of default is traditionally based on ex-ante assignment of ratings to counterparty exposures or a portfolio of exposures of a particular variety (such as all commodity *murābaḥas* for a class of goods). A modern approach that can be used for larger listed companies is based on market information on equity prices. Observed market value of firm's equity and estimated volatility of equity prices can be used to estimate the likelihood of default using the option pricing approach to bankruptcy prediction.[4] In practice various methods can be combined during the risk management process in order to arrive at a credit rating and the associated probability of default based on historical experience. The estimation of probabilities – or correct assignment of ratings – will however require historical data on loan structure and performance, borrower characteristics and on broader industry and macroeconomic environment; and thus the ratings will change over time as financial conditions and environment changes.

Losses will clearly depend upon the potential credit exposures at the time of default (exposure at default (EAD)). In general, exposure at default would be facility specific, depending upon the extent of discretion that the borrower can exercise in drawing down lines of credit, prepaying already drawn accounts, or any specific events that affect the value of contingent claims (e.g., guarantees to third parties). In *murābaḥah*, and *salam* contracts, exposure at default in most cases would simply be the nominal value of the contract. In long-term *ijārah*, and *istiṣnā*ʿ

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[3] Basel II definition (para 452).
[4] For a survey of new approaches to credit risk measurement and an overview of traditional methods see Saunders(2001).

contracts, EAD will depend upon projected environmental factors that will be facility specific.

Losses will ultimately depend upon the rate of recovery following default, or in a mark to market model, the reduction in the value of the loan if ratings change. Loss given default (one minus recovery rate times exposure at default) is likely to depend upon ease of collecting on the collateral, value of the collateral, enforceability of guarantees if any, and most importantly on the legal environment that determines creditors' rights and the features of insolvency regime. For example, the juristic rules for *murābaḥah* imply that "in case of insolvency, creditor should defer collection of the debt until he becomes solvent".[5] The precise interpretation of such considerations would determine the length of time needed to recover overdue debt. In addition, there could be additional legal risks owing to difficulties in enforcing Islamic Finance contracts in certain legal environments.[6] Moreover, the inability of Islamic Banks to use penalty rates as a deterrent against late payments could create both higher risk of default and longer delays in repayments.[7] Finally, the limitations on eligible collateral under Islamic Finance – or excessive reliance on commodities and cash collateral – may exacerbate market and interest rate risks generally, and reduce the potential recovery value of the loan if commodity collateral proves too volatile in value. For these reasons, loss given default (LGD) in *murābaḥah* facilities could be different, probably higher, than in conventional banks, thereby affecting size of losses and capital at risk.

Given the estimates on probability of default, or probabilities of transition from one rating class to another (Transition Matrix), and the estimated loss given default (or change in value of loan for any given transition from one rating class to another), the expected and unexpected losses can be readily computed. For example, in the Default Model, expected loss is given by:

Expected Loss = P x LGD x Exposure

Where P is probability of default and LGD is expressed as a proportion of exposure. The unexpected loss can be calculated based on assumptions on the distribution of default and recoveries. Assuming that LGD is fixed, and that borrowers either default or do not default, the default rate is binomially distributed, and the standard deviation of default rate is:

$$\sigma = \sqrt{P(1-P)}$$

Therefore, a measure of unexpected loss on the loan is:

Unexpected loss = $Z_a \sqrt{P(1-P)}$ x LGD x Exposure.

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[5] AAOIFI (2001), Financial Accounting Standard Number 2, Appendix B.
[6] Djojosugito (2003).
[7] Chapra and Khan (2000)

Z_α above is a multiple (for example, a normal deviate) that limits the probability of unexpected losses to a specified probability level. This is the value-at-risk for this credit facility, representing the amount of capital needed to cover the unexpected loss in this exposure. In the case of Mark to Market Model, the calculation of expected loss and unexpected loss takes into account the prospects for both upgrades as well as downgrades of the loan, and considers the change in value of the loan for each possible change in the rating of a facility from its current level, and the corresponding probability of rating transition.[8]

While similar considerations apply in the case of *salam* contracts for calculating counter party credit risk, there is an additional commodity price risk embedded in these contracts that should be added to the credit risk. The commodity price risk will arise even when the counter party does not default, and when there is default (e.g. Delivery of substandard good, or delayed delivery of good, etc) the commodity price risk- taking into account any offsetting parallel Salem positions- could be included as part of the loss given default. Thus potential loss in a *salam* contract is the sum of loss due to credit risk, and the loss due to commodity price risk when there is no credit risk. In addition there could be a correlation between these two types of risks (for example due to common factors such as draught that could affect both commodity price risk and counter-party credit risk), which is ignored for the time being for simplicity. In the absence of liquid commodity markets as well as Sharīʿah--compatible hedging products to mitigate price risks, commodity price risk can be measured by calculating the value-at-risk of commodity exposures in different maturity buckets using historic data on prices. While commodity exposures can be treated as part of market risk measurement for capital allocation purposes, it is important to compute this market risk separately for each *salam* contract or for a portfolio of *salam* contracts and add it to the credit risk so that the full risk in each contract (or portfolio of contracts) can be properly measured and taken into account in the pricing the contract (or the facility). Also, the estimated commodity price risk should be regularly monitored as price volatility could change over time due to shifts in macroeconomic and market – specific conditions.

Finally, credit risk of a portfolio of exposures and facilities could be lower or higher depending upon the extent of diversification or concentration in specific credit categories. The credit risk measurement can take into account the benefits of diversification by computing the joint distribution of default events based on correlations between different classes and segments of the portfolio i.e. correlations between defaults among counterparties and joint probability of default of any pair or group of counterparties can be estimated. This can form the basis for valuing the loan portfolio and computing the expected loss in the loan portfolio as a whole, based on the joint distribution of components of the portfolio. In some models, default rates and transition probabilities can be made a function of macroeconomic

[8] See Wilson (1998), and Caouette, Altman, and Narayanan (1999) for detailed illustration.

variables. The probability distribution of gains and losses of the loan portfolio, or the loan facility can then be used to compute both expected and unexpected losses (at a given probability level). In case of loans to a diversified group of individuals and small businesses, with standard instalments and commodity leases, supervisors and banks might treat the class of loans as a retail exposure with smaller risk weight (reflecting lower Value-at-Risk due to diversification effects). At the same time credit concentrations by sectors and rating classes should be monitored as alternative indicators of credit risk.

3.3 Equity Risks in *Muḍārabah* and *Mushārakah* Facilities

These are equity type facilities, typically a very small share of total assets in part reflecting the significant investment risks that they carry. In a sample of Islamic banks, the share of *muḍārabah* and *mushārakah* facilities and traded equities varied from 0% to 24%, with a median share of about 3%. The possible unexpected losses in such equity type contracts will depend upon the functions of the underlying enterprise in which bank acquires equity exposure[9]. In an enterprise that trades in commodities of foreign exchange, the equity position risk and is from the risk of underlay transitions by the enterprise. A measure of the potential loss in equity exposures that are not traded can be derived based on the standard recommended in Basel II (paragraph 350). For the net equity exposures in other types of business, the loss can be estimated by using the probability of default corresponding to a debt exposure to the counterparties whose equity is being held, and applying a fairly high loss given default such as 90 % to reflect the equity risks. A measure of both expected and unexpected loss (UL) could then be computed from these parameters. In addition, *muḍārabah* facility may need to be assigned an additional UL due to operational risk factors, with the extent of operational risk adjustment depending on the quality of internal control systems to monitor *muḍārabah* facilities on the asset side. High quality monitoring would be very important in Islamic banks, since the finance provider cannot interfere in the management of the project funded on *muḍārabah* basis. In the case of *mushārakah*, the need for operational risk adjustment may be less, insofar as the bank exercises some management control. If the banks' equity interest in a counter party is based on regular cash flow and not capital gains, and is of long-term nature linked to customer relationship, a different supervisory treatment, and a lower LGD could be used. If, however, equity interest is relatively short term, relies on capital gains (e.g. traded equity), a VAR approach, subject to a minimum risk weight of 300 % could be used to measure capital at risk (as proposed in Basel II).

3.4 Market Risks and Rate of Return Risks

The techniques of market risk measurement in the trading books of Islamic Banks should be broadly identical to those in conventional banks. The trading book, in Islamic Banks, however, is likely to be limited, to traded equities,

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[9] IFSB 2005_b

commodities, foreign exchange positions, and increasingly various forms of *ṣukūks*. A large share of assets of Islamic Banks also consist of cash and other liquid assets, with such short-term assets typically exceeding short-term liabilities by a large margin, in part reflecting limited availability Sharīʿah compatible money market instruments. Against this background, exposure to various forms of market risk can be measured by the traditional exposure indicators such as:

- Net open position in foreign exchange;
- Net position in traded equities;
- Net position in commodities;
- Rate-of-return gap measures by currency of denomination;
- Various duration measures of assets and liabilities in the trading book.

Most Islamic Banks compute and often disclose liquidity gap measures – gap between assets and liabilities at various maturity buckets – and hence the computation of rate–of–return or re pricing gap should be fairly straightforward. More accurate duration gap measures may also be available in some banks.[10] Impact on earnings of a change in exchange rate, equity price, commodity price, or rates of return can be directly obtained by multiplying the appropriate gap or other exposure indicators by the corresponding price change. Such a simple approach will not, however, suffice for computing the impact of changes in interest rates on equity type exposures of fixed maturity (such as *muḍārabah* and *mushārakah*). The impact of changes in the rates of return on the expected rate of profits (i.e. *muḍārabah* and *mushārakah* income) would need to be first computed, or equivalently the equity exposures should be adjusted by a multiplicative factor (that a supervisor can specify) before computing gaps in each maturity bucket.

Such gap measures may not, however, capture the maximum losses that could occur (at some probability level), particularly in Islamic Banks. They do not properly recognize other market related risks arising from changes in spread over benchmark rates, or twists in the yield curve, or shifts in market volatility, which could affect potential losses. For these reasons, market risk is commonly measured by various value-at-risk (VAR) measures. This is particularly important, given the likely importance of equities and commodities in Islamic Bank balance sheets, which have potential to cause large losses. For example, for both equities and commodities, VAR based on 99 % confidence level (one-sided confidence interval)) could be computed. VAR could be based on quarterly equity returns

[10] For a discussion of gap and duration measures and their availability in banking statistics, see Compilation Guide for Financial Soundness Indicators IMF (2004). Duration measures are important indicators of financial soundness, but they are not readily available in many banking systems. See Baldwin (2002) for a discussion of duration measures in the context of Islamic Banking.

(*muḍārabah* or *mushārakah* profit rate) net of a risk free rate, or quarterly or monthly changes in commodity prices.

In most Islamic Banks, the rate-of-return risk in the banking book is likely to be much more important than market risk in the trading book[11]. The rate-of-return gap and duration gap applied to the banking book would provide measures of exposures to changes in benchmark rates of return, and the impact of these changes on the present value of bank earnings. For example, a simple stress test of applying a 1 % point increase in rates of return on both assets and liabilities maturing/ or being reprised/ at various maturity buckets would yield a measure of potential loss (or gain) due to a uniform shift in term structure of rate of return.

Alternatively, the impact on present value of earnings of shifts in rate of return can be calculated directly from duration measures:

Impact of change in rate of return = $(D_A - D_L)\ \Delta\ i_r$

Where: D_A = duration of assets

D_L = duration of funding
$\Delta\ i_r$ = change in rate of return

Another important source of risk is the possible loss due to a change in the margin between domestic rates of return and the benchmark rates of return (such as LIBOR), which may not be closely linked to the domestic return. Many Islamic banks use an external benchmark such as LIBOR to price the mark-up in *murābaḥah* contracts, in part reflecting the lack of reliable domestic benchmark rate of return. If domestic monetary conditions change requiring adjustments in returns on deposits and loans, but the margin between external benchmark and domestic rates of return shift, there could be an impact on asset returns. This is a form of “Basis risk” that should be taken into account in computing the rate-of-return risk in the banking book (and also market risks). Existence of this basis risk highlights the importance of developing a domestic rate-of-return benchmark so that both deposits & assets can be aligned to similar bench marks.

3.5 Liquidity Risk

This risk is interpreted in numerous ways such as extreme liquidity, availability of liquid assets to meet liabilities, and the ability to raise funds at normal cost. This is a significant risk in Islamic Banks, owing to the limited availability of Sharīʿah compatible money market instruments and LOLR facilities. Standard measure of liquidity risk is the liquidity gap for each maturity bucket and in each currency. The share of liquid assets to total assets or to liquid liabilities is also a commonly

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[11] In principle, in the presence of profit sharing and loss bearing IAH, the changes in asset returns due to changes in benchmark market rate of return would be offset by corresponding shifts in the returns payable to IAH. In practice, due to return smoothing, risk of losses due to changes in market rate of returns would remain significant.

used measure. While the availability of core deposits which are rolled over, and not volatile, provides a significant cushion for most Islamic Banks, the remaining volatile deposits cannot be readily matched with short-term liquid assets, other than cash and other low-yielding assets;

In addition, specific aspects of Islamic contracts could increase the potential for liquidity problems in Islamic Banks. These factors include: cancellation risks in *murābaḥah*, the Sharīʿah requirement to sell *murābaḥah* contracts only at par thereby limiting the scope for secondary markets for sale based contracts, the illiquidity of commodity markets, and prohibition of secondary trading of *salam* or *istiṣnāʿ* contracts (See Syed Ali 2004).

3.6 Operational Risk

This is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputation risk".[12] Such risks are likely to be significant in Islamic Banks due to specific contractual features and the general legal environment. Specific aspects that could raise operational risks in Islamic banks include the following: (1) The cancellation risks in non binding *murābaḥah* and *istiṣnāʿ* contracts, (2) problems in internal control systems to detect and manage potential problems in operational processes and back office functions, (3) technical risks of various sorts, (4) the potential difficulties in enforcing Islamic Finance contracts in a broader legal environment, (5) the risk of non-compliance with Sharīʿah requirements that may impact on permissible income, (6) the need to maintain and manage commodity inventories often in illiquid markets, and (7) the potential costs and risks in monitoring equity type contracts and the associated legal risks. In addition, increasing use of structured finance transactions–specifically, securitization of loans originated by banks to manage risks on the asset side–could expose banks to additional legal risks.

The three methods of measuring operational risks proposed in Basel II would need considerable adaptations in Islamic Banks owing to the specificities noted earlier. The use of gross income as the basic indicator for operational risk measurement could be misleading in Islamic Banks, insofar as large volume of transactions in commodities, and the use of structured finance raise operational exposures that will not be captured by gross income. In contrast, the standardized approach that allows for different business lines would be better suited, but would still need adaptation to the needs of Islamic Banks. In particular, agency services under *muḍārabah*, the associated risks due to potential misconduct and negligence, and operational risks in commodity inventory management, all need to be explicitly considered for operational risk measurement.

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[12] Basel II, paragraph 644.

4. Overall Risk of an Islamic Bank and Approaches to Risk Mitigation

Potential losses due to each category of risk could be quantified and aggregated to derive the total impact of the different risks, and examine the adequacy of capital to absorb the risks. However, it is unlikely that the unexpected losses will exceed their upper bounds at the same time for different types of risk, and the arithmetic total of individual risks will be an overestimate of the aggregate VAR for the bank as a whole. Such an aggregate VAR is, however, important for informing investment account holders of Islamic Banks, who are expected to share in the overall risks. An overall risk measure could be obtained from historical distribution of earnings, and calculating earnings volatility, as already discussed.

A key issue for Islamic Banks is to manage the risk sharing properties of Investment Account- both restricted and unrestricted- in order to mitigate some of the risks to share holders. Thus, in addition to collateral, guarantees, and other traditional risk-mitigants, the management of risk-return mix, particularly of unrestricted investment account holders, could be used as a key tool of risk management. Appropriate policies toward profit equalization reserves (and possibly investment risk reserves) coupled with appropriate pricing of investment accounts to match the underlying risks, would improve the extent of overall risk sharing by these accounts. Under current practices, reserves are passively adjusted to provide a stable return to investment account holders, effectively not allowing any risk mitigation through investment account management. For example, many banks with sharply divergent risk profiles and return on assets, seem to be offering almost identical returns to investment account holders, that is broadly in line with the general rate of return on deposits in conventional banks. These relationships are analyzed empirically using data from a sample of 14 Islamic Banks in 8 countries (and for two time periods for each bank). A simple correlation analysis of data on net return on assets (RA-SP), return on equity (RE), return to investment accounts (RIA), general market return on deposits, and capital to asset ratio, suggests that (see Charts 1, 2, 3, and 4, Appendix 2):

- Return on investment accounts is uncorrelated with net return on assets, as well as with return on equity, in contrast to a positive & significant relationship that would be expected if the return on assets were shared between investment accounts and bank owners, without adjustments in various reserves.
- Return on investment accounts is significantly positively correlated with general market return on deposits, suggesting significant reliance on profit equalization reserves (and investment risk reserves) in order to align the returns on investment accounts with market rates.
- Return on equity is strongly positively correlated with net return on assets.

- Multiple regression analysis of return on investment accounts and its determinants (Appendix 1: Table 1) shows that return on investment accounts is significantly and positively related to market return on deposits, even after taking into account any sharing of returns with equity holders. Surprisingly, however, a higher (or lower) net return on assets, for any given level of deposit rates and capital asset ratios, seems to reduce (increase) the return on investment accounts, with the change in the asset returns being absorbed by adjustments in the return on equity.

Thus evidence is consistent with a significant amount of return smoothing, and a significant absorption of risks by bank capital (and thus, only a limited sharing of risks with investment accounts). This raises a broader issue of how best to measure empirically the extent of risk sharing between unrestricted investment accounts and bank capital. A specific framework for such measurement, based on Value-at Risk (VAR) methodology is suggested in the Appendix 2 to this paper.

Effective investment account management would, however, require disclosure of overall risks facing these account holders (and share holders), and offering them a range of products with different risk-return combinations. This in turn would require more active management of assets, with greater reliance on securitizing asset side positions originated by banks, and trading of these securitized assets in the market to match the risk and maturity profile of assets with risk and maturity profile of liabilities. Such on-balance-sheet risk management based on securitization would seem a more feasible alternative for Islamic Banks than the use of derivatives and other more standard off-balance-sheet risk management tools that are available for conventional banks. This is because, Sharīʿah compatible futures, options, and swap markets are not yet available, and could take time to develop. Thus new product innovations, based on innovative uses of Islamic asset securitization, would facilitate development of products with specific risk return combinations for restricted investment accounts and better control of the risks in unrestricted investment accounts.

Another challenging issue for Islamic Banks is to recognize the specific bundling of risks in individual facilities, and the associated correlation among risks, and price the risks for each facility in a centralized and integrated manner. For example, *murābaḥah* and *salam* facilities will have a mix of operational risk, credit risk, and commodity price risk, and these should be estimated and aggregated at the facility level in order to price the facility accurately. Aggregation of all different risks by type of risks is, in any case, important for ensuring adequacy of capital and effective control of different types of risks.

5. Disclosure Regime For Islamic Banks

Discussion above suggests that for IFSIs, both aggregate measures of Value-at-Risk for banking organization as a whole, as well as measures of specific types of risks need to be measured and disclosed. For comparison, Appendix 1: Table 2

provides a summary of current disclosure practices of a sample of 15 Islamic Banks, based on the published annual reports.

The disclosure practices of Islamic Banks are highly varied, and Supervisor's authority to impose disclosure norms is also highly varied. Nevertheless, the AAOIFI Financial Accounting Standards (FAS) – in particular FAS No. 1, which establishes the content of financial statements to be published – provide a sound basis for further developing prudential disclosures. Such further development should have two key purposes:

- Develop consumer-friendly disclosures to inform investment account holders on the inherent overall risks that they face, and the related reserving policies.
- Develop market-oriented disclosures to inform public at large, particularly other professional counterparties, including regulators (who will require more details, not publicly disclosed) on capital, risk exposures and capital adequacy, along the lines of Pillar III of Based II.

The current AAOIFI standards, and the supervisory disclosure rules do not cover the quantitative risk measures of the type discussed in Section III. Development of new disclosure standards particularly on credit risk and equity risk exposures would, however, require significant further development of databases to calculate the underlying parameters, such as PD, LGD and EAD, and VAR measures at both aggregate and disaggregated levels. While data for market risks can be built over time by individual banks, data bases needed for credit risk measures can however, benefit from cooperative approaches among Islamic Banks.

6. Summary and Policy Conclusions

Application of modern approaches to risk measurements, particularly for credit risk and overall banking risks is important in Islamic Finance for at least four reasons:

- To properly recognize the unique mix of risks in Islamic Finance contracts;
- To ensure proper pricing of Islamic Finance facilities, including returns offered to investment account holders;
- To manage and control various types of risks;
- To ensure adequacy of capital and its effective allocation, according to the risk profile of the IFSI.

The preliminary review of current state of financial reporting and disclosure in IFSI's suggest, that systematic future efforts at data compilation would be needed particularly to measure credit and equity risks with some of accuracy. The situation is similar for many conventional banks, but the need to adapt new measurement approaches is particularly critical for Islamic Banks because of the role investment

account holders play, the unique mix of risks in Islamic finance contracts, and the need to more actively use security markets and securitization products for risk management. For these reasons, rapid progress in consumer friendly disclosures to inform investment account holders of the risk-return mix they face, and market-oriented disclosures to inform markets of capital adequacy, risk exposures and risk management, are important.

In addition, managing the risk-sharing property of investment accounts through proper pricing, reserving, and disclosure policies would greatly enhance risk management in Islamic Finance. This requires measurement and disclosure of aggregate value at risk of *muḍārabah* income in the consolidated balance sheet of IFSIs, and greater use of asset securitization in order to offer assets of specific risk return characteristics to investment account holders. Also a measure of the extent to which the risks to share holders are reduced on account of risk sharing with investment account holders should be the basis of any capital relief or lower risk weights on the assets funded by investment accounts. For example, the proposed capital adequacy standard for Islamic banks (IFSB 2005b) calls for supervisory discretion in determining the share "α" of risk-weighted assets funded by PSIA that can be deducted from the total risk-weighted assets for the purpose of assessing capital adequacy. This share "α" represents the extent of total risk assumed by the PSIA, with the remainder absorbed by the shareholders on account of displaced commercial risk.

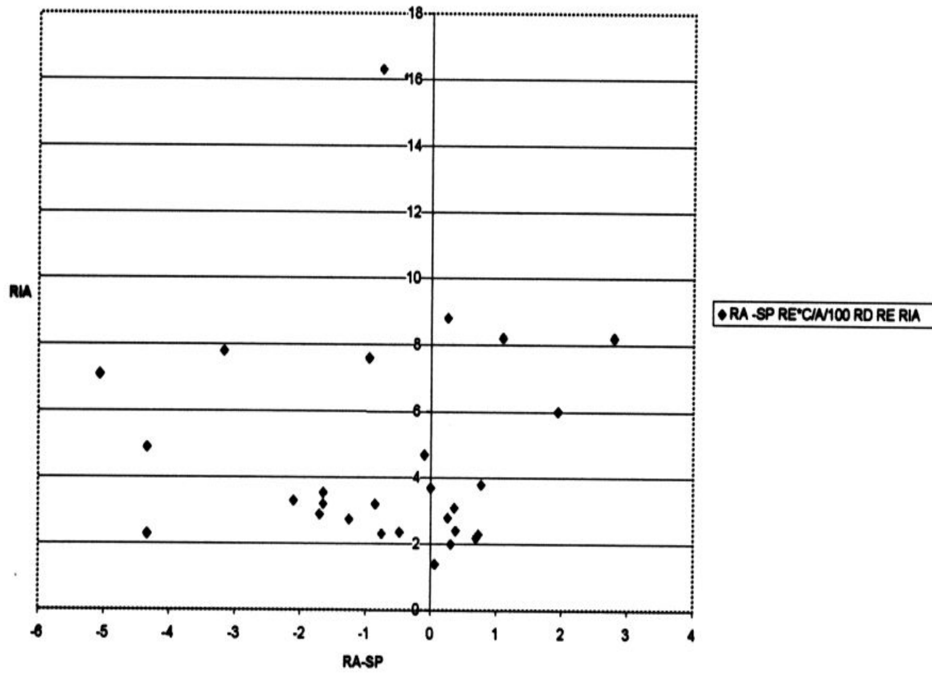
These observations suggest several policy and operational considerations and proposals:

- Appropriate measurement of credit and equity risks in various Islamic Finance facilities can benefit from systematic data collection efforts, including by establishing credit (and equity) registries.
- IFSIs would require both centralized and integrated risk management that helps control different types of risks while allowing disaggregated risk measurements to price specific contracts and facilities, including the risk-return mix offered to investment account holders. This integrated approach to risks would need to be supported by appropriate regulatory coordination and cooperation among banking, securities and insurance supervisors.
- Disclosure regime for IFSIs needs to become more comprehensive and transparent, with a focus on disclosures of risk profile, risk-return mix and internal governance. This requires coordination of supervisory disclosure rules and accounting standards, and proper differentiation between consumer friendly disclosures to assist investment account holders, and market-oriented disclosures to inform markets.
- Supervisory review process should monitor and recognize the actual extent of risk sharing by investment account holders in assessing capital adequacy, and thereby encourage more effective and transparent risk

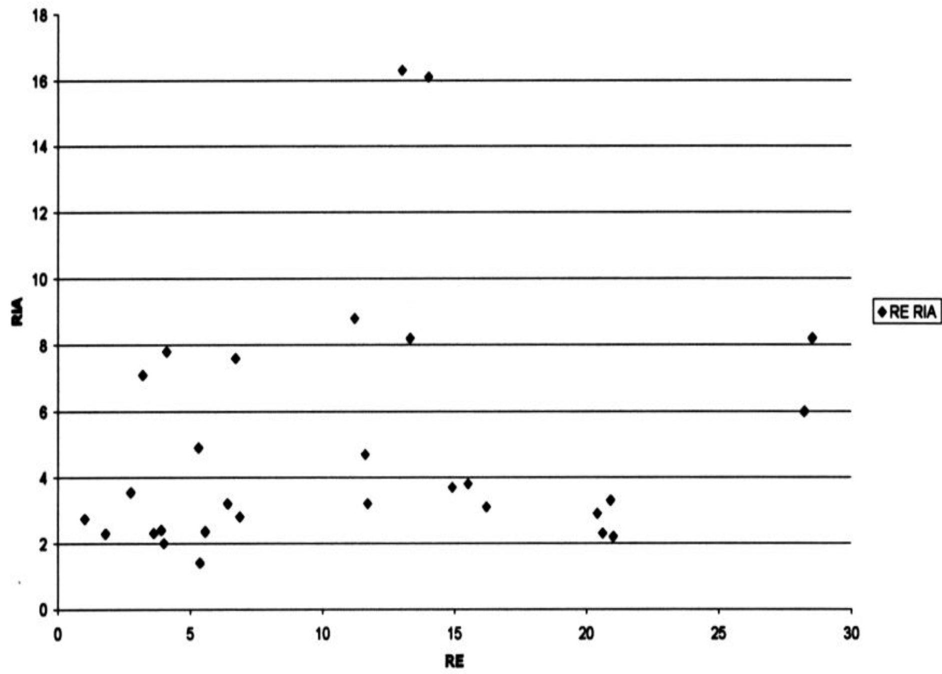
sharing with investment account holders. Disclosure of risks borne by PSIA and shareholders should be a requirement for granting capital relief on account of PSIA. The measurement of these risks, and estimation of appropriate capital relief can be based on VAR methodology as discussed in the Appendix 2.

Appendix 1

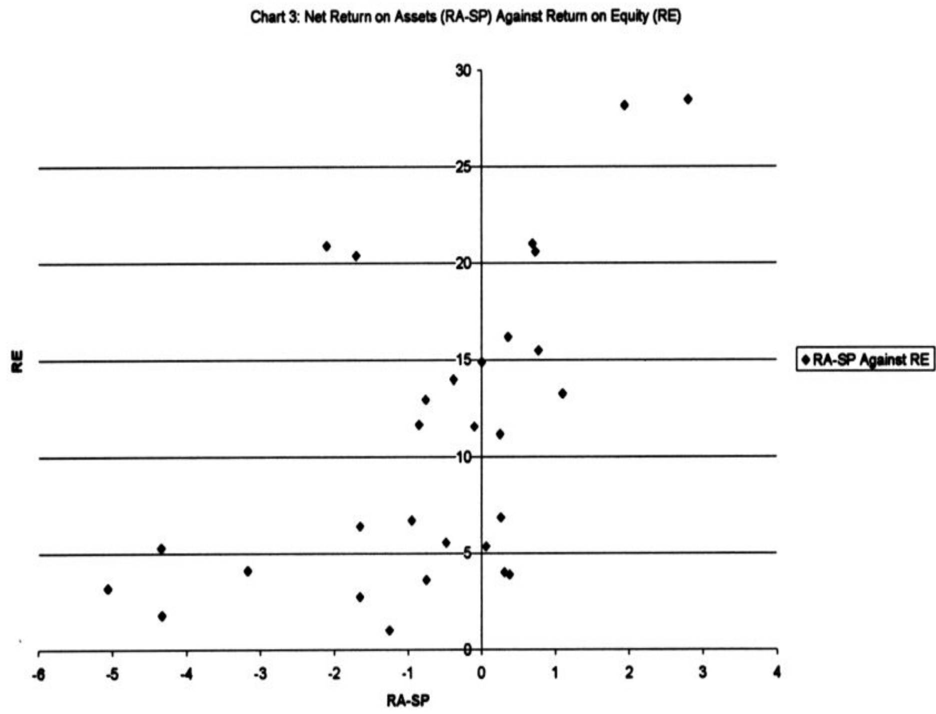
Chart 1: Net Return on Assets (RA -SP) Against Return on Investment Accounts (RIA)



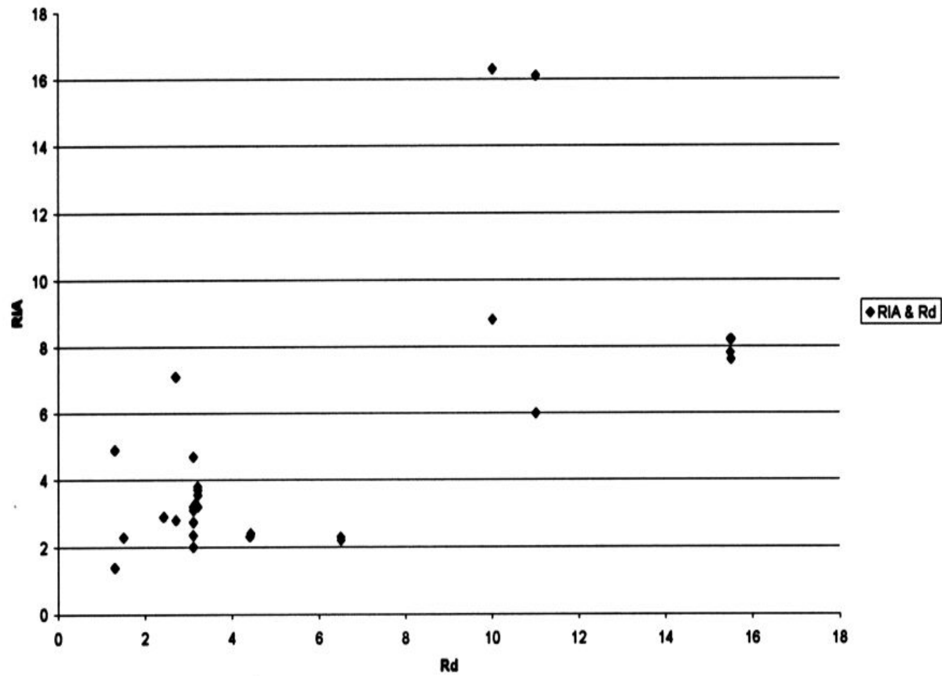
Note: Correlation Coefficient = 0.0251, not significantly different from zero.



Note: Correlation Coefficient = 0.179, not significantly different from zero.



Note: Correlation Coefficient = 0.580, significantly different from zero.



Note: Correlation Coefficient = 0.654, significantly different from zero. With t-statistics of 4.487; An in crease in market deposit rate of 1 percentage point leads to an increase in investment account return of 0.5 percentage points.

Table 1: Determinants of Return on Investment Accounts (Standard Error in Parenthesis)

1. $RIA = 2.67 - 0.13(R_A\text{-}S_P) + 0.14\ Re + 0.09\ C/A$
   (1.94) (0.52) (0.12) (0.10)
   ADJ. R^2 =-0.0441, SEE = 3.88

2. $RIA = 1.80 - 1.10(R_A\text{-}S_P) - 0.05\ Re + 0.84\ Rd - 0.26\ C/A$
   (1.29) (0.38) (0.08) (0.15) (0.09)
   ADJ. R^2 = 0.5463, SEE = 2.55

3. $RIA = 0.67 - 0.59(R_A\text{-}S_P) + 0.05\ Re + 0.57\ Rd$
   (1.38) (0.38) (0.09) (0.13)
   ADJ. R^2 = 0.4177, SEE = 2.90

4. $RIA = 1.28 - 1.15(R_A\text{-}S_P) + 0.814Rd - 0.24\ C/A$
   (0.86) (0.36) (0.13) (0.08)
   ADJ. R^2 = 0.5590, SEE = 2.52

5. $RIA = 1.21 - 0.48(R_A\text{-}S_P) + 0.584\ Rd$
   (0.98) (0.32) (0.12)
   ADJ. R^2 = 0.4332, SEE = 2.8592

Note: Ordinary Least Square (OLS) Regression based on data for 14 Islamic Banks in 8 Countries, for two time periods, yielding total of 28 observations. Insofar as RIA and RE are jointly determined, OLS will not yield consistent estimates. Alternative estimation methods using Instrumental Variables will be used when data set is expanded to include other exogenous variables and additional observations.

Table 2: Disclosure Practices of Islamic Banks

Items of Disclosure	Comments
Risk management framework and practices	Disclosures are presented at a very general level, occasionally mentioned the existence of specific committees, such as ALM committee
Classification of facilities by asset quality, and data on NPLs	All banks disclose classification of facilities by supervisory categories such as current, substandard etc. Only some banks (30%) disclose NPLs. Only one bank mentioned the use of internal rating system.
Specific provisions	Most banks (94%) disclose this as a total, Provisions as % of assets varied from less than 1% to 6%. Only some banks (30%) disclose provisions classified by facilities.
Sectoral distribution of credit, and connected exposures	Many banks (66%) disclose this
Large exposures	Very few banks (6%) disclose this
Capital adequacy	All banks disclose capital asset ratios – ranging from 2.5% to 38.4%; while many (66%) disclose regulatory capital to risk weighted assets
Value-At Risk (VAR)	None disclose this; One bank reported using VAR.
Liquidity ratios	All banks disclose various liquid asset ratios. Ratio of liquid assets to short term liabilities ranged from 13% to 144%.
Maturity Gap	Many banks (64%) disclose gaps at various maturity buckets
Deposit composition: Share of Investment deposits to total deposits	Generally disclosed, ranging from 0% to 95%, and averaging 80%, with some banks (36%) reporting no investment deposits
Composition of facilities: Share of equity type assets to total assets	Generally disclosed. Share of equity, varied from less than 1% to about 23%, with significant year to year change in some banks
Return on Assets	Generally disclosed; large variation from 0.5% to 4.3%

Items of Disclosure	Comments
Return on Equity	Generally disclosed; Large variation from 0.7% to 58%
Return on unrestricted Investment deposits	All banks disclose this, with returns ranging from 1.45% to 16.35%, depending on country and bank.
Commodity inventories	Only some (30%) disclose this
Return on restricted Investment Deposits	Very few (only one bank in the sample) disclose this
Profit equalization reserves	Some banks disclose (30%)
Net open position in foreign exchange	Many banks (66%) disclose; the ratio as % of capital varied from 0 to 100%
Foreign currency liabilities to total liabilities	Many (66%) disclose; the ratio varied from 0 to 100%
Net position in equities to capital	Generally disclosed, with ratio ranging from 0% to 4%
Gross income to assets	All disclose, varies from 1% to 8%
Personnel expenses to total assets	All disclose, varies from 30% to 65%
Operational expenses to total assets	All disclose, varies from less than 1% to 5%

Source: Based on Annual Reports of 15 sample banks covering the years 2002 and 2003; Percentages of sample banks that disclose a particular item is shown in parenthesis.

Appendix 2

Measurement of *Muḍārabah* Profits and Calibrating Risk Sharing between Investment Account Holders and Bank Owners: A VAR Methodology

Accounting Definitions

Relationship between *muḍārabah* income and overall return on bank assets is first explored based on available accounting standards. Drawing on this relationship, a methodology to measure the risks facing investment account holders, and the risk sharing between bank owners and investment account holders is suggested.

According to Financial Accounting Standards Number 6 (FAS 6) of the Accounting and Auditing organization of Islamic Financial Institutions (AAOIFI), when a bank commingles own funds (K= Capital) with *muḍārabah* Funds (DI=Unrestricted Investment Deposits), profits are first allocated between *muḍārib's* Funds and the fund's of investment account holders, and then the share of Islamic Bank as a *muḍārib* for its work in deducted from the share of profits of the investment account holders.

In addition, FAS 6 states that profits of an investment jointly financed by the Islamic Bank and unrestricted investment account holders shall be allocated between them according to the contribution of each of the two parties in the jointly financed investment. Allocation of profit based on percentages agreed upon by the two parties is also juristically acceptable, but the standards call for proportionate contribution.

The minimum standards for calculating the rate of return – specified by Bank Negara Malaysia in the "Framework of the Rate of Return" (2001, and 2004) calls for the share of profits to depositors (and to the Bank as *muḍārib*) be uniform across banks as specified in the framework documents, and provides an uniform definition of profit & provisions to ensure a level playing field. Profit is defined as income from balance sheet assets plus trading income minus provisions, minus profit equalization reserves, minus the income attributable to capital, specific investments, and due from other institutions. This is the *muḍārabah* income (RM) distributable between investment depositors and bank (as *muḍārib*). Provisions are defined as general provisions plus specific provisions & income-in-suspense for facilities that are non-performing. The framework then distributes *muḍārabah* Income between depositors and bank as *muḍārib* and then by type and structure of deposits;

In addition, both AAOIFI standards and the rate of return Framework of BNM recognize Profit Equalization Reserve and Investment Risk Reserve. Profit Equalization Reserves (Rp) refer to account appropriated out of gross income in order to maintain certain level of return for depositors; and this is apportioned

between investment account holders and shareholders in the suitable proportions that apply to the sharing of profits. Investment risk reserves are reserves attributable entirely to investment account holders, but maintained specifically to equalize rate of return over time.

Measuring Risks in Investment Accounts and Risk Sharing

Measuring risks and risk sharing based on these definitions, *Muḍārabah* Profit (RM) can be written as (ignoring Investment Risk Reserves for simplicity)

$$RM = A\,(R_A - Sp) - AR_P - K \cdot R_K$$

Where R_A = return on assets, R_p = Profit Equalization Reserves (as a % assets)

S_p = Provisions as a % of assets,

R_K = Return on Capital assigned for the purpose of computing distributable *Muḍārabah* income.

Rate of Return for Investment Account holders (R_I) can then be calculated by applying the agreed share on *Muḍārabah* income.

$$R_I = \alpha RM/DI = \alpha\,[A\,(R_A - S_p - R_P) - K \cdot R_K] / DI \qquad (1)$$

The total return on capital can be calculated to ensure that total income accruing to banks' own funds -- equal to assigned return on capital plus income earned as a *Muḍārib* – provides as required return on equity of R_E.

$$R_E = (1-\alpha)\,RM/K + R_K \qquad (2)$$

Combing (1) & (2)

$$R_I = \frac{A\,(R_A - S_p - R_P) - KR_E}{DI} \qquad (3)$$

$$R_K = \frac{1}{\alpha} R_E - \frac{(1-\alpha)}{\alpha K} A\,(R_A - S_p - R_P) \qquad (4)$$

$$R_E = \frac{A\,(R_A - S_P - R_P) - DI.\,R_I}{K} \qquad (5)$$

Risk in investment deposit returns can be calculated based on the variance of R_I.

$$VAR\,(R_I) = (A/DI)^2\,[VAR\,(R_A - S_p) + VAR\,(R_P) - 2Cov(R_A - S_p, R_P)] + (AK/DI)^2\,VAR\,(R_E) \qquad (6)$$

Similarly, the risk in overall return to capital can be computed by calculating the variance of R_E and its components based on equation (5).

Thus, true risk for investment depositors is given by equation (6), while actual risk in any one period can be further dampened by setting aside Investment Risk Reserves – treated as equity of investment account holders – for smoothing the returns over time. The choice of the level of Rp and the assigned return on capital R_K will redistribute the returns between investment depositors and bank owners; the policy on profit equalization reserves reflected as the correlation between R_A-

P_A&R_P -- will also impact on the level and distribution of risk to investment depositors & bank owners. Investment Risk Reserves will provide additional mechanism to smooth returns on investment accounts.

In the above framework, return to equity owners is assumed to equal a desired target level, which could vary depending on the level of risks, and market returns on alternative investment opportunities. Thus the risks to returns on investment accounts -- *Muḍārabah* risks summarized in equation (6) above, -- is a function of three components: 1), aggregate banking risks given by variability of net return on assets (R_A-S_p), 2), bank policy that determines variability of profit equalization reserves and its correlation with net return on assets; and 3), the variability of desired return on equity. This variability is assumed to be exogenous and uncorrelated with specific asset returns (admittedly an unrealistic assumption, used only for simplifying the presentation).

Using this framework, the sharing of risk -- risk defined as unexpected losses (UL), measured by a profit at risk measure as illustrated in Section III A of the text-- between account holders and owners can be calculated as follows:

First, at a given probability level the unexpected losses, UL_0 on the total return to capital (R_E) can be calculated assuming that returns on investment accounts R_I is determined based on market returns independently of bank income, as in conventional banks. In this scenario, profit equalization reserves adjusts automatically to ensure that return to IAH are fully smoothed to equal market rates of return on deposits. Then at the same probability level, unexpected losses UL_1, on the total return to capital can be computed assuming that R_I is allowed to share in bank's profits & losses based on a set of policies governing profit equalization reserves, assigned return to capital, investment risk reserves, and other market considerations, based on historical experience. In practice, both UL_0 and UL_1 can be computed based on historical data that reflect actual policies, and actual return experience of investment accounts and general market rates of return. A third scenario would be to compute unexpected losses UL_2 when risks are transferred fully to IAH, by assigning profit equalization to zero, and setting the return to equity to equal a benchmark return on assets of similar risk. In this scenario, IIFS's shareholders do not sacrifice any return (other than Mudarib's share) in order to cushion the returns to IAH in bad states of the world.

Risks transferred to Investment Account Holders (UL_D) can then be measured as

$$UL_D = UL_0 - UL_1$$

Risks transferred to shareholders compared to the situation of full risk transfer to IAH can be measured by

$$UL_S = UL_1 - UL_2$$

Displaced Commercial Risk is measured by UL_S. These measures of risk transfer (UL_D, and UL_S) can form the basis for defining the risk weight adjustment (the share "α" in the IFSB capital adequacy formula in IFSB 2005b) for the assets backed by investment accounts in the capital adequacy calculation for Islamic Banks.

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6

Transparency and Market Discipline in Islamic Banks

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It is widely believed that market discipline is generally enhanced if the activities of the bank are disclosed to the market participants. This widespread belief has given rise to a number of attempts to increase the transparency in banks particularly by the Basel Committee on Banking Supervision. There is no exception to Islamic banks. This paper attempts to see the issue of transparency and market discipline in the context of Islamic banks. Using a questionnaire survey directed to 28 Islamic banks in 14 countries and also to the bank supervisors, rating agencies, external auditors and the representatives of IFSB and AAOIFI, their perceptions on several issues are highlighted. The findings show that Islamic banks are still deficient in their risk disclosure, even though it is found that transparency in Islamic banks are more pertinent than conventional banks due to their profit sharing arrangements. This finding is useful for the policy makers and standard setters to design policies and standards to improve the transparency in Islamic banks.

Introduction

Transparency means that market participants get the information they need to allocate their resources within the market. Transparency in the context of banking is defined as public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, its business activities, risk profile and risk management practises (Basel Committee on Banking Supervision - BCBS, 1998). Greater transparency and disclosure keep corporate stakeholders better informed about the way a bank is being managed and governed. In addition, studies suggest that better disclosure has

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a positive impact on the efficient functioning of capital markets. In particular, Healy and Palepu (2001) review research on financial reporting and voluntary disclosure of information by management, and conclude that the increased pace of entrepreneurship and globalisation has increased the value of reliable information in capital markets.

The use of market discipline as a complement to bank supervision and regulation has gained greater acceptance in the US and abroad. It is also widely recognized that effective market discipline depends on market participants' having information about the risks and financial condition of banking organizations.

The objective of this paper is to report the empirical research conducted to explore the issue of transparency and market discipline in Islamic banks. Since Islamic banks are based on profit sharing arrangement, transparency is more important in Islamic banks compared to conventional banks as investment account holders require greater information to monitor their investments. Section 2 provides the background of the study and discusses the previous literatures on this issue. Section 3, then covers the research method for and the results of this study. Finally, Section 4 concludes the paper.

2. Background of the Study and Previous Literatures

2.1 Signalling Theory

Signalling theory considers problems of information asymmetry in the market. The theory shows how this asymmetry can be reduced by the party with more information signalling to others (Morris, 1987). It was originally developed to address problems of information asymmetry in labour markets and how information asymmetry can be reduced by the party with more information signalling to others. However, signalling is a common phenomenon applicable in any market with information asymmetry (Morris, 1987).

Signalling theory suggests that when banks' performance is good, banks will wish to signal their high quality information to the market. It is hoped that this information could assist the financial statement users in their decision making (Watts and Zimmerman; 1986). Signalling is hoped to motivate corporate disclosure.

The signalling theory has been tested by examining the stock market's valuation of loan loss provisions. Loan loss provisions are a relatively large accrual for commercial banks, and therefore, have a significant impact on banks' earnings and regulatory capital. The motive for loan loss provisions that has been forwarded in the literature is to signal financial strength. Beaver et al. (1989) suggest that loan loss provisions can indicate that 'management perceives the earnings power of the bank to be sufficiently strong that it can withstand a "hit to earnings" in the form of

additional loan loss provisions'.[1] Wahlen (1994), Beaver and Engel (1996) and Liu et al. (1997) investigate this theory. Consistent with this signalling theory, Wahlen (1994) documents a positive relation between discretionary or unexpected loan loss provisions and bank stock returns. Beaver and Engel (1996) document a positive coefficient on the discretionary component of loan loss provisions in a regression of market value of equity on earnings (before provisions), loan loss provisions, discretionary component of loan loss provisions, and non-performing loans. Liu et al. (1997) find a positive relation between stock returns and unexpected loan-loss provisions for banks with low capital ratios, but a negative relation for banks with high ratios, which is also consistent with a signalling theory. Griffin (1998) provides evidence of a differential negative market reaction to bank loan loss announcements based on the timeliness of the announcement relative to the end of a fiscal quarter. His results are consistent with a stock market that obtains loan impairment information from timely sources of that information, for example, loss provisions reported in bank financial statements.

Gibson (2000) confirms these findings by developing a model in which banks use write-offs to signal private information about the credit quality of their loan portfolios in the Japanese banking sector. More recently, Kanagaretnam et al. (2003) find that managers of undervalued banks use loan loss provisions to signal their banks' future earnings prospects. In contrast the aforementioned empirical findings, Ahmed et al. (1999) find no support for the signalling theory. They do not find evidence of a positive relation between loan loss provisions and one-year ahead future change in earnings as in Wahlen (1994). Based on their argument, their findings suggest that Wahlen's (1994) and Beaver and Engel's (1996) results are likely to be specific to the time period examined in their study.

The empirical evidence indicates that the propensity to signal differs across banks based upon the degree of information asymmetry. Signalling is a reaction to informational asymmetry in markets. In this case, banks have information that the market does not. Asymmetries can be reduced if the party with more information signals to others. In this case, leading banks (for example UBS), will wish to distinguish themselves from non-leading banks through voluntary disclosures. The signalling theory suggests that when banks' performance is good, banks will wish to signal their high quality information to the market. It is hoped that this information could assist the financial statement users in their decision making (i.e. Market discipline exists).

2.2 Market Discipline in Conventional Banks

As explained above, signalling is a reaction to informational asymmetry, where the management has information that the market does not. This signalling theory is

[1] Note that the signalling effects in the loan loss provisions studies are opposite to the signalling effects hypothesised in the studies on discretionary accruals more generally such as Subramanyam (1996) and Ahmed (1996).

also relevant for market discipline. If market discipline is weak, theoretically, the signalling theory would be less applicable and a more prescriptive set of risk disclosure standards together with a more intrusive style of supervision would be necessary in applying Basel II.[2]

In the context of banking, market discipline includes notably a market based incentive scheme in which investors in bank liabilities such as subordinated debt or uninsured deposits "punish" banks for greater risk-taking by demanding higher yields on those liabilities (Berger, 1991). Banks collect deposits and invest these funds in risky assets (loans). To safeguard against insolvency, banks hold a capital buffer against adverse outcomes in their investments in risky assets (loan default). But the bank's private solvency target may not take into account the interests of depositors, or of society as a whole. As a result, banks may engage in excessive risk-taking. Market discipline is a mechanism that can potentially curb the incentive to take excessive risk, by making risk-taking more costly for banks.

There are a number of potential social benefits from enhancing market discipline in a country's banking sector. First, by punishing excessive bank risk-taking, increased market discipline may reduce the moral hazard problems, which government guarantees create for banks by providing incentives to undertake excessive risks. Second, market discipline may improve the efficiency of banks by pressuring some of the relatively inefficient banks to become more efficient or to exit the industry (Berger, 1991). Finally, the social cost of supervising banks may be lowered if regulators cede greater control to market forces that can tell "good" from "bad" banks. In particular, the market is an anonymous and constant overseer, which is hard to lobby for forbearance, and may react more quickly than regulators to increases in bank risk-taking.

In order for market discipline on banks to be fully effective in ensuring financial stability, Crockett (2001) suggests four pre-requisites. First, market participants need to have sufficient information to reach informed judgements. Second, they need to have the ability to process it correctly. Third, they need to have the right incentives and finally, they need to have the right mechanism to exercise discipline.

The following section discusses Basel II in relation to market discipline issues.

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[2] The Basel Accord has been introduced by the BCBS in July 1988. This Accord focuses on the total amount of bank capital, which is vital in reducing the risk of bank insolvency and the potential cost of a bank's failure for depositors. Basel II intends to improve safety and soundness in the financial system by placing more emphasis on banks' own internal control and management, the supervisory review process and market discipline. There are three pillars in Basel II. The first pillar is minimum capital requirement; the second pillar is supervisory review and the third pillar is market discipline. Section 2.3 gives more explanation on this Basel II, particularly Pillar 3.

2.3 Basel II: Pillar 3

'The BCBS aims to encourage market discipline by developing a set of disclosure recommendations (and requirements) which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment and management processes, and hence the capital adequacy of the institution' (Consultative Document, January 2001)

Bank's regulators and rating agencies have access to internal data which market participants do not. Hence from the standpoint of capital adequacy, public disclosure of validation data is largely irrelevant.

Basel II should benefit the banks which perform risk management well, with effective programmes to communicate their processes and results to the investment community, at the expense of the other less well performing banks. Isn't that what market discipline is supposed to accomplish?

Pillar 3 of Basel II relies on enhancing bank disclosure to strengthen market discipline. Imperfect understanding of a bank's actual risk exposure can impair the decisions made by bank regulators and shareholders. A prerequisite for the sort of market discipline envisioned by the BCBS is broad disclosure of bank's financial information to allow investors and other market participants to accurately assess a bank's risk profile.

2.4 Banking Crises

For most banks, market risk accounts for only a small proportion of their overall risk profile. Despite changes in financial markets, the credit risk charge remains the most significant factor in determining the regulatory capital requirement for the majority of banks. Credit risk is the major risk faced by many banks, since loans are their major asset category. Experience from around the world (Rahman, 1999) indicates that poor credit quality coupled with weak credit risk management practises continues to be a dominant factor in bank failures and banking crises (Asia, Russia and Brazil). During such crises, it would appear that the risk during such periods was of a much greater magnitude than existing risk management techniques were able to capture. Therefore, it is clear that information on banks' credit risk management processes is crucial in market participants' and supervisors' assessments of their condition, performance and ability to survive in the long run.

Fons (1998)[3] examines the role that poor transparency played in the East Asian financial crisis and argues that weak transparency increases funding costs, especially in times of financial distress. Transparency can only help prevent a financial crisis and should not be seen as a cure for systems already under stress. According to him, the meltdown in currency, bond and equity markets, over the

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[3] Fons, S.J (1998), 'Improving Transparency in Asian Banking Systems' Paper presented at 'Asia: An Analysis of Financial Crisis Conference' sponsored by the Federal Reserve Bank of Chicago and the International Monetary Fund, 1998.

past year or more of his study has contributed to massive credit rationing for East Asia, particularly by foreign creditors.

Poor accounting standards enable banks to evade prudential and other restrictions on insider lending (Rahman, 1999). Furthermore, Rahman (1999) argued that inadequate disclosure contributed to the depth and breadth of the banking crisis. Since financial statements act as the most reliable and easily accessible vehicle for dissemination of banking information, lack of adequate accounting disclosures prevented investors and creditors from receiving necessary and timely information for choosing between successful and potentially unsuccessful banks. It is known that the very threat of disclosure influences behaviour and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practises of the banks in the crisis-hit countries. The financial statements did not reflect the extent of risk exposures and clear indications of the magnitude of debt problems.

Llewellyn (2002) analyses the causes of the recent banking crises, which include weak monitoring and supervision by official agencies, the absence of effective market discipline on banks and structurally unsound corporate governance mechanisms within banks and their borrowing customers

A permanent solution to the East Asian financial crisis will require a restoration of interbank confidence in the region' s banks, which, in turn, will require credible transparency, massive restructuring and state-financed recapitalisation. Interbank creditors will demand solvency and transparency. The problem is that transparency could be seen as revealing insolvency, further shaking creditor confidence, wiping out existing shareholder claims and endangering non-depository creditors (e.g., subordinated debts in the case of conventional banks).

Regulators may not want transparency, to prevent public criticism arising from the failure to resolve or close a troubled bank. Certain banks would favour poor transparency, mainly because it costs money to institute timely, accurate and detailed accounting systems. Resources that might be more profitably employed elsewhere are relegated to a reporting function. Statements must be formatted to international standards and "Big Four"[4] auditors must be hired to give opinion on the quality of reporting. Many banks in developing countries are small and the costs of complying with transparent reporting practises may be significant. Transparency also restricts management's ability to engage in self dealing. Fully transparent reporting may also reveal competitive strategies or vulnerabilities where a bank holds a large un-hedged position in some asset or currency. These may affect the market discipline's ability to be effective in the banking system.

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[4] "Big Four" accountancy firms include Pricewaterhouse Coopers, KPMG Peat Marwick, Ernst and Young and Delloitte and Touche.

Cordella and Yeyati (1998) examine how public disclosure of banks' risk exposure affects banks' risk taking incentives, and assess the impact of the presence of informed depositors on the soundness of the banking system. They used the data from New Zealand banks. The results show that when banks have complete control over the volatility of their loan portfolio, public disclosure reduces the probability of banking crises. However, when banks do not control their risk exposures, the presence of informed depositors may increase the probability of bank failures. This indicates that banks must be able to have control over their risk exposure in order for public disclosure to be effective. This again shows the importance of enhancing the dissemination of financial information. However, their studies do not really look into the importance of risk disclosure by the banks, but rather at the relationship between public disclosure and banks' failures. The next section discusses the role of bank supervisors in enhancing the transparency in banks.

2.5 Supervisory Information

Bank supervisors need timely and reliable information about the financial condition and risk profile of banks in order to conduct effective supervision. Although such information can be obtained in part from regulatory reports and public disclosure, a key source is on the on-site examination. Bank examinations enable supervisors to confirm the accuracy of information in regulatory reports. More important, the examinations allow supervisors to gather confidential information about bank's financial conditions and to assess qualitative attributes, such as internal controls and risk management procedures that affect bank risk profiles.

Sijben (2002) argued that the strategy to enlarge market discipline refers to the availability of information and transparency for both supervisors and market participants aiming at an appropriate judgement of the soundness of the banks. Hoenig (2003) suggests that increased disclosure to the market of supervisory information could be of significant value to the market which could help to enhance the effectiveness of market discipline.

Bank supervisors can play an important role by checking that the financial condition of the bank is as reported (De Young et al., 2001, Jordan et al., 2000; Berger et al., 2000; Flannery and Houston, 1998; Berger and Davies, 1998; Gilbert, 1993). Market participants, on the other hand, may not be able to uncover the deteriorating health of a bank in a timely manner, instead discovering it only when bank management, possibly at the investigation of bank supervisors, eventually makes financial disclosures that reveal the bank's problems (Gilbert, 1993). These could be announcements related to income and balance sheet statements such as lower earnings or increased non-performing loans.

In their assessment of banks, for instance, bank supervisors make use of proprietary and internal information in each bank, as well as confidential

information on customers. As a result, bank supervisors have a detailed knowledge of individual bank conditions that could prove useful in several ways. Disclosure of financial position, risk concentrations and asset profiles, for instance, could provide a new and valuable source of information to the market. In addition, bank supervisors would be in a good position to identify deficiencies in a bank's own public disclosures.

A growing line of research provides empirical support for the proposition that bank supervisors at times have an information advantage over other outside monitors. Flannery and Houston (1998) show that financial markets evaluate accounting data differently when an examination by a supervisor has occurred recently. For a sample of banks examined in the fourth quarter of 1988, they find that accounting statements of examined banks are more informative than those of non-examined banks; they also find that examined banks' market values are slightly better. These effects are stronger for smaller banks, banks with higher stock return variances, banks with harder-to-value assets, and banks not rated by rating agencies. They argue that these findings provide evidence that bank supervisors (examiners) play a valuable role in the certification of banks' accounting data and that bank shareholders benefit from this activity.

2.6 Transparency and Market Discipline in Islamic Banks

Islamic banks face great challenges to successfully serve the *Ummah* (nation) in which they operate. They have to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable and relevant information to financial statement users. The establishment of Islamic banks is intended to cater for the needs of Muslims in order to follow the principles of Sharīʿah. Such ways and means are characterised by many features, including the prohibition of interest, the use of profit sharing and other investment vehicles. Since Islamic banks mobilise funds on a profit sharing basis, it becomes essential that all parties to their transactions should have full access to information covered by agreements. Adequate disclosure and transparency provide an assessment of the degree of risk associated with participation. Accordingly, the attractiveness of Islamic banks to Muslim stems mainly from their compliance with Sharīʿah in their dealings, whether with shareholders, current and investment account holders or others for whom such banks invest their funds.

On the other hand, the Muslim's choice of investing or depositing funds in or dealing with one Islamic bank versus another, is based on his/her evaluation of and confidence in the bank's ability to maintain its capital at a level sufficient for solvency purposes. In addition, the bank's ability to realise rates of returns commensurate with the assumed investment risk for both its shareholders and the investment account holders is also important in decision making. Lack of such confidence might cause Muslims to stop dealing with the Islamic bank. Among the important sources of such information are the financial reports of Islamic banks

which are prepared in accordance with standards that are applicable to Islamic banks.

3. Methods and Findings

This study covers 28 Islamic banks and supervisors of Islamic banks in 14 countries (refer to Annexure I for the sample details) using the questionnaire survey to obtain the perceptions about the transparency and market discipline in Islamic banks. Each question asked the respondents to provide a response on a scale of 1 to 5 of their level of agreement with the statement of the question with 1 being strong disagreement and 5 representing a strong-agreement. The same questions are also asked to external auditors of Islamic banks, rating agencies and representatives of IFSB and AAOIFI. Furthermore, the study examines the information required by supervisors of Islamic banks in 14 countries to monitor the risk profile in Islamic banks.

The findings from the questionnaire survey, supplemented by material from the interviews where appropriate, will be presented in 2 sub-sections: supervisors of Islamic banks' opinions about the information required most to monitor risk profile and management of Islamic banks and transparency and market discipline in Islamic banks.

3.1 Supervisors' Opinions about the Most Required Information to Monitor Risk Profile and Management of Islamic Banks

This section discusses the supervisors of Islamic banks' perceptions about the information required most to monitor risk profile and management of Islamic banks and the risk assessment approaches to supervise Islamic banks.

Table 1 shows that Islamic bank's supervisors rated all the risk information to be important to monitor the risk profile of Islamic banks (the mean values are between 3.84 and 4.84). The most important information as perceived by the bank supervisors is information on the type of risks, the risk management and the asset quality (all have the mean values of 4.84) and compliance with Sharīʿah requirements (mean value of 4.79).

The interview with one of the supervisors of Islamic banks supports this finding. As stated by one Islamic bank supervisor: "Apart from annual reports, the supervisors of Islamic banks require additional information to be submitted to them either weekly, quarterly or annual basis, whether it is on the domestic or global position".

Table 1 also shows that the total number of respondents (supervisors of Islamic banks) in Bahrain is only 2. This is because according to Bahrain Monetary Agency's representative, the responses represent the collective views of all members of the directorate. Therefore, additional questionnaires would have the same response.

Table 1: Mean Values for the Risk Information Required by Supervisors of Islamic Banks

	Items	Required by IAS/AAOIFI	Total	Malaysia	Bahrain	Others
1.	Type of risks	IAS 32, FAS 1	4.84	4.89	5.00	4.75
2.	Severity of risks	No	4.63	4.56	4.50	4.75
3.	Risk management	IAS 32	4.84	4.89	4.50	4.88
4.	Breakdown – operating segments	IAS 14	4.26	4.22	3.50	4.50
5.	Breakdown – geographical segments	IAS 14	3.84	3.78	4.50	3.75
6.	Capital adequacy ratio and banks' own ratio	Statement of CAR, AAOIFI	4.74	4.89	5.00	4.50
7.	Liquidity	FAS 1	4.68	4.89	5.00	4.38
8.	Maturity matching	FAS 1	4.58	4.56	5.00	4.50
9.	Profitability	FAS 1	4.37	4.44	5.00	4.13
10.	Asset quality	No	4.84	4.78	5.00	4.88
11.	Compliance with relevant accounting standards	IAS 1, FAS 1	4.58	4.44	5.00	4.63
12.	Compliance with Sharīʿah requirements	Governance Std 2	4.79	4.89	4.00	4.88
13.	Sharīʿah's view – permissibility of taking on certain risks	No	4.26	4.44	3.00	4.38
14.	Sharīʿah's view – risk mitigation techniques	No	4.00	4.44	3.00	3.75
	Total (n)		19	8	2	9

In addition, from the open-ended questions asked to them, they also point out that they need additional non-public information (apart from the issue of frequency), which is also not required by financial reporting standards to supervise Islamic banks. They include:

1. Rating of the bank by a rating agency.
2. Any non-compliance to Sharīʿah requirement - Reputation risk.
3. The implementation of good corporate governance.

This is consistent with the findings of studies in the literature that bank supervisors have an information advantage over other parties (De Young et al, 2001; Jordan et al, 2000, Flannery and Houston, 1998; Berger et al, 2000; Cole and Gunter, 1998 and Berger and Davies, 1998). They need more information than what is required by financial reporting standards in order to perform their supervision on Islamic banks, apart from the issue of frequency.

Additional questions were also asked in the questionnaire to get the survey respondents' perceptions on the role of supervisors of Islamic banks in improving bank's transparency (Statements 1, 2, 3 and 4).

Statements:

1. The most effective way to ensure the bank adheres to public risk disclosure requirements as required by accounting standards is to impose penalties for non-disclosure.
2. Sufficient attention has been given by bank supervisors to ensure that public risk disclosure requirements are proportionate to the nature and scale of the bank.
3. Bank supervisors have adequate information that enables them to assess the risks inherent in Islamic banks.
4. Bank supervisors impose on Islamic banks rules for public risk disclosure that improve banks' transparency.

Table 2 presents the descriptive statistics for statements 1, 2, 3 and 4. In general, a majority of the respondents agree or strongly agree that the Islamic bank's supervisors play an important role in improving transparency in Islamic banks by imposing rules for public risk disclosure. This is evidenced from the negative coefficient of skewness for all the statements, and the mode is 4 (Agree) for all statements.

Table 2: Descriptive Statistics for Statements 1, 2, 3 and 4

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
1	3.66	4.00	4	0.853	1	5	-0.525	65
2	3.43	4.00	4	0.918	1	5	-0.602	65
3	3.42	4.00	4	0.917	1	5	-0.307	65
4	3.80	4.00	4	0.754	2	5	-0.550	65

3.2 Transparency and Market Discipline in Islamic Banks

This section intends to discuss several issues related to transparency and market discipline in Islamic banks. The section is divided into 3 sub-sections.

3.2.1 Transparency with regard to risk reporting is perceived to be more important in Islamic banks than in conventional banks

Statements 5 to 10 aim to get the opinion of the respondents on the importance of transparency in Islamic banks as compared to conventional banks. The main reason is that Islamic banks have profit sharing investment account holders which require more transparency in order to monitor their investment in Islamic banks.

Statements:

5. Investment account holders in Islamic banks need more information on all risks faced by the banks than conventional depositors.
6. The more information on risks that are disclosed, the greater the confidence felt by investment account holders to invest in Islamic banks.
7. Greater risk disclosure in Islamic banks informs investment account holders of the potential risks to which their investments are exposed.
8. Greater risk disclosure encourages new investments in Islamic banks.
9. The more risk information disclosed in the annual report of Islamic banks, the more is market participants able to monitor the banks.
10. It is necessary to have a separate statement in the annual report to highlight the Islamic banks' risks and risk management techniques.

Table 3: Descriptive Statistics for Statements 5 to 10

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
5	4.12	4.00	4	0.857	2	5	-0.704	65
6	3.98	4.00	4	0.893	2	5	-.0377	65
7	4.06	4.00	4	0.710	2	5	-0.365	64
8	3.71	4.00	4	0.765	2	5	-0.091	65
9	4.09	4.00	4	0.631	2	5	-0.456	65
10	3.97	4.00	4	0.847	1	5	-1.054	65

Based on the analysis in Table 3, the lowest value of the mean is 3.71 and the highest is 4.12, the median and the mode are 4 for all statements, and there is a negative coefficient of skewness for all. This implies that the respondents agree with what was discussed by these statements. However, the lowest mean of 3.71 for Statement 8 means that the respondents were not strongly convinced that

greater risk disclosure encourages new investments in Islamic banks. 21% of the Islamic bankers, 16% of the Islamic bank supervisors and 0% of other respondents strongly agree with this statement.

3.2.2 In the countries in which Islamic banks are surveyed, it is perceived that effective disclosure helps market participants to assess the bank's performance

The question in this part aims to get the opinion of the survey respondents about the relationship between transparency, market discipline and disclosure. However, the researcher was aware about the social desirability bias[5] problem based on the ways the following statements have been phrased. But, the questions were still asked in order to get some general opinion from the respondents relating to these issues.

Statements:

11. Transparency is a pre-requisite for achieving market discipline.
12. Market discipline can work effectively only on the basis of adequate and accurate information disclosure and transparency.
13. Lack of transparency in financial reporting on risks could lead to difficulties in assessing the bank's performance.
14. Effective disclosure is essential to ensure that market participants have a better understanding of the banks' risk profiles.

Table 4: Descriptive Statistics for Statements 11 to 14.

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
11	4.44	5.00	5	0.639	3	5	-0.700	64
12	4.43	4.00	5	0.585	3	5	-0.446	65
13	4.48	5.00	5	0.589	3	5	-0.618	65
14	4.46	5.00	5	0.614	3	5	-0.684	65

Table 4 shows that the lowest mean value is 4.43 and the highest is 4.48, the mode is 5 for all these statements and the median is 5.00 (except for Statement 12, where the median is 4.00). There is a negative coefficient of skewness for all

[5] In some circumstances, respondents may be tempted to give the socially desirable response rather than describe what they actually think, believe or do. This has typically been assumed to be a function of two factors, the general strength of need for approval felt by an individual (personality trait) and the demands of a particular situation (Phillips and Clancy 1972).

statements. This implies that the respondents strongly agreed with what was discussed by these statements.

3.2.3 Basel II is Applicable to Islamic Banks with Some Modifications

The main theme of including statements 15 to 17 is to find out the perceptions of the respondents about Basel II.

Statements:

15. The New Basel Accord (Basel II) is a welcome development for Islamic banks.
16. There is a need to adapt the New Basel Accord (Basel II) to cover the uniqueness of Islamic banks.
17. Islamic Financial Services Board (IFSB) can facilitate the adoption of the New Basel Accord (Basel II) in Islamic banks.

Table 5: Descriptive Statistics for Statements 15 to 17

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
15	3.44	4.00	4	0.957	1	5	-0.768	64
16	3.94	4.00	4	1.037	1	5	-0.930	64
17	4.19	4.00	4	0.664	3	5	-0.226	64

It can be seen from Table 5 that the mean values are between 3.44 and 4.19, the median and the mode are 4 for all these three statements. There is also a negative coefficient of skewness in all statements as shown in Table 5, which again support the above findings.

The results from the interviews6 indicated that there are problems in applying this Basel II to Islamic banks as stated by one Islamic banker: “The main problem to apply this Accord was in terms of human resource and costs to be invested in the system.” This problem is faced by conventional banks and is even worse for Islamic banks due their relatively small size.

Another problem mentioned by one Islamic bank’s risk manager related to the lack of rating agencies in Islamic banks and the fact there is no historical data to implement the Accord:

> “No doubt that the Accord will serve the soundness of the financial institutions in the manner in which they operate. However, it may not suit all banks and financial institutions or rather the region in which they operate

[6] Follow-up e mails were used to the Islamic bankers in other countries than Malaysia to clarify several issues due to time and budget constraints. The answers obtained were used in this discussion chapter.

due to the requirement that all banks or financial institutions and their clients be rated by external rating agencies. There is a lack of rating agencies specialized in the Gulf region or the Arab world. As the Accord also suggests that in case there is no rating the company need to be rated in accordance to the internal rating model of the Bank or Basel I or the Financial Institution which may not reflect the soundness of the company or not take into consideration important facts or realities that form an important aspects for the business."

Another Islamic bank's risk manager stated that:

"Even not all conventional institutions would be able to subscribe to the Accord, let alone the Islamic institutions. Anyway, the IFSB should be of some assistance to this. Otherwise, the Islamic bank will have to apply the standard method which is disadvantageous. This is because the Islamic bank does not have the historical data to use the advanced method".

4. Concluding Remarks

The findings confirm that Islamic bank supervisors require additional information compared to what is required by financial reporting standards in order to supervise Islamic banks. This is consistent with the findings in conventional literatures regarding the informational advantage of bank supervisors (Berger and Davies, 1994; Berger et al., 1998). The results from the questionnaire survey show that type of risks, the risk management, asset quality and compliance with Sharīʿah requirements are the most important risk information required by Islamic bank supervisors to monitor the risk profile of Islamic banks.

Other information required by Islamic bank supervisors, which are not required by current financial reporting standards (IAS and AAOIFI) include rating of the bank by a rating agency and the implementation of good corporate governance.

In view of the UK FSA's initiative on Risk Based Approach to Supervision of Banks (1998), Islamic bank supervisors tend to share the same view. The FSA's aim is to ensure that the attention is focused, in the case of each bank, on those areas which can put depositors' funds at risk, in which they adopt the RATE (for UK and EEA banks) and SCALE (for non-EEA banks) frameworks. Risk management and type of risks faced by the Islamic banks are perceived to be the most important information to Islamic bank supervisors. Looking at the risks, which the Islamic banks are exposed to Islamic bank supervisors need to play even a greater role to assess and evaluate these risks in their supervision.

Looking at Basel II, it is clear that the three Pillars in this accord complement each other. The supervisory review process (Pillar 2), together with Pillar 3 (market discipline), complements Pillar 1 (minimum capital requirements) in achieving a level of capital commensurate with a bank's overall risk profile.

Pillar 2 suggests the banks to assess their capital adequacy relative to their overall risk exposures, and for supervisors to review and take appropriate actions in response to those assessments. This is a key component in effective banking supervision.

One key principle of Pillar 2 is that the assessment of risk and capital adequacy requires more than a simple assessment of whether the bank meets the minimum capital requirements. The supervisory review emphasises the need for both the banks and supervisors to have in place strong risk assessment capabilities and processes.

There is no exception for supervisors of Islamic banks. They have the same systems in place in their supervisions, even in most cases they require different information from that supplied by conventional banks due to Sharīʿah requirements.

Transparency of risk reporting in Islamic banks is perceived to be more important than in conventional banks due to the existence of profit sharing arrangements, and in particular to unrestricted investment account holders. Effective disclosure may help market participants to assess the bank's performance. For Islamic banks, transparency is an important supervisory pillar and has considerable relevance for enhancing their ethical responsibility and credibility, thereby contributing to their greater acceptance, and elimination of any misconceptions of their activities. However, the information made available to the market must be of the right quality and volume, and it is important to avoid flooding the market with information that would be hard to interpret or different to use in understanding the bank's actual risk profile.

In the countries with Islamic banks, that were surveyed, it is perceived that effective disclosure is important to inform the market participants about the condition of the bank. As Islamic banks' shareholders play a lesser role in monitoring Islamic banks, the results of the questionnaire survey and interviews (also follow-up e-mails) indicated a perception that transparency is still lacking in Islamic banks.

The BCBS has issued standards and principles in risk areas including credit, liquidity operations, consolidation and capital adequacy. Many of these standards are equally relevant and applicable to Islamic banks but with some modifications. The results from the interviews indicated that there are problems in applying Basel II to Islamic banks in terms of human resources and costs to be invested in the system. This problem is also faced by conventional banks and is even worse for Islamic banks due to their relatively small size. Another problem mentioned by Islamic bankers relate to the lack of rating agencies for Islamic banks.

This suggests that there should be some modifications to Basel II to suit the Islamic banks' transactions, which is also supported by the questionnaire findings. The results from the questionnaire survey suggest that majority of the respondents

either agree or strongly agree (86%) that IFSB can facilitate the adoption of Basel-II in Islamic banks and there was no significant difference in their perceptions of this. This implies that IFSB can play an important role as shown in the findings to adapt Basel II to suit the nature of Islamic banks.

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Annexure I

Sample

Islamic banks included in the survey are as follows:

	Islamic banks	Country
1.	Bank Islam Malaysia Berhad	Malaysia
2.	Bank Muamalat Malaysia Berhad	Malaysia
3.	Al Baraka Islamic Bank	Bahrain
4.	ABC Islamic Bank	Bahrain
5.	Bahrain Islamic Bank	Bahrain
6.	Shamil Bank	Bahrain
7.	First Islamic Investment Bank	Bahrain
8.	Bank Mmuamalat Indonesia	Indonesia
9.	Faisal Islamic Bank of Egypt	Egypt
10.	Jordan Islamic Bank	Jordan
11.	Islamic International Arab Bank	Jordan
12.	Al Meezan Investment Bank Limited	Pakistan
13.	Al Baraka Islamic Bank	Pakistan
14.	Qatar International Islamic Bank	Qatar
15.	Qatar Islamic Bank	Qatar
16.	Islamic Development Bank	Saudi Arabia
17.	Al Rajhi Banking and Investment Corp	Saudi Arabia
18.	Tadamon Islamic Bank	Sudan
19.	Sudanese Islamic Bank	Sudan
20.	Al Shamal Islamic Bank	Sudan
21.	Animal Resources Bank	Sudan
22.	El Gharb Islamic Bank	Sudan
23.	Abu Dhabi Islamic Bank	United Arab Emirates
24.	Dubai Islamic Bank	United Arab Emirates
25.	Kuwait Finance House	Kuwait
26.	Al Barakah Turkish Finance House	Turkey
27.	Faisal Islamic Bank of Kibris Ltd	Turkey
28.	Islami Bank Bangladesh Ltd	Bangladesh
29.	Bank Saderat Iran	Iran

Central banks included in the survey are as follows:-

1.	Bank Negara Malaysia
2.	Bahrain Monetary Agency
3.	State Bank of Pakistan
4.	Bank Indonesia
5.	Bank of Sudan
6.	Central Bank of Kuwait
7.	Qatar Central Bank
8.	Saudi Arabian Monetary Agency
9.	Bank Markazi Jamhouri Islami Iran
10.	Central Bank of Jordan
11.	Central Bank of Bangladesh
12.	Central Bank of Egypt
13.	Central Bank of the UAE
14.	Central Bank of the Republic of Turkey

BLANK PAGE

7

A Design for Islamic Banking Rating System: An Integrated Approach

Dadang Muljawan*

In this paper, we analyze an alternative tool to assess the operational soundness of the Islamic banks. The tool should accommodate the salient features of the Islamic banks so that it is capable of being used as an effective supervisory tool not only for assessing the operational quality but also directing the Islamic banking authority when formulating the supervisory actions based on the supervisory review. Basically, the tool designed can still use the CAMELS rating system but with some adjustments on financial ratios and managerial assessment. Operationally, Islamic banking could use the CAMELS rating system when assessing the soundness of the Islamic banks. The difference would be on several aspects like: (1) the agency role in the capital assessment, (2) value added distribution, (3) identification of risks which do not appear in the conventional banks, and (4) the incorporation of the Islamic values and norms which particularly emphasis professionalism, competence to promote conducive and friendly atmosphere in the organization and other Islamic values like environment orientation besides transactionally Sharīʿah compliance. Islamic bank rating system is expected to benefit the supervisory process as it could reflect the operational soundness more objectively. The rating system would then be used as a base to formulate supervisory actions. Therefore, the rating system should be able to locate the problems in the bank more precisely.

Introduction

Bank rating system has been one of important tools for banking authorities to assess the operational quality of the banking institutions.[1] A bank with high quality rating is expected to operate sustainably in the future. Each country might have

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[1] The need to have a prudential set of banking regulations has been outlined in the Basle Core Principles (Basle Committee (1997) and Basle Committee (1999b) and also Hall (1997)).

different approach when conducting assessment, depending upon its peculiarity. Most countries use C(apital), A(sset quality), M(anagement), E(arning), L(liquidity) and S(ensitivity to market risk) rating system as the framework for conducting supervisory activities. Some countries use CAEL when conducting the assessment of bank operational quality. The CAMELS rating system has also evolved in time. The components cover quantitative aspects as well as qualitative, like supervisory judgements.

The rapid development of Islamic banking industry in Indonesia in the last few years has promising optimism for further development that would benetif the Indonesian economy in general. The development would also pose challenge to the authority as it requires a different set of banking regulations. Conceptually, Islamic banking should be financially sound and Sharīʿah compliant so that the the system could always maintain a high level of public confidence. Islamic bank rating system design should be able to promote the financial soundness and the salient features of the Islamic banking operations. The operational differences of Islamic banking compared to the conventional one span over several aspects. First, all the financial transactions should have Sharīʿah endorsement from the Sharīʿah authority which cover the legality of the transaction and the object transacted. Second, the different financial structure would require different financial ratios and methods when assessing the financial soundness. The implementation of sharing principle, for instance, would require modification in the solvency indicators and application of additional indicators to indicate the agency role played by the Islamic bank.

The design for Islamic banking regulation, as a matter of fact, should be able to benefit from the current development achieved in the conventional banking system. The latest framework of the CAMELS rating system has been improved to describe the structural soundness of the bank which has been adjusted by risk assessment. This approach would be in line with the implementation of Risk Based Supervision (RBS) as a new approach towards more effective banking supervision activities.

The paper proceeds as follows. The section 2 discusses the background of the need to design an appropriate bank rating system in order to promote the soundness of the banking operations. The section 3 discusses the salient features of the Islamic banking operation that differentiates the Islamic banking system from the conventional one. The section 4 discusses the possible approach to an appropriate design of Islamic banking rating system with a comprehensive scope. The section 5 concludes the paper.

2. Background Analysis

2.1. Bank Rating System As An Indicator for Operational Sustainability

Banking institutions are expected to operate sustainably in order to contribute to the economic development through intermediation process i.e. promoting

investment activities through public funds mobilization.[2] However, the banking authority should also concern about possible systemic costs that result from bank failures that would ultimately put expensive burden on all stakeholders.

$$NW_A^{\infty} = \lim_{t \to \infty} NetWorth(A(t)) > 0 \tag{2.1}$$

Equation (2.1) describes networth (NW) of a bank 'A' that is expected to have a positive value until the period of infinity. This is, in fact, in line with the treatment of the banking system as a highly regulated industry (see Dewatripont and Tirole (1994), Fama (1985) and Wesson (1995)).

Public regulation should be in place when the total costs resulting from the failures exceed the private costs.(Hart et.al., 1999)

The banking authority would, in practise, minimize the supervisory cost that results from either the monitoring cost or the cost of bailing-out (see Llewellyn (1999a)). This calculation would be one of the significant factors when implementing the exit policy. The banking authority might opt to cease the operational activities of a bank if the condition of the bank indicates a higher maintenance cost compared to its bail-out cost. Contrary wise, the banking authority might opt to continue the operation of the bank if the maintenance cost is lower than the bail-out cost.[3] An operationally prudent and efficient bank implies a lower maintenance cost which technically is expressed below.

$$Min\left[\pi C_{BO} + (1-\pi)\int_t^{\infty} \Gamma C_M \, dt\right] \tag{2.2}$$

Where π is the probability of having bail-out, C_{BO} is the cost resulting from the bail out process, C_M is the maintenance cost, and $\Gamma = 1/\rho$ is the discount rate. The first expression πC_{BO} describes the cost expectation from bail-out, whilst the second expression $(1-\pi)\int_t^{\infty} \Gamma C_M dt$ describes expectation of present value of the maintenance cost accrued from t to infinity (see Greuning et.al (2000) and Hall (1996b)). In determining the variables for the event probability, the banking authority would choose a series of dependent variables which are

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[2] There have been a number of academic papers discussing the implementation of a fractional reserve banking and its implication to its operational stability (see Benston et.al. (1976, Campbell et.al. (1980), Fama (1980) and Diamond (1984).

[3] In depth discussion on the systemic costs could be seen in Campbell (1980), Diamond (1983) and Llewellyn (1999b) and (1997).

considered capable of reflecting the actual condition of a bank; $\pi : \pi(x_1,...,x_{n-1},x_n)$. The assumption is that if the result of the calculation of the independent variables for Bank A is higher than Bank B ($\pi_A > \pi_B$), then the probability for longer operational sustainability for Bank A is higher than that of Bank B ($P(NW_A^\infty > 0) > P(NW_B^\infty > 0)$). As mentioned earlier, the banking authority would tend to adopt CAMELS framework in assessing the level of soundness of a bank.

Capital – Indicates the operational sustainability of a bank particularly when facing temporary financial shocks so that the bank would consistently operate in its risk taking capacity. Externally, capital would also indicate the potential systemic cost since it reflects the actual networth of the bank in the event of default. Therefore, most banking authorities use capital as important aspect to support exit policy. The aspects cover capital adequacy ratio (CAR), capital composition, trend of the capital, capital coverage on the risky assets, internal support on capital growth and access to sources of capital including the existing shareholders.

Asset Quality – Basically, the profit or loss of the bank depends upon the quality of is earning assets. The higher the quality of the assets, the higher the bank would have the operational profit in the long run. The assessment process would also describe the capability of the bank in spreading the risk, and recovering the problem loans. Specifically, the aspects cover general figure of non performing loans, concentrated loan on particular debtors and sectors, credit granting process, documentation and treatment of non performing assets.

Management – The quality of the management would bring impact on the bank operations in the long run. The assessment of the management quality covers the general management, risk management.and compliance. General management covers structure and composition of the management, the quality of corporate governance, transparency and effectiveness of the committee. Risk management covers supervisory process of the commissioners, policies and procedures, risk management process and comprehensive internal control. The bank would also be assessed for its compliance to particular regulations such as legal lending limit, net open position, know your customer and other commitments and specified regulations.

Earning – The level of earning indicates the competitiveness of the bank in the industry. A bank with a high level of efficiency would be expected to be more robust in facing fierce competition by acquiring bigger share in the market as it could sell products with a relatively lower price. The assessment also shows how the bank would be financially sustainable. The aspects cover return on asset, return on equity, net interest margin, operational efficiency and the trend of operational earnings.

Liquidity – The level of liquidity indicates the capability of a bank in optimizing prudential aspect and profitability at the same time. It has been

evidenced how illiquidity could throw a solvent bank into insolvency since the bank were forced to liquidate its asset far under par value to fulfil its current financial obligation. The aspects cover the composition of current asset and liabilities, short term maturity mismatch, cashflow projection and deposits.

Sensitivity to Market Risk – Assessing the capability of an Islamic bank in identifying, measuring, monitoring and controlling the exposure to market risk according to business volume and its complexity. The aspects cover the capital accumulations available for covering adverse movement of interest rate, exchange rate, the implementation of market risk management and effectiveness in the implementation of internal control.

Recent development has also indicated the involvement of qualitative judgement as additional factors to improve the quality of the assessment. The assessment report covers both the financial ratios and also the management quality when achieving particular financial objectives. The assessment report on operational soundness of the bank is normally used by the banking authority as an internal guidance to set supervisory actions. This is conducted in the light of risk based supervision that focuses the activities onto the critical points and adopt the forward looking principle.

2.2 Bank Rating System in Different Countries

The implementation of CAMELS rating system may vary from country to country. The US banking authorities determine a set of financial performance indicators set in a composite assessment that reflect the evaluation of standards, criteria and financial principles and operations of those institutions. The objective of the assessment is to identify the deficiencies in terms of financial capability, quality of the operations, risk management and compliance with prudential standards that require supervisory actions. The Financial Services Authority (FSA) of UK puts the assessment spots on nearly the same aspects as the US banking authority plus several additional aspects i.e. business analysis, internal control, organization and management quality. The assessment framework is known as CAMELB-COM. Different from the US and British authorities, the Belgian bank rating system does not specifically assess the capital, asset quality, management quality, earning and bank liquidity like in CAMEL. The bank is assessed on the aspects of inherent risk, risk management and risk controlling. The French banking authority (The General Secretaria of the Commision Bancaire) applies three supervisory appliances to assess the risks of the banks. The first appliance focuses on the profitability and the capital structure of the banks. The indicators are compiled industrially to describe the level of efficiency at the industry level. The second appliance is designed to detect potential deficiencies at the earliest possible by analyzing all the components relating to the bank activities and external factors that affect the bank financially. Based on the analysis, the banking authority sets the supervisory actions to rectify the adverse condition faced by the bank. The third appliance is an automated system fed by internal as well as external database to

indicate the early symptoms of potential problems. Other countries like South Korea, Malaysia implement the US type CAMELS rating system

3. Salient Features of Islamic Banking and Oversight Requirement

3.1. The Operational Foundation of Islamic Banking

The birth of Islamic economics and finance is driven by the eagerness of Muslim community to have a financial system (including banking system) that incorporated Islamic values in the activities. It is believed to promote sustainable development not only economically but comprehensively in the society (see Ahmed (1983) and Khan (1983)). The Islamic principles characterizing the economic system that are considered unique as compared to the mainstream one are as follows:

Ethical investment – Islamic economics requires all transactions to facilitate activities which are considered *ḥalāl*, such as: fulfiling the requirements in preserving the environment, avoiding projects that can cause damage to the public morality e.g. drugs, narcotics and prostitution. These issues, partially, have also been raised by international community by putting the environmental cost into account. It is believed that the long term economic system can only be sustained by moral fibres within the economic system. The economic development ignoring moral values would loose its strength in the long run since the quality of the players (which is one of the supporting components that characterize the system) would deteriorate.

The prohibition of ribā (usury) and the obligation of zakāh – The essence of prohibition of taking usury and the fulfilment in paying *zakāh* is actually forming the incentive mechanism so that the idle funds would be pushed into real sector of economy. While in the micro level, the implementation of sharing concept (as the replacement of interest in the transaction mechanism) is believed to bolster the feeling of brotherhood since both parties are sitting in the same position when facing the uncertainty. This point has, in fact, been raised by mainstream economists who suggested the application of stamp duty on the notes when it is held idle. The reason behind his suggestion is because the notes are considered as public goods that should be in circulation so that everybody would have a fair chance to use as measure of exchange. Prominent economists, like Krugman and Weitzman, state that equity based economy is more stable in facing an economic disturbance. It is understandable since in the equity based economy the burden resulting from any economic disturbance will be shared by the wider economic participants.

Non-speculative transactions – The prohibition of conducting speculative activities, particularly the transaction with no real underlying transaction, is

essentially aimed at preventing a financial detachment in an economic system; although the application of this concept would reduce the level of liquidity in the market as a trade-off. However, this would create contradiction to the current development achieved in the financial market in which the players are free to create any instrument which is considered acceptable to the market and could potentially generate substantial profits.

Besides those three basic distinctive features, Islamic contents relating to the financial best practise also promote other values which are very much in line with the universal perception towards having a safe and sound financial system. The implementation of the concept of *sidque* (honesty), *fathanah* (professionalism and competence), *amānah* (responsibility) and *tabligh* (openness and education) are in accordance with the international practises towards the implementation of good corporate governance and maximum level of transparency which have been addressed internationally. In short, Islamic economics and finance could be perceived to promote professionalism, competence and good governance universally besides ethical contents which is typical to the Islamic finance.

Those salient features mentioned above would bring operational particularities as compared to the conventional one. First, the presence of investmetn accounts that are based on profit and loss sharing would shift the fiduciary role performed by the bank to the agency role proportionate to the intensity of the investment account present in a particular Islamic bank. This would bring a shift on the paradigm when calculating the capital adequacy of the Islamic bank. Second, the interpretation of Islamic values could also be extended to the managerial aspects. Some relevant Islamic values can be implemented to improve the quality of good corporate governance (GCG), transparency and ethics; besides the compliance with the particular Sharīʿah transactional arrangements. Third, the implementation of the Islamic norms would bring in the difference when conducting value added distribution which cover not only the management and the share holders of the Islamic banks, but also its other stakeholders. Fourth, the difference in determining the rate of returns to the investors of the Islamic banks would also bring possibility of an Islamic bank to be exposed to the commercial displacement risk. Although conceptually the Islamic banks do not use the interest rate as the bechmark when determining the return to the investor, they cannot ignore the potential of the investors to suddenly shift their fund to other financial institutions that commit for a relatively higher returns.

3.2. The Oversight Requirements

One of the important aspects that should be described to build an efficient Islamic banking system is the oversight structure that would allow the regulatory and supervisory functions to operate well. In the banking sector, particularly, the implementation of the Basle standards would impact on the strengthening the capability of Islamic banking authority to maintain the soundness of Islamic banking system. The regulatory framework applied should be consistent to promote

the quality of the banking operation and, at the same time, be flexible enough to accommodate the dynamics in the market that are caused by the product innovation and the technological invention. However, the flexibility to adopt the market changes should consistently reflect the uniqueness of Islamic banking operations as its distinctive features (see Errico and Farahbaskh (1998)).

Operationally, the oversight framework should also be able to accommodate the prospective changes in the market. In the traditional financial system, the saving-investment process and trading activities are conducted mostly through banking system. The investors are not supplied with adequate level information allowing them to objectively assess the risk inherently contained; and therefore, most investors would choose banking institutions to invest their funds whilst maintaining minimum level of liquidity required. The traditional banking simply transforms liquidity which is accumulated through fractional reserve system into non-marketable and non-liquid investment. In the modern days, banking industry around the world faces formidable challenges from other non-bank financial institutions. They are losing some of their past monopolies and comparative advantages which have underpinned their position in the financial system. Due to the impact of the technological innovation and regulatory shift, the entry barrier into banking becomes lower. Consequently, banks are facing competition from a wider range of actual and potential suppliers of banking services: the capital market, money market, non-bank financial institution. The banks are now expanding into new areas: insurance, life insurance, unit trusts and other financial services that were not done in the past. As entry and regulatory barriers are eroded banks and other financial institutions will face asymmetric competition from a wider range of potential competitors. Some large corporate customers have become more creditworthy than their bankers, in which case it is not surprising that they displace banks and to some extent, provide limited range of banking services to others. Technological inventions have a powerful effect on the mode of delivering financial services such as direct banking including phone baking and online banking. Development in technology have the effect that financial systems are substantially over-supplied with infrastructure and overlapping delivery system through a duplication of traditional delivery system. In some models, the existence of banks is viewed as an endogenous response to imperfect and incomplete markets. The process of spectrum filling reduces the number and extent of discontinuities in the range of market instruments. The borrowers have now a wider range of capital market instruments. In addition, new information and trading technology has reduced information and transaction cost in capital markets relative to bank lending cost. Supported by the technological development, the banking and financial transactions become borderless as a number of internationally active banks and financial institutions try to facilitate international financial activities more actively. Islamic banking and financial industry should have an explicit and transparent regulatory framework that would effectively define its operating areas

to cope with prospective changes that would eventually affect the scope of supervision and regulation.[4]

4. A Comprehensive Approach Towards Structural Assessment

4.1 The Objectives of the Assessment on Islamic Banking Operational Soundness

Risk based supervision is now widely accepted as among the best ways to regulate conventional banks. The practice has developed in the wake of increasing complexity of the financial transactions and their inherent risks. Islamic banking can also benefit from the current developments in banking supervision as far as there is no contradiction in the goals and the process. Islamic banking industry might also use the same CAMELS framework when designing an appropriate rating system for Islamic banking, but with some improvement and modifications to adapt for the typical differences in the Islamic banking operations. Like in a conventional system, the rating system thus designed can become a significant base in conducting supervisory actions. The supervisory authority should have strong confidence when letting a particular Islamic bank to operate or even when deciding to stop operation of a particular Islamic bank. Besides playing a role as significant source of information regarding the financial soundness, the regulations set would also play a role as an effective tool when shaping the operations of an Islamic bank. The Islamic bank rating system is also meant to promote Islamic norms being implemented comprehensively. Therefore, the Islamic bank rating system might cover a wider scope of assessment as compared to the conventional one. It should, at least, contain the prudential aspects which apply universally plus typical salient features, such as compliance to the Sharīʿah principles, incorporation of sharing concept into the assessment tools (i.e. Financial ratios and thresholds) and the implementation of Islamic norms in the management. In the long term, the Islamic bank rating system should be capable of directing the Islamic banks to the ideal state of operations, including the products offered and the management style. Exhibit 1 shows the comparison between the components of the conventional bank rating system as compared to the Islamic bank rating system.

[4] Khan et.al (2000) discuss the possible regulatory and supervisory regime applied to the Islamic banking system after considering the possible adoption of existing prudential regulations applied to the conventional banking as long as it is still relevant to the Islamic values besides also trying to implement Islamic values in the concept.

Exhibit 1: The components of bank rating systems: a comparison

Components	Conventional banking	Islamic Banking	Notes
Capital	Solvency level	The same	-
	Prediction	The same	
	-	Agency role	The existence of investment deposit puts the issue of agency role as an important aspect
Asset quality	Probability of default	The same	
	-	Variable income	The existence of variable income assets
	Performance	The same	-
	Concentration risk	The same	
	Administration	The same	
Management quality	MU – GCG, transparency and efficiency	The same	
	-	MU - Sharīʿah value in management	There are Islamic values that should be reflected in terms of profesionality, morality and brotherhood
	MR – Identification, measurement, monitoring and control	The same	-
	Comp – Prudential	The same	
	-	Comp – Sharīʿah compliance	Management capability to comply with the existing regulations
Earning	BEP – Efficiency	The same	-
	-	BEP - Pricing policy	Assessing the pattern when determining the cost of capital-nya
	Industrial comp – ROE/ROA	The same	-
	-	ROE/benefit	Measuring the value added resulted and compare it with the non financial aspects
Liquidity	Short term mismatch	The same	-
	-	Short term mismatch-Displacement risk	Measuring the potential of the funds displacement resulted from the dynamics of market indices
	Structural mismatch	The same	-
Sensitivity to market risk	Interest rate risk	Schenario analysis on commercial displacement risk	Measuring the potential of the funds displacement resulted from the dynamics of market indices
	Exchange rate risk	Idem	-

Generally, Islamic bank rating system might have the same objectives except: the agency role at the liabilities side, the existence of variable income assets, the need to incorporate Islamic values in the management and the compliance with the internal policies, pricing policy, value added distribution principles and the possibility of facing displacement risk as a result of dynamics of the market indices. The rating system implemented should be able to describe the actual financial condition as well as the benefits (including socially) from the existence of the Islamic banks which, indeed, reflects the *maṣlaḥat* as its principles of operations.

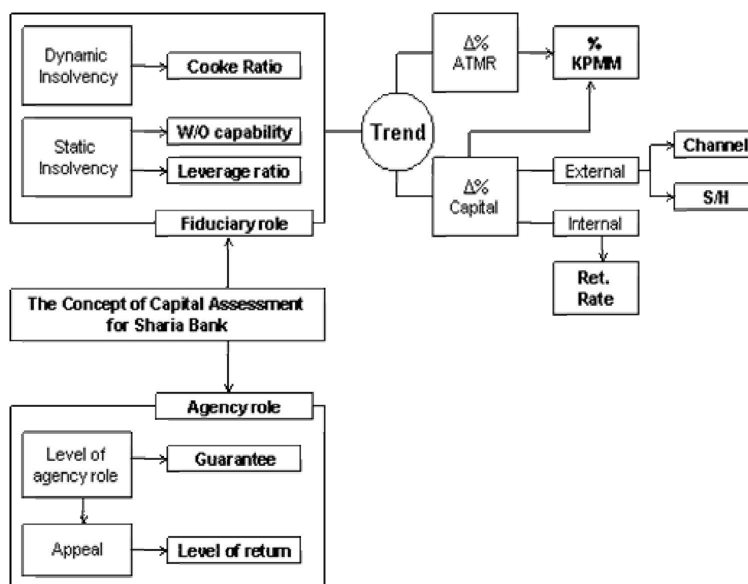
Technically, the assessment process would cover nearly the same aspects except for particular aspects as follows. First, the assessment tools for assessing the financial soundness would be adjusted into the structure of Islamic banking. Second, it would cover the Islamic objectives that have not been covered in the conventional framework, such as ethical investment, Sharīʿah compliance and the adoption of Islamic values in the banking operations.

4.2. The Components of Islamic Bank Rating System

4.2.1. The Component of Capital

The analysis of capital is conducted to prevent the insolvency of the banking system since any negative networth would eventually be levied on the public as tax payers. As indicated in Exhibit 2, it is proposed that the capital assessment cover three major areas: the level of solvability which reflects bank's capability in performing fiduciary role, the trends of the solvability and the level of agency role performed by the bank (see Appendix- 1 for ratios and details).

Exhibit 2: The indicators used for the bank's capital assessment



There are three indicators possibly used to indicate the level of bank's solvency with different interpretations. First is the Cooke ratio which is known widely as Capital Adequacy Requirement (CAR).[5] Second is the Equity Coverage Ratio that reflects the capability of the own capital to effectively cover the potential loss resulting from bank's financial exposures. Third is the leverage ratio that indicates the estimate of the residual claims of the bank.

Besides the indicators that reflects the current capital condition, it is also recommended to assess the trends of the solvency level based on some assumptions and prediction. There are three sources of information that can be used: internal support of capital, external support of capital and the business expansion. The internal support could be assessed from the dividend policy set by the bank's management as indicated from retention rate. This would reflect the internal commitment to stay in the business by accumulating parts of the financial profit to build a stronger capital base. The external support could also be considered as one assumption when predicting the future risk absorbing capacity as long as there is strong indication towards the realization. The assessment on the business expansion can be predicted from the bank's business plan which is regularly reported to the banking supervisory authority. The level of agency role of an Islamic bank can be seen from proportion of the profit and loss sharing deposits on its liabilities. The higher the proportion, the higher the bank performs its agency role. There are three possible financial ratios to assess the agency role. First is the ratio of unrestricted investment account holder to the total deposits. This would simply reflect intensity of agency role performed. Second is ratio between the Tier-1 capital to the unrestricted investment account that reflects the agency costs to the shareholders, and third is the level of return to the restricted investment account holders.

4.2.2. The Component of Earning Asset Quality Assessment

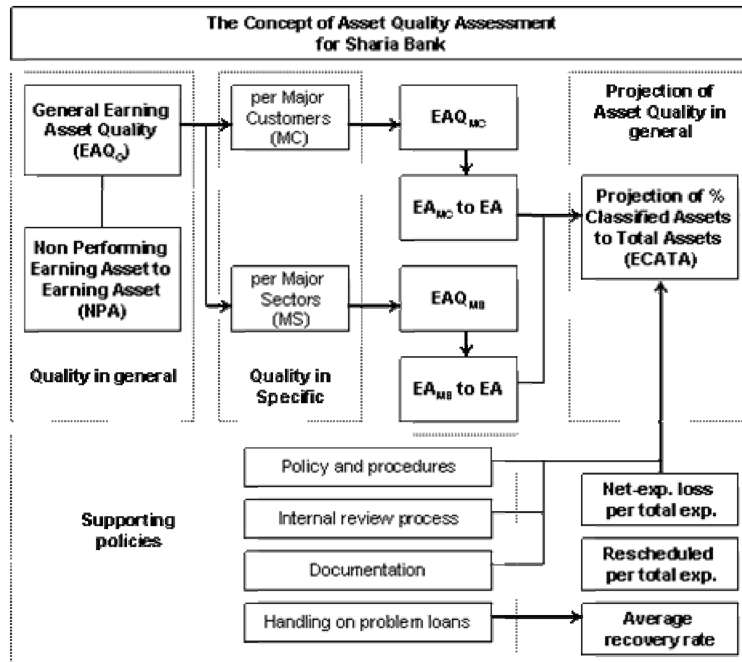
The Islamic banking can use almost the same principles and techniques to assess the earning asset quality that is currently used by the conventional banking. As indicated in the Exhibit 3, the assessment process would concentrate on four main areas: general asset quality assessment, specific asset quality assessment which covers specifically large exposure customers and business sectors, supporting policies implemented to promote sound granting process and the projection of asset quality projection in general which is based on the first three assessments (see Appendix-2 for ratios and details).

The general assessment on earning asset quality covers the potential loss of the earning asset (proportionated to the total earning assets) and the proportion of the non performing assets to the total earning assets. The general assessment for

[5] The calculation of the CAR for Islamic bank following the recommendation by the IFSB that structurally differs the assets based on its sources of funds

earning assest quality can also be applied to assess the risk specifically in the particular major customers and sector where the banks get into.

Exhibit 3: Indicators used for earning asset quality assessment



Besides the quantitative aspects reflected in the financial ratios, the asessment of earning asset quality should also cover the qualitative aspects, such as the supporting policies, as the significant aspect when drawing the conclusion. The qualitative aspects cover the policy and procedure quality, internal review process, documentation process. Normally, the policy assessment would also cover the capability of the banking handling problem financing. This would ultimately be indicated by high recovery rate. This should be supported by a high haircut level and appropriate representation of rescheduled assets.

4.2.3. Component of Management Quality Assessment

The management quality assessment is suggested which covers a wider area than it used to. The suggested framework would cover general bank management, the qualitative aspects of risk management process, and the compliance to the prudential banking regulations. This, in fact, adopts the current best practises in the western banking system which has been evolving through time and experience. Besides adopting the current developments from the western banking system, the concept designed should also contain Islamic values and norms which are reflected from its operations. This is quite important since the regulations set should also

promote the implementation of Islamic values and norms which are demanded by the customers.[6]

Exhibit 3.(a): Islamic values relating to the general management aspects

Supporting indicators	Notes	Relevant Islamic values
Structure and composition of bank management	Bank has an effective composition of boards of commisioners that is in accordance with the business volume and the level of complexity in the daily operations. Besides capacity in financial management, the board should also be presenting a positive attitude, manners and morality.	ʿAdl – positioning the personnel appropriately according to their competences; *Masūlīyah* – accountability in performing the tasks; resource optimalization; *Intāj* – high productivity; *iḥsān* and *Fatanah* – professionalism; Divine leadership – financial and spiritual leadership.
Capacity to handle possible conflict of interest	Internal management system designed could minimize the potential moral hazard. Management as the executor has an integrity in decision making process.	*Ijābiyah* - Positive attitude when facing 'agency problem' resulting from potential conflict of interest; *Istiqāmah* – compliance with the operational policy; *Masūlīyah* – Accountability when performing the tasks.
Managerial independency	The members of the board have capacity to independently take action in anticipating any possible interference causing deterioration of the GCG.	Independence – Independency in the decision making process and robust from external interference.

[6] In depth discussion on the Islamic perspectives towards management system could be found in Al-Buraey (1990).

Supporting indicators	Notes	Relevant Islamic values
Capacity in maintaining the quality of the GCG	Capacity to avoid any activitiy that potentially deteriorate ke quality of GCG like unsound financing granting process. Sound relationship among the work force which is indicated by harmony and effective official chains among individuals in the bank.	*Imān* – clear objectives in all levels of the management *Akhlāq* – the management has positive intention when performing the tasks; Divine leadership – adequate care of the work force; *Amānah* and loyal – stick to the commitment and be responsible; *Jama'ah* – managerial cohesiveness in achieving the objectives; Communicative – adequate communication skill; Efficiency – cost consciousness; *Ikhlās* – sincerity *Islāḥ* – continual improvement
Informational transparency and educations	Adequate level of transparency in implementing GCG to the stakeholders to mitigate the reputation risk.	Learning organization – adequate informational dissemination in the management and to the customers in general. Sidiq – honesty.
Effectivity of the committee	Adequate understanding by the board in the area of risk management to effectively evaluate their performance and formulate the business strategy.	*Fatanah* – professionalism.

Supporting indicators	Notes	Relevant Islamic values
Fair value added distribution	Mechanism in place to ensure value added distribution internally as well as externally.	*ʿAdl* – just in distributing value added including management, customers and the environment; *Tawāzun* – balance in achieving the objective materially and spiritually
Brotherhood	Effective mechanism in place to promote brotherhood and positive cohesiveness internally as well as ixternally.	*Ukhuwah* – positive relationship internally as well as externally *Mushāwarah* – maṣlaḥa oriented decision making process *Silaturrahm* – close and warm relationship
Social education	Effective mechanism in place for appropriate positioning financially as well as the activities building up the quality of human being in general	*Tablīgh* – performing social education to the stakeholders
Service excellence	Memiliki motif pelayanan yang tinggi terutama terhadap nasabah	*Ri'āyah* – the spirit to deliver the best to the stakeholders

Assessment on the quality of general management

The areas of the assessment on the general management assessment covers several aspects i.e. The structure and the composition of the bank management; the capability to handle possible conflict of interest; the managerial independency; the implementation of Good Corporate Governance (GCG); informational transparency and education; and, the performance of the committee. Sharīʿah principles, in practice, contain managerial guidances that are, in fact, in line with current management concept promoting a higher level of operational efficiency. Moreover, Islamic values has a wider coverage which are illustrated in Exhibit 3.(a). It can be seen that Islamic principles have close relationship to the factors supporting the general operational soundness. In specific, the aspects that have not been covered in the current best practises are: the quality of leadership in both aspects, financially and spiritually; the capacity to handle the possible conflict of interest; the just position among the managerial components leading to the implementation of GCG.

Other indicators that have not been covered in the the assessment on general management include fair value added distributions, brotherhood, social education and service excellence. Islamic values promote the concern on the fair value added distribution by the bank including the community and environment preservation; brotherhood enabling a fruitful participation in the decision making process including facilitating the voice of strategic investors of an Islamic bank to participate in the decision making process; social education; and service excellence.

Exhibit 4.(b): Compliance to the banking regulations

Supporting indicators	Notes	Relevant Islamic values
Legal lending limit	Emphasizing the mitigation on concentration risk.	*Qunuunuyah* – compliance with the existing regulations.
Net open position	Emphasizing the mitigation on the currency risk.	
Know your customers	Compliance with the regulation assuring all the funds coming from the legitimate funds.	*Qunuunuyah* – compliance to the existing regulation. *Niat* – each financing process should be believed to generate *maṣlaḥat*
Compliance to the sharīʿah principles	Internal corrective mechanism to ensure a low level of compliance on sharīʿah regulations.	Sharīʿah – Compliance with the matters considered as prohibited such as: maysir, immorality, *gharar*, *ḥarām*, *ribā*, *iḥtikār*, and dangerous.
Ethical investment	Besides Sharīʿah compliance, management should also concern about aspects which have moral dimansion such as environment etc.	Moral Environmental consciousness

Assessment for the quality of risk management

In the risk management assessment, the Islamic values are conceptually in line with the best practises. The assessment covers the supervisory activities by the top management on all banking activities, policy adequacy, procedures and limits; risk management process (identification, measurement, monitoring and mitigation); and internal management. The Islamic values relating to the risk management cover supervisory principles through check and recheck culture, good administration (*idarah*), realistic planning (*tadarruj*), continual evaluation (*muhasabah*), continual improvement (*tawakal*), fulfilment to the commitment by the management (*wafa*) and appropriatness in the risk management (*wasathan*).

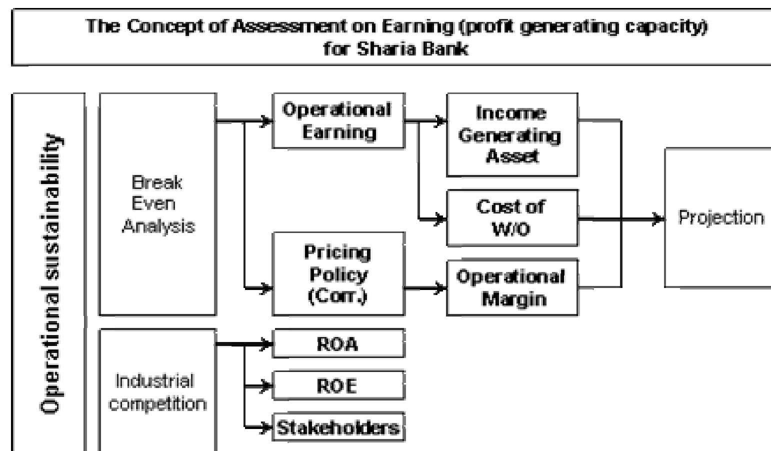
Assessment for the bank compliance with the banking regulation

Islamic values promote compliance with the regulations issued by the regulatory body as the party that performs the role in achieving *maṣlaḥat* for the community. The regulations issued would cover both financial aspect and Sharīʿah aspect as shown in the Exhibit 4.(b).

4.2.4. Components of Earning Assessment

Earning asset quality indicates the ability of an Islamic bank to operate sustainably. The assessment is represented by two main indicators i.e., breakeven analysis and the industrial competitiveness (see details in Appendix-3 for ratios and details).

Exhibit 4: Indicators use in earning quality assessment



Breakeven analysis focuses the analysis on describing the banks capacity to operate sustainably based on the actual activities. The first tool is the operational earning to expenses ratio. The second ratio (portfolio composition ratio) describes the actual percentage of earning assets that sustain the bank operations. The third ratio is proposed to describe the proportion of operational expenses that is disposed as write off. The forth ratio is operational margin reflecting the operational surplus or deficit as a result of the business activities.

Analysis on the industrial competitiveness would involve three indicating ratios. As they are widely used, the first two indicators are Return on Assets (ROA) and Return on Equity (ROE). The ROA indicates the bank's efficiency level if compared to the industrial benchmark; whilst the ROE indicates level of attatctiveness of the industry to the potential investors. Besides those two ratios, the additional ratio that reflects the bank's competitiveness is the correlation ratio of the return of the Islamic banks to the investors. The more uncorrelated the return to the investors are across banks, the more the Islamic bank is independent from

adverse effect resulting from the dynamics of the interest rate i.e. The investors will not easily shift because of the rate differential between the two industries.

4.2.5. Components of Liquidity Assessment,

Liquidity is one of the important aspects in the banking business since its operations are based on public confidence. Illiquidity could throw solvent bank into insolvency since it has to sell its assets far below its market values to fulfil its current financial obligations.

Exhibit 5 (a): Component of liabilities and its characteristic

No	Items	Terms	Maturity
1	Short term liabilities (including interbank liabilities)	Short	Certain
2	Medium and long term liabilities	Medium to long term	Certain
3	Expected withdrawal of deposit funds	Depends upon the confidence level of the depositors	Uncertain
4	Equity	Infinity	Certain

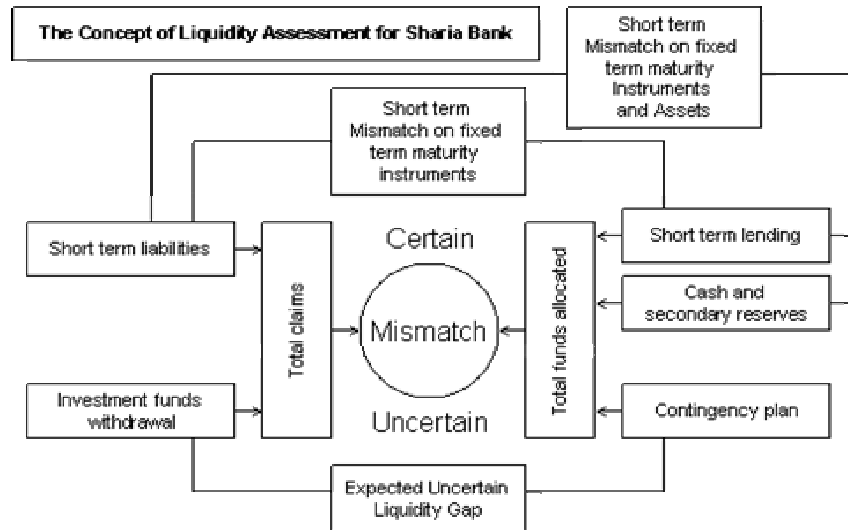
As a financial intermediary institution, an Islamic bank has a certain level of similarities on the liquidity profile to the conventional bank. An Islamic bank has short, medium and long term products with certain periods of maturity and uncertain period of maturity. Exhibit 5 (a) and 5 (b) describe the components of the asset and liabilities side of an Islamic bank and its characteristics.

Exhibit 5 (b): Component of asset and its characteristic

No	Items	Terms	Maturity
1	Cash (including secondary reserves owned by the bank)	Short	Certain
2	Short term lending (including interbank claims)	Short	Certain
3	Medium term lending	Medium	Certain
4	Long term investment	Long term	Certain
5	Channelling (including strategic alliences and access to financial market	Depends upon the confidence level of the lenders and the liquidity condition of the market	Uncertain

A soundly operated Islamic bank should be able to synchronize the possible liquidity mismatch to minimize unnecessary costs that resulting from 'panic' sale of the assets.

Exhibit 5 (c): Indicators used on the liquidity assessment



The liquidity assessment is conducted to describe the potential liquidity mismatch resulting from imbalance of scheduled assets and liabilities (financial products with exact maturity periods). The first ratio describes the simple composition of scheduled short term financial structure leading to financial mismatch (short term mismatch ratio). The second ratio adds two additional components (cash and secondfary reserves) to the first ratio to describe the potential current mismatch more representatively.

The third ratio describes the potential withdrawal by the core depositors. The ratio simply finds the proportion of the core depositors to the total deposit funds. A higher ratio indicates a higher possibility of the bank being exposd to a significant withdrawal of the deposit funds. The fourth ratio describes the growth of the core deposit which represents the future dependence of the bank on the core depositors. In order to anticipate the unexpected withdrawal, an Islamic bank would also be expected to set up a strategic alliance with other Islamic financial institutions to establish a line for mutual liquidity assisstance. The commitment would be quantitatively measured in the fifth ratio.

4.2.6. Components Used for Sensitivity to Market Risk Assessment

Due to the higher exposure to the market variables, Islamic banks can experience losses as a result of the dynamics in the market variables. The market variables include interest rate, commodity price and exchange rates. As mentioned earlier, the Islamic banks face commercial displacement risk as a result of lower yields given by the Islamic banks as compared to the conventional ones. The Islamic banks would also be exposed to the price risk when holding commodities

in the *salam*-type of transactions. Islamic banks would also be exposed to exchange rate risk since it could conduct cross currencies business activities. The banks are supposed to quantify the risks and compare the potential losses to the bank capital (see Appendix-4 for ratios and details). The choice of the methods for the assessments is given to the Islamic banks.

5. Concluding Remarks

Operationally, Islamic banking could use the CAMELS rating system when assessing the soundness of the Islamic banks. The difference would be on several aspects like: (1) the agency role in the capital assessment, (2) value added distribution, (3) identification of risks which do not appear in the conventional banks, and (4) the incorporation of the Islamic values and norms which particularly emphasis professionalism, competence to promote conducive and friendly atmosphere in the organization and other Islamic values like environment orientation besides transactionally Sharīʿah compliance. Islamic bank rating system is expected to benefit the supervisory process as it could reflect the operational soundness more objectively. The rating system would then be used as a base to formulate supervisory actions. Therefore, the rating system design should be able to locate the problems that may occur in the bank more precisely.

Appendix – 1
Components of Capital Assessment

I. Fiduciary Role

Ratio Capital 1 - Capital Adequacy Ratio

$$CAR = \frac{E_{Tier 1+2+3}}{RWA}$$

CAR : Capital Adequacy Ratio

E : Equity (tier 1, 2 dan 3)

RWA : Risk Weighted Assets

Ratio Capital 2 - Equity Coverage Ratio

$$ECR = \frac{E_{Tier 1} + AEAL}{EAaR}$$

ECR : Equity Coverage Ratio

E: Equity (tier 1)

AEAL : Allowance for Earning Assets Losses ($\approx PPAP$)

EAaR : Earning Assets at Risk ($\approx PPAPWD$)

Ratio Capital 3 - Equity to Deposit Ratio

$$EDR = \frac{E_{Tier 1}}{D_G}$$

EDR : Equity to Debt ratio

E: Equity (tier 1)

D_G : Guaranteed Debt (third party fund)

Assumption :

Short fall is a result from asset value multiplied by recovery asset (discounted value) minus bank's obligation

$$(\alpha A - D_G) = S_f$$

Networth positive in long term can be achieved if genuine bank's capital can covers short fall.

$$E_{Tier 1} = A - D_G$$

By mathematical substitution process, we can set the expected long term networth position

$$\alpha E_{Tier1} + (\alpha - 1)D_G = S_f$$

$$E_{Tier1} = \left[\frac{(1-\alpha)}{\alpha} D_G + \frac{S_f}{\alpha} \right]$$

$$\frac{E_{Tier1}}{D_G} = \left[\frac{(1-\alpha)}{\alpha} + \frac{S_f}{D_G \alpha} \right] = EDR*$$

II. The Trend of the Bank Solvability

- **Exposure at risk** covers risk projection of placement and development of bank's asset in the future. The indicator of this projection comes from expected projection of Risk Weighted Asset (RWA/ATMR in bank's business plan.)
- **Internal source**, comes from retained earning which is related with devidend pay out policy which is formed in retention rate :

  $$RR = \frac{E(1-DPO)}{E_{tier1}}$$

  RR : Retention Rate

  E : Earning (available to shareholders)

  DPO : Dividend pay out ratio

  E_{tier1} : Equity (tier 1)

  Ratio Capital 4 – Internal Support Ratio

  $$IS_t = \frac{RR_t}{\%\Delta RWA_{t+1}}$$

  IS : Internal Support

  RR : Retention Rate (current)

  $\%\Delta RWA_{t+1}$: Growth expectation RWA/ATMR (%) 1 period after in the future

- **External sources**, cover the ability of bank to invite investor and the ability of existing shareholder to improve its participation as shareholder. The bigger access to capital market and or the bigger financial ability of shareholder, it's easier for a bank to solve its capital

problem especially if the growth of internal source slower to the development of its risk exposure. This need bank's supervisor professional judgement.

Ratio Capital 5 – Capital Growth

$$\%CAR = \frac{\%\Delta E_{Tier1+2}}{\%\Delta RWA_{t+1}}$$

III. Agency Role

Ratio Capital 6 – Agency Role

$$AR = \frac{D_{NG}}{D_{total}}$$

AR : Agency Role

D_{NG} : Non-guaranteed Debt (non-guaranteed third party fund)

D_{Total} : Debt (third party fund total)

Ratio Capital 7 – Financial Participation

$$FP = \frac{E_{Tier1}}{D_{NG}}$$

FP : Financial Participation

E : Equity (tier 1)

D_{NG} : Non-guaranteed Debt (Non-guaranteed third party fund/muḍārabah)

Ratio Capital 8 – Investment appeal

$$ROD_{NG} = \frac{R_{NG}}{D_{NG}}$$

Appendix – 2
Components of Earning Asset Quality Assessment

I. General Asset Quality Assessment

Ratio Asset Quality 1 – General Credit Value at Risk

$$EAQ = 1 - \frac{EAaR}{EA}$$

EAQ : Earning Assets Quality

EAaR : Earning Assets at Risk

EA : Earning Assets (aktiva produktif)

Ratio Asset Quality 2 – Non performing asset ratio

$$NPA = \frac{NPEA}{EA}$$

NPA : Non Performing Assets

NPEA : Non Performing Earning Assets (earning asset with collectibilty other than current and in special mention)

EA : Earning Assets (aktiva produktif)

II. Earning Asset Quality Specific

The assessments are conducted exactly like the general asset quality assessment but on the specific major customers and major economic sectors.

III. Supporting Policies

The assessment of earning asset quality covers qualitative aspect which covers three major spots: policy and procedures, internal review process and documentation.

The policy and procedure quality – The assessment is conducted to figure out the potential agency problem that could result in unsound granting process and failure to implement four eye principles in its activities.

Internal review process – The assessment is to ensure the the bank has delivered sufficient efforts to comply with their internal operating procedures. The assessment covers frequency of the review, the level of independeny of internal audit, incompliance of the operational activity with its internal procedures, and information system which supports administration process and management decision process.

Documentation – The assessment focuses on the quality of documentation process that should reflect the completeness and the traceability of the documents when there is a documentation failure. This includes quantitative data which can be used in back-testing process (to test validity of bank's risk modelling process as based for decision making proses)

IV. Handling on Problem Loans

Ratio Asset Quality 3 – Haircut Level

$$HCL = \frac{EE}{EAaR}$$

Ratio Asset Quality 4 – Rescheduled Asset Ratio

$$RA = \frac{REA}{EA} \text{(RA - 8)}$$

RA : Rescheduled Assets

REA : Rescheduled Earning Assets

EA : Earning Assets (Aktiva produktif)

Ratio Asset Quality 5 – Non Performing Asset Ratio

$$ARR = Avg\left[\frac{RV}{TWO}\right] \text{(RA - 9)}$$

ARR: Average Recovery Rate

RV: Recovery Value

TWO: Total Write-Off

Appendix – 3
Components of Earning Asset Quality Assessment

I. Breakeven Analysis

Ratio earning asset quality 1 – Operational efficiency ratio

$$OER = \frac{OE}{OR}$$

OER : Operational Efficiency Ratio

OE : Operating Expenses

OR : Operating Revenue

An efficient bank tends to have low operational efficieny ratio. The ratio is made to also accommodate the business plan of the bank with confidence level of 95 %

$$OE_t * \left[1 + \left(\sum_{t=-3}^{+1} \% \Delta RWA \right) / 4 \right] = OR_{\alpha=5\%}$$

Ratio earning asset quality 2 – Income generating assets

$$IGA = \frac{(EA - NPEA)}{TA} \quad \text{(RE - 2)}$$

IGA : Income generating Asset

EA : Earning Asset (aktiva produktif)

NPEA : Non-Performing Earning Assets

TA : Total Assets

$R_{EA} * EA = R_D * D + R_E * E + OC$, dgn $NPEA \approx 0.05 * EA$ maka:

$$IGA = \frac{0.95 * (R_D * D + R_E * E + OC)}{TA * R_{EA}}$$

Ratio earning asset quality 3 – Fee base income

$$IC = \frac{FBI}{NFBI}$$

IC : Income Composition

FBI : Fee Based Income

NFBI : Non Fee Based Income

Ratio earning asset quality 2 – Cost of write off

$$WOC = \frac{WO}{OE}$$

WO : Cost of Write-off

OE : Operational Expenses

Ratio earning asset quality 3 – Operating margin

$$OM = \frac{COR - COE}{avg(EA)} \text{ (RE - 9)}$$

OM : Operational margin

COR : Core Operational Revenue

COE : Core Operational Expense

Avg(EA) : Average Earning Assets

II. Analysis of Industrial Competency

Ratio earning asset quality 3 – Return on Assets

$$ROA = \frac{EBT}{TA}$$

ROA : Return on Assets

EBT : Earning Before Tax

TA : Total Assets

Ratio earning asset quality 4 – Return on Equity

$$ROE = \frac{EAT}{PC}$$

ROE : Return on Equity

EAT : Earning After Tax

PC : Paid in Capital

Ratio earning asset quality 5 – Income correlation

$$RCorr = Corr(r, i) \qquad \text{(RE - 10)}$$

Rcorr : Return Correlation

R : tingkat imbalan deposito mudaharabah 1 bulan

I : tingkat bunga deposito 1 bulan

Appendix – 4
Components of Liquidity Assessment

Ratio Liquidity 1 – Short Term Mismatch

$$STM = \frac{STA}{STL}$$

STA : Short Term Assets

STL : Short Term Liabilities

Ratio Liquidity 2 – Short Term Mismatch Plus

$$STMP = \frac{STA + C + SR}{STL}$$

C: Cash

SR : Secondary Reserve

Ratio Liquidity 3 – Intensity of the Core Depositors

$$RDS = \frac{DS}{DPK}$$

DS : Special Deposits

DPK : Total Deposits

Ratio Liquidity 4 – Growth of the Intensity of the Core Depositors

$$GRDS = \frac{\%\Delta DS}{\%\Delta DPK}$$

%ΔDS : Earning Assets Quality

%ΔDPK : Earning Assets at Risk

Ratio Liquidity 5 – Liquidity Assisstance

Bank also has an obligation to quantify sources of liquidity support fund (Expected Liquidity Aid - ELA) and then compare this with net short term mismatch.

$$RCP = \frac{ELA}{DI + Net(STMP)}$$

ELA : Liquidity Commitments

DI : Special Deposits

Appendix – 5
Components of Sensitivity Assessment

Ratio Sensitivity Analysis 1 – Interest rate

$$Sir = \frac{E[Loss_{ir}]}{Capital}$$

$E[Loss_{ir}]$: Expected loss resulted from the interest rate volatility

Ratio Sensitivity Analysis 2 – Commodity price risk

$$Sir = \frac{E[Loss_{eq/com}]}{Capital}$$

$E[Loss_{com}]$: Expected loss resulted from the commodity price volatility

Ratio Sensitivity Analysis 1 – Exchange rate risk

$$Sir = \frac{E[Loss_{er}]}{Capital}$$

$E[Loss_{er}]$: Expected loss resulted from the exchange rate volatility

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Comments

on "Transparency and Market Discipline in Islamic Banks" by Noraini Mohd Ariffin, Simon Archer and Rifaat Ahmed Abdel Karim

Mohammad Al-Suhaibani*

First, I would like to express my appreciations to the authors for their effort. The topic is relevant, timely, and of interest to the policy makers and standard setters. The paper is generally well written; clearly addresses the topic; well organized and presented in a format that is accessible to the practitioners.

Below, I will provide general and specific comments aimed at enhancing the paper.

General Comments

It would be very useful to the readers to know the existing level of transparency in Islamic banks as well as their reporting requirements under the existing regulations to strengthen market discipline. Therefore, I suggest expanding section 2.6 of the paper to include the current status of transparency and market discipline in Islamic banks as basis for the subsequent analysis. Potential sources of information that can help in this regard include: Bank of International Settlement (BIS) policy papers, Islamic Financial Services Board (IFSB) publications, and the World Bank webpage on Islamic finance.

The global trend is towards more deregulation of the financial services industry, which in turn demands a change in the role of supervisors. Against these developments, regulators have reassessed existing rules and adopted a consolidated supervision framework to prevent regulatory gaps that could become a source of systemic concern. As a result, Central Banks in countries where Islamic banks operate will either change their mandate or yield more powers to other regulatory bodies to supervise bank operations (FSA in UK is a good example). I noticed that the survey covers only central banks as they are the current supervisors of Islamic banks. I wish that the authors would also have discussed how this trend is changing the role of supervisors in Islamic countries (central banks vs. other regulator of financial services) and the future implications of potential changes in the regulatory

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environment on Islamic bank reporting.

The paper's conclusions are based on the assertion that Islamic banks are based on profit sharing arrangements, as it can be understood from these quotations:

> "Since Islamic banks are based on profit sharing arrangement, transparency is more important in Islamic banks compared to conventional banks as investment account holders require greater information to monitor their investments" (section 1)

> "Transparency of risk reporting in Islamic banks is perceived to be more important than in conventional banks due to the existence of profit sharing arrangements, and in particular to unrestricted investment account holders" (section 4)

However, it is well known that debt-based financing is widely used by Islamic banks, and with the spread of *tawarruq* mode of finance, the differences between Islamic and conventional banks are diminishing. As a result, the current recommendations to have a different set of requirements for Islamic banks become irrelevant. This fact actually highlights the need to develop the financial infrastructure, markets and institutions that are designed to reduce the asymmetric information problems faced by bank in their working environment to encourage them to base their operations in optimal PLS contracts.

Certainly, transparency is critical for financial institutions to gain public and investor confidence and for the regulators to conduct effective supervision. As expected, the respondents to the survey, on average, rated all statements demanding more information to be very important, even by banks that tend to resist releasing more information. I think that the general statements used in the survey have led to this consensus, and as a consequence, directed the paper to broad recommendations to policy makers. However, policy makers and standard setters are more eager to have specific recommendations to act upon and design policies and standards that can improve the transparency in Islamic banks. I think the paper will be more useful if it addresses the situation in more detail by complementing the survey with focused case studies to examine the issues in detail and to provide more specific recommendations for policy makers at least in those particular cases. Also, expanding the survey to include other information users (other than bank supervisors) will add to the credibility of the results.

2. Specific Comments

A clarification of the market discipline concept in the introduction and how it relates to transparency will be useful. I suggest highlighting the fact that market participants need to have four prerequisites for market discipline to be effective: sufficient information to reach informed judgements (transparency); the ability to

process it correctly; the right incentives; and the right mechanisms to exercise discipline.[1]In the absence of strict regulation to strength transparency (weak market discipline), lateral voluntary solutions such as signalling and screening will prevail. Signalling will become the choice for good Islamic banks (to distinguish themselves from bad type of banks) and screening will be the choice for market participants (to differentiate between good and bad type of banks). Forcing transparency by a third party (regulators) will increase the quantity of public information vs. private information, and as a result will reduce the adverse selection risk faced by market participants and the moral hazard risk for banks. This is not consistent with the authors view stated in section 2.2 "*If market discipline is weak, theoretically, the signalling theory would be less applicable*".

I suggest highlighting, in the literature review, the contribution of Chapra and Khan made in their prominent paper on regulation and supervision of Islamic banks.[2]

Finally, I do not see appropriate to quote selective responses from the interview in this paper unless we are sure that they represent the opinions of the most respondents. The survey result can be generalized but the comment received is not.

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[1] Andrew Crockett: "Market Discipline and Financial Stability", Banks and Systemic Risk Conference, Bank of England, London, 23-25 May 2001. In this speech, Crockett uses the term "market discipline" in a broad sense, to denote internal and external governance mechanisms in a free-market economy in the absence of direct government intervention.

[2] Chapra M. Umer and Tariqullah Khan, *Regulation and Supervision of Islamic Banks*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, 2000.

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Comments

on "A Design for Islamic Banking Rating System: An Integrated Approach" by Dadang Muljawan

Sofyan S Harahap*

Objectives

The paper aims to formulate a model for assessing the soundness of Islamic banks. The model is still based on conventional formulae, i.e., CAMELS but it tries to accommodate some characteristics of Islamic banking and values to the model.

Argument

The paper argues that conventional CAMELS model can be used in assessing the soundness of Islamic banks, however the model would need to accommodate some indicators that reflect the salient characteristic of Islamic banking. The paper tries to identify some differences of CAMELS components between Islamic and conventional banks and proposes these to be included into the new model.

Coverage

The paper covers several issues that help us understand the difference between Islamic and conventional bank assessment related to each element of CAMELS rating. But it fails to show the real difference between the two, especially to create a new model. It also fails to show the difference between Islamic values and the modern values i.e. professionalism, responsibility, continuous improvement etc., which in my view are also a part of conventional tradition. The paper does not justify why Islamic bank regulators can still use conventional model in assessing Islamic bank soundness while the philosophy of Islamic banking is different from the conventional banking.

Differences between Islamic Bank and Conventional Bank:

The paper discusses the differences between conventional and Islamic banks but, in my opinion, it fails to identify the differences clearly and consistently especially for use in the CAMELS model. In some paragraphs, the paper identifies the difference between the two but these are not presented consistently. Moreover, it fails to show how these differences affect the new model for assessing the

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soundness of Islamic bank. The failure to clearly identify the differences between the two in the CAMELS model will affect the measurement aspect which will be used in the Neo-CAMELS to assess the Islamic bank healthiness.

The following quotations from the paper show inconsistency in identification of the differences and how the paper fails to focus which elements will influence the new CAMELS model:

1. In the abstract the author argues that the difference between conventional and Islamic banks in CAMELS model are:
    a. The agency role of Islamic bank in the capital assessment
    b. Value added distribution
    c. Identification risks
    d. Incorporation of the Islamic values and norms which emphasize professionalism, competence, and Sharīʿah compliance.
2. In section 3.1:
    a. Ethical investment
    b. Probation of *ribā* (usury) and obligation of *zakāh*
    c. Non-speculative transaction
    d. Concept of Shiddiq, fathanah, *amānah*, and tabligh
3. In section 4:
    a. Compliance to the Sharīʿah principles
    b. Sharing concept
    c. Islamic norms in management
4. In Exhibit 1: Component of bank rating systems: A comparison:

Capital:	Agency role
Asset quality:	Variable income
Management Quality:	MU Sharīʿah value in management; Sharīʿah compliance
Earning:	BEP Pricing policy; ROE benefit
Liquidity:	Short term mismatch; displacement risk
Sensitivity to market risk:	Scenario analysis on commercial displacement risk

    There is no formulae to measure the difference and its effect on CAMELS model.
5. In section 4.2.1:
    a. Financial soundness would be adjusted into the structure of Islamic banking
    b. Islamic objectives: ethical investment, Sharīʿah compliance, Islamic values in the banking operation.

6. In Exhibit 3a:

   Management aspect:
   Fair value-added distribution, brotherhood, social education and service excellent.

7. In section 4.2.3:

   Quality of risk management:
   Cheque and recheck, good administration, realistic planning, continual evaluation, continual improvement, fulfilment to commitment, appropriateness in the risk management.

8. In the concluding section 5:

   a. the agency role in the capital assessment
   b. identification of risks which do not appear in conventional bank
   c. the incorporation of the Islamic values and norms which particularly emphasis professionalism, competence, to promote conducive and friendly atmosphere in the organization and other Islamic values like environment orientation beside transactionally Sharīʿah compliance

These are eight places in the paper discussing the differences between the Islamic and conventional banks and arguing that the CAMELS model should accommodate these components in assessing the soundness of an Islamic bank. These 8 instances are not using a consistent and similar elements and do not clearly define and specify the differences. The paper fails to provide a new CAMELS model based on the Islamic banking spirit. Failure to identify the difference has resulted in the failure to device a measure or the assessment criteria for use in the model.

Assessment System

Even though CAMELS model is used in many countries however it has its own limitations in assessing the soundness of a bank especially its subjective judgement. CAMELS uses quantitative as well as qualitative criteria. The latter has been used in assessing management aspect of the bank. Some authors argue that the qualitative criteria might be subjective. However I agree with the author that CAMELS model can be used in assessing the soundness of an Islamic bank with some modifications.

There are some limitations of proposed model:

a. subjective components
b. unclear indicators of Islamic value measurement in every component of CAMELS.

The paper can be improved, if it clearly shows the differences between Islamic bank and conventional banks and specify some criteria to measure them so as to

make them a part of the Islamic bank based CAMELS model. The paper should also propose a model, not simply a list of features that are to be included in the model.

Conclusion and Recommendation

The paper has attempted to address a very important topic of formulating a model for assessing the soundness of Islamic banking operations. We appreciate the work the author has done to study the topic. The paper has elaborated extensively the possible differences between Islamic bank and conventional bank particularly in assessing the soundness of the bank.

I fully agree with the argument on the need for a new model in assessing soundness of Islamic bank. I also agree that the conventional based CAMELS should be modified to accommodate the differences between conventional and Islamic banks. I agree also with the difference between the two as discussed in the paper. However, there are some grey areas in claiming whether the points are Islamic monopoly as some are also part of conventional spirit. For example, aspects like professionalism, check and recheck, good administration, realistic planning, continual evaluation, continual improvement, fulfilment the commitment, appropriateness in the risk management are also relevant to the conventional bank evaluation framework.

In my opinion, the author has succeeded in raising the important issues however it fails to distinguish between Islamic and conventional banking, especially their affect on the CAMELS model. The paper identifies the difference but fails to measure the elements that may affect the CAMELS model in assessing an Islamic bank's soundness.

If the author can show us a clear and objective model to asses the soundness of Islamic banks it will be an invaluable contribution to Islamic bank supervisory task. All in all, the author deserves a high appreciation from academics, practitioners and regulators in raising this important and critical issue.

Part-III

Corporate Governance and Social Responsibility

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8

Banking on Islam? Determinants of Corporate Social Responsibility Disclosure

Sayd Farook [*]
Roman Lanis [**]

Islamic banks offer distinct financial services and as such have grown significantly in Bahrain, Bangladesh, Jordan, Kuwait, Malaysia, Qatar, Turkey and U.A.E over the past two decades. They are unique in the sense that they are accountable to fulfil a social and ethical role inherent in their character as an 'Islamic' institution. They also have a duty to discharge their accountability through disclosing corporate social responsibility (CSR) information consistent with the principles of Islam. However, recent anecdotal evidence finds that Islamic banks may not be fulfilling their social role in accordance with the prescriptions of Islam because they disclose less CSR information than expected. It has been suggested that disclosure may also be driven by the extant economic incentives. Hence, the exact nature of the CSR disclosure process by Islamic banks remains unclear due to a paucity of a priori research and statistical analysis of extant data. In light of that, this study develops an a priori model linking CSR disclosure to socio-political influences and corporate governance factors. Then resultant hypotheses are tested on a sample of 47 Islamic banks' annual reports from 14 countries.

Keywords: Corporate Governance, Corporate Social Responsibility Disclosure, Islamic Banks, Political Economy, Legitimacy Theory.

JEL Classification: F23, G21, I31, M14, M41, P48, Z12, Z13

Introduction

A combination of political, economic and demographic factors, including and not limited to the impact of the Iranian revolution, a growing Muslim middle class, the rise of Asian tigers, increased deregulation and the oil shocks of the 1970's;

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have stimulated the development of Islamic banks (Akacem and Gilliam 2002).[1] Some reports suggest that Islamic banks are growing at an annual rate of more than 15% making them the fastest growing segment of the credit market in Muslim countries (Zaher and Hassan 2001; Bahrain Monetary Agency 2004). The latest figures suggest that the assets of Islamic banks worldwide stand at over US$260 billion, while the number of Islamic banks have increased from 176 in 1997 to 267 in 2004 operating in over 60 countries throughout the world (Bahrain Monetary Agency 2004).

Islamic Banks should ideally operate in accordance with the principles laid down by Islamic law (Sharīʿah).[2] The primary contributing factor that hastened the need for Islamic Banks is the prohibition of usury (*ribā*).[3] Merged with this function is the social role of Islamic Banks that entails social justice and accountability, requiring the banks to disclose corporate social responsibility (CSR) information. Usmani asserts that the philosophy behind Islamic banking was "aimed at establishing distributive justice free from all sorts of exploitation" (2002, p. 113). According to Islamic principles, business transactions can never be separated from the moral objectives of society (Usmani 2002). As such, a number of scholars have developed a normative standard for reporting (Gambling and Karim 1986, 1991; Baydoun and Willett 2000; Lewis 2001) and indeed social reporting for Islamic businesses based on Islamic principles (Haniffa 2001; Maali, Casson and Napier 2003). Governments in Muslim populated countries such as Malaysia and international regulatory institutions such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have also voiced their support for the development and adoption of such CSR reporting standards encouraged and propagated by Islam (Sharani 2004; Yunus 2004).

Recent ad hoc studies indicate that Islamic banks are not completely fulfilling their social role in accordance with the prescriptions of Islam (Metwally 1992; Aggarwal and Youssef 2000; Maali et al. 2003). Usmani emphasises that Islamic banks "were supposed to adopt new financing policies and to explore new channels of investment which may encourage development and support of small scale traders to lift up their economic level" (2002, p. 116). Islamic banks should have advanced towards profit and loss sharing (*mushārakah*) in gradual phases and should have increased the size of *mushārakah* financing (Usmani 2002). However, it remains that very few Islamic banks and financial institutions have paid attention to this social aspect. Usmani (2002) further highlights that in a number of Islamic

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[1] In this paper, Islamic Banks are synonymous with Islamic Financial Institutions namely commercial banks, investment banks, and *muḍārabah* companies.

[2] The Sharīʿah is the sacred law of Islam derived from the Muslim holy book *(*Qur'ān*)*, the sayings and deeds of the Prophet Muhammad *(Sunnah)*, consensus (*ijmāʿ*), reasoning by analogy *(qiyās)*, and public interest *(maslaḥa)*.

[3] *Ribā* is translated strictly as usury; however Islamic scholars equate it as being equivalent to interest.

banks, other permitted forms of financing are not effected according to the procedures required by the Sharīʿah.

Given, a contradiction in the behaviour of Islamic banks little rigorous research has been conducted to study the problem. Most research associated with Islamic banks fails to provide an a priori basis to explain their behaviour. Hence, the motivation for this study.

Consistent with Maali et al. (2003), the first objective of this study is to measure the annual report social disclosure levels of Islamic banks based on a benchmark derived from Islamic principles. More importantly, the second objective of this paper is to ascertain a priori the determinants of Islamic banks' social disclosures which will subsequently be tested utilising the disclosure measures obtained. In particular, tests for the determinants of social disclosure from a legitimacy and political economy perspectives are to be performed (Gray, Kouhy and Lavers 1995; Williams 1999). Departing from previous research, this study also tests for the relationship between corporate governance mechanisms and CSR disclosure.

2. Prior Research

Despite the growth of Islamic banks in size and complexity, little research has addressed the issue of social responsibility in the context of Islamic banks. While a number of researchers have explored Islamic accounting and corporate reporting of Islamic institutions and banks, they have generally been either normative or analytical papers, without any empirical testing of the actual disclosure practices of Islamic organisations.

Gambling and Karim's (1986), Hamid, Craig and Clarke (1993), Karim (1995), Sadeghzadeh (1995) and Lewis (2001) provide the overall theoretical framework and practical application of Islamic accounting. Dealing specifically with Islamic banks, Archer, Karim and Al-Deehani (1998) detail the contractual basis of Islamic banks to outline the special need for corporate governance and disclosure by Islamic banks due to the monitoring weaknesses inherent in the Islamic banking system. Their analysis is a significant attempt to extrapolate the various contracting issues inherent in Islamic banks.

The only noteworthy exceptions to these normative or analytical papers in the area of Islamic corporate reporting and social reporting are the works of Askary (2001) and Maali et al. (2003). Askary (2001) draws on research examining the influence of culture on accounting to classify accounting practises in different Muslim countries according to cultural variables developed by Hofstede (1980), Gray (1988) and Perera (1989). However, his research focuses on all companies in Muslim countries rather than on Islamic banks specifically and measures overall disclosure rather than CSR disclosure.

Lastly, Maali et al. (2003) make a significant attempt to substantiate the actual social disclosure practises of Islamic banks. They utilize a sample of 29 Islamic

banks from a number of different countries and compare CSR disclosure to a pragmatic benchmark based on Islamic values. They find that Islamic banks are disclosing CSR information far below the expected level. However, their rudimentary analysis makes only vague inferences as to what may drive the social disclosure practises of these banks. They conjecture as to a number of possible explanations from the CSR literature (Maali et al. 2003). Alluding to economic incentives that may drive CSR disclosure, Maali et al. (2003) also suggest that Islamic banks may only disclose CSR information to construct an Islamic reality while not subscribing to that reality and its resultant obligations.

3. Theory Development

3.1 Theoretical Framework

Corporate social responsibility disclosure has been the subject of substantial academic accounting research. Gray, Owen and Maunders define CSR disclosure:

> …as the process of providing information designed to discharge social accountability. Typically this act would…be undertaken by the accountable organisation and thus might include information in the annual report, special publications or even socially oriented advertising (1987, p. 4).

To that effect, a number of theories have been proposed to explain why corporations voluntarily disclose CSR information.

A review of accounting research indicates that theory development related to CSR disclosure in general is fragmented and rudimentary, while almost no theory development has occurred in relation to CSR disclosure of Islamic banks (Maali et al. 2003; Sadeghzadeh 1995). At most, the literature on Islamic banks suggests that a priori there are two major influences on the Islamic banks CSR disclosure:

1. socio-political context within which the banks operate; and
2. economic opportunities available to Islamic banks.

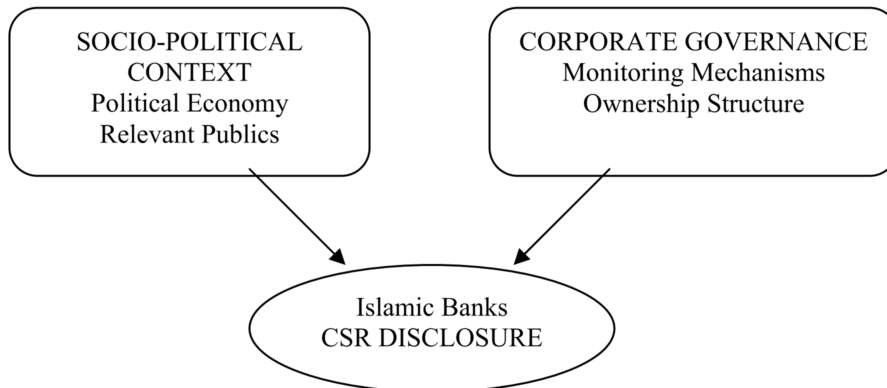
In the CSR literature, the former influence is identified with systems oriented theories such as political economy, legitimacy and stakeholder theories (Wilmhurst and Frost 1999; Deegan 2002; Campbell, Craven and Shrives 2002). As part of that programme, the political and social contexts have been found to be important determinants of the decision to disclose CSR information (Roberts 1992; Williams 1999).

The economic incentives viewpoint is consistent with research that explains CSR disclosure in the context of agency theory (Cowen, Ferreri and Parker 1987; Adams 2002; Campbell 2000).

The diagrammatic portrayal (Figure-1) is an endeavour to capture the two major possible influences. The socio-political context variables, as derived from systems oriented theories, measure cross-national differences whereas the corporate

governance variables measure organisation specific differences that may influence the CSR disclosure of Islamic banks.

FIGURE 1. Diagrammatic portrayal of the influences on CSR disclosure by Islamic banks



3.2 Systems Theories, Social Responsibility and Islam

The view of systems oriented theories such as political economy, stakeholder and legitimacy is consistent with Islam where the concept of Unity (*tawḥīd*) prevails. According to this concept, God is the Creator, Owner and Source of all things (Maali et al. 2003).[4] In light of God's ownership of everything, it is believed that God has entrusted mankind to the use of resources.[5] Thus, in return for the use of the physical universe, mankind agrees to be accountable for how the universe is used (DeLorenzo 2002). This position of trust is the source of accountability for individuals and consequently organisations.[6] The trusteeship requires a total commitment to the will of God and therefore "involves both submission and a mission to follow the Sharīʿah in all aspects of life", including economic aspects (Baydoun and Willett 2000, p. 80).

However, Islam does not deny individual rights to self-interest. Enjoyment of self-interest is only conditioned by the permanent needs of greater society (*Ummah*) (Sadeghzadeh 1995). As such, individual freedom is sacred only as long as it does not conflict with the larger societal interest or as long as the individual does not transgress the rights of others (*ḥuqūq-al-ibād*). Some Practical examples of this concept are demonstrated by the forbiddance of a number of activities such as drinking alcohol, adultery and gambling because of their contributory effects to families and societies. The conceptual basis of this implicit contract between the

[4] Ali 1989, The Holy Qur'ān 2:116; 2:107; 3:189; 5:17; 18:40.
[5] Ali 1989, The Holy Qur'ān 33:72. Vicegerency (*istikhlāf)* or trusteeship is similar to the concept of Stewardship in Christianity.
[6] Ali 1989 The Holy Qur'ān 102:8.

individual and greater society are emphasised in great lengths in the Qur'ān and the teachings of Prophet Muhammad.

Similarly defined by the proponents of political economy, stakeholder and legitimacy theories, the relationship between individuals, organisations and society is consequently viewed as a 'social contract' (Ramanahthan 1976; Deegan 2002; Williams 1999).

Organisations themselves play a large role in society and have responsibilities assigned to them based on their status in society. As such, they "…exist only to the extent that the particular society considers that they are legitimate" (Deegan 2002, p 292).

Accordingly, organisational legitimacy is defined as:

> …a status, which exists when an entity's value system is congruent with the value system of the larger social system of which an entity is a part. When a disparity, actual or potential exists between the two value systems there is a threat to the entity's legitimacy (Lindblom 1994 cited by Newson and Deegan 2002, p. 184).

The concept of corporate social responsibility in Islam likewise emerges from this 'social contract' that necessarily has to do with the congruency of the value system of the organisation to the larger value system of an Islamic society. In Islam, organisations are similarly, if not more so, accountable to society as are individuals. As Lewis (2001) elaborates, the implications for business enterprises is that "both managers and providers of capital, are accountable for their actions both inside and outside their firms; accountability in this context means accountability to the community" to establish socio-economic justice within their own capacity (2001, p.113). A number of commandments in the Qur'ān and the tradition of the Prophet Muhammad stipulate what must be done in order to establish socio-economic justice and therefore be socially responsible. Some examples of these are the obligatory payment out of income and wealth (*zakāh*), philanthropic trusts (*waqf*), alms, charity (*ṣadaqah*), interest free loans (*qarḍ-al-ḥasan*) (Sadeghzadeh 1995). The forbiddance of *ribā* also stems out of principles of socio-economic justice in Islam in that the objective is to disallow any unjust distribution of wealth through forced or undeserved loss to one party or unearned gain to the other party (fixed interest). Against that background, it is reasonable to conclude that Islamic business values and norms are consistent in general with the current definition of corporate social responsibility.

3.2.1 CSR Disclosure as a Means of Legitimation

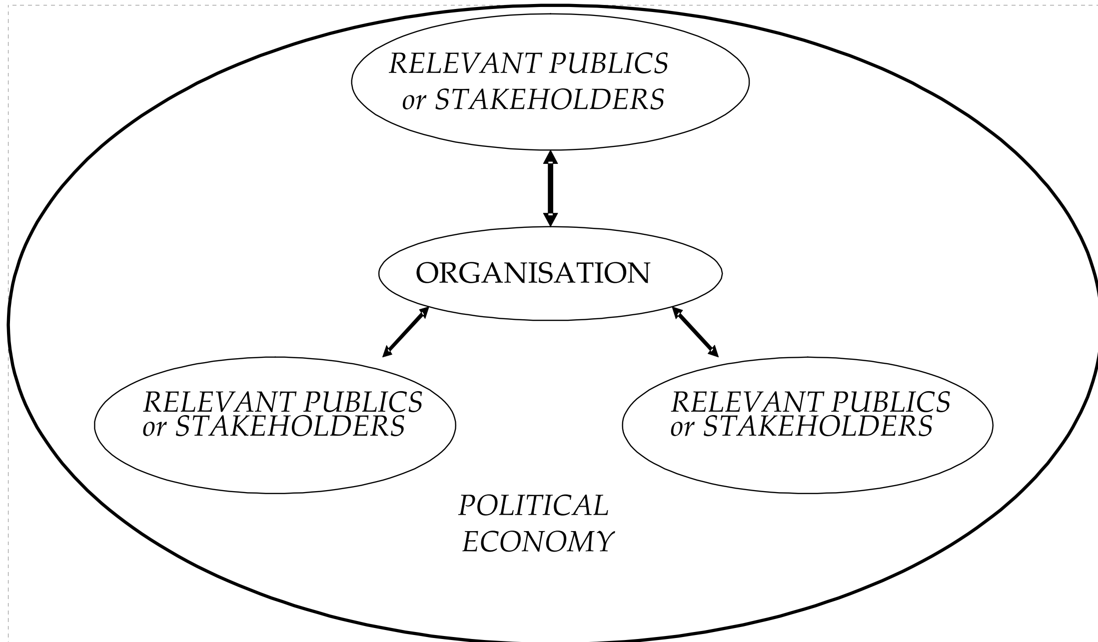
To discharge their corporate social responsibility, political economy, legitimacy and stakeholder theories' proponents argue that corporations (management) provide CSR information as part of the dialogue between the corporation and greater society (Gray et al. 1995). Even if the organisation is complying with

society's expectations, organisational legitimacy can be threatened if it has failed to make disclosures that show it is complying with societal expectations (Newson and Deegan 2002). Hence, managers need to demonstrate that they are complying with the 'social contract' by disclosing information in line with society's expectations.

Although different obligations and responsibilities are due of different types of organisations in different contexts, the overall general framework for social responsibility and accountability in Islam is derived from Islamic teachings embodied in the detailed jurisprudence surrounding the Qur'ān and the teachings of Prophet Muhammad. Hence, the expectations of an Islamic populace towards any organisation that claims to be Islamic are unambiguous. Islamic banks are expected to disclose relevant CSR information to discharge their responsibility and to earn legitimacy for their continued existence (Sadeghzadeh 1995; Baydoun and Willett 2000; Haniffa 2001; Lewis 2001; Maali et al. 2003). However, the expectation to disclose is only a necessary condition for disclosure.

The disclosure of CSR information by Islamic banks will depend on a number of other factors necessarily "focussing on the role of information and disclosure in the relationships" between the organisations, the State, individuals, groups and particularly the Islamic society (*Ummah*) (Gray, Owen and Adams 1996, p.45). In light of this, two factors from systems oriented theories are identified that will directly influence the level of CSR disclosure by Islamic banks. Extracted from political economy theory, the first factor focuses on the broader social and political environments in which organisations interact and is captured by the 'political rights and civil liberties' variable (Williams 1999). The second factor, proxied by the 'relative size of Muslim population' variable, is derived from legitimacy theory and attempts to capture the concept of the 'relevant publics' from which the organisation requires legitimation to exist (Newson and Deegan 2002). Figure 2 indicates the proposed effect of both the socio-political factors on the organisation. The figure demonstrates that multiple groups of 'relevant publics' or 'stakeholders' influence the organisation within the context of the social, political and economic frameworks represented by the 'political economy' (Gray et al. 1995). In addition, Figure 2 indicates that each theory addresses a "different level of resolution of perception" (Gray et al. 1995, p. 52).

Figure 2. Diagrammatic portrayal of the relationship between the organisation and greater society.



3.2.2 Hypothesis: Political Economy

As Islamic banks operate in a broader social and political environment, the interplay of power affecting the rights and responsibilities of all actors within this environment will determine the flow of information and dialogue. This will consequently affect the level of CSR disclosure by Islamic banks.

Political Rights and Civil Liberties

One factor that may influence the interplay of power is the political rights and civil liberties in a country. Williams suggests that "violations of political rights and civil liberties associated with various forms of political structure may restrict political and civil freedom and therefore act as a hindrance to full and fair disclosure" (1999, p. 213). Gastil (1981) points out that as political and civil repression increases, the influence and effectiveness of social interest bodies decrease. For example, repressive governments will restrain the activities of institutions such as the press which ensure a level of accountability through the effective flow of information and dialogue.

Within countries exhibiting limited political rights and civil liberties, societal interest groups, whether Islamic or otherwise, lack the capacity to voice their concerns regarding organisational conduct. Under such repressive regimes,

organisations may face lower social expectations and pressure (Williams 1999). On the other hand, organisations and particularly Islamic banks operating in relatively open communities with greater freedom may need to provide further justification to legitimize their existence and hence disclose CSR information. As with Williams (1999), a significant negative relationship is expected between the levels of CSR disclosure presented by Islamic banks and the extent of political and civil repression.

H_1: There is a negative association between the level of political and civil repression and the level of CSR disclosure presented in annual reports by Islamic Banks.

3.2.3 Hypothesis: Relevant Public

Relative Size of Muslim Population

While the broader social and political environment may affect the flow of information and the effectiveness of social interest groups in a particular country, the relative size of the Muslim population as a proxy for the Islamic society will contemporaneously determine the level of CSR disclosure presented by Islamic banks.

Newson and Deegan (2002) point to the crucial factor that is directly relevant to management: the 'relevant publics' to which the organisation is accountable. As articulated in the theory development section, it could reasonably be justified that the main 'relevant public' in the case of Islamic banks is the Islamic society. Applying Newson and Deegan's (2002) concept, while there may be limited expectations about social responsibilities within a particular country, if an Islamic bank relies on support from the Islamic public, then it must demonstrate adherence to the expectations thereof.

Newson and Deegan (2002) elaborate that while there may be national differences across countries with regards to disclosure perhaps attributed to cultural and other factors, their notion of a 'global' culture and Islamic culture in this study, should work against the differences in CSR disclosure policies. Reiterating this point, Maali et al. (2003) indicate that Islamic banks claiming to follow Islamic principles are required to make certain universal voluntary disclosures regardless of local standards, because the need to report such items is based on accountability to the Islamic public or society.

However, the extent to which Islamic banks comply with these universal expectations of CSR disclosures depends on the relative power of the 'relevant public' to influence the activities of Islamic banks. Given that the relevant public in the case of Islamic banks is the Islamic society, the proportion of population in a country that adhere to the principles of Islam or in other words, the relative size of the Islamic society could arguably represent the influence of the 'relevant public' for Islamic banks (Karim 1990). If the 'relevant public' comprise a larger proportion of the overall population, there will be increased pressure on the Islamic

banks to legitimise their actions to this constituency who enjoy a relatively stronger position in the social and political environment within which Islamic banks operate (Roberts 1992). Hence, a significant positive relationship is expected between the proportion of adherent Muslims and the level of CSR disclosure presented by Islamic banks.

H_2: There is a positive association between the proportion of adherent Muslims (in a Muslim country) and the level of CSR disclosure presented in annual reports by Islamic banks.

3.3 Corporate Governance

It has been suggested that Islamic banks are also driven by economic realities within which they operate. According to Archer et al. (1998), Islamic banks are an efficient means of contracting for investors and fund users wishing to comply with the laws and principles of Islam. The banks usually comprise a group of shareholders that attract funds for investment using a version of the *muḍārabah* contract. The *muḍārabah* contract is a profit sharing financial instrument with "detailed juristic rules derived from the Sharīʿah which regulates the relationship between investment account holders (IAH) as providers of funds and the bank in its capacity as entrepreneur (*muḍārib*)" (Archer et al. 1998, p. 152).

The aggregate investment portfolio of an Islamic bank is financed by IAHs' funds,[7] shareholder's equity and other sources of funds available to the bank (Archer et al. 1998). The bank's management acts as an agent not only for the shareholders, but also for investment account holders as the *muḍārib*. The Islamic bank then invests these funds in activities acceptable in the Sharīʿah.[8]

Since Islamic banks cannot earn or pay any interest, Islamic banks invest their funds through profit and loss sharing arrangements such as partnership contracting (*muḍārabah* or *mushārakah*) or other acceptable contracts such as mark-up (*murābaḥah*), deferred payment (*bayʿmu'ajjal*), leasing (*ijārah*), forward sale contract(*salam*) and manufacturing contract (*istiṣnāʿ*) (Usmani 2002).

3.3.1 Agency Problems

In light of the above, a number of agency problems are encountered in the contractual structure of Islamic banks which may also affect the CSR disclosure presented by Islamic banks in their annual reports.

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[7] IAH funds usually comprise a mix of *unrestricted* and *restricted muḍārabah* contracts. The IAH who use *unrestricted muḍārabah* authorise their *muḍārib* to invest their funds at its discretion including co-mingling the IAH's funds with those of the shareholders. The *restricted muḍārabah* IAH, on the other hand specify to the bank the type of investment in which their funds should be invested e.g. real estate, currencies or leasing.

[8] An Islamic bank is not allowed to invest in activities that are associated with gambling, alcohol, pork and generally encouraged to invest in social development activities.

The principal problem is that the two types of principals (the IAH and shareholders) have inferior information to that possessed by management, particularly about the application of Islamic laws in relation to the banks' operations. Islamic banks are under an implicit contractual obligation to both their shareholders and IAH to function according to the laws and principles of Islam. Bakar states that "Sharīʿah compliance is the very essence of an Islamic bank and its banking business" (2002, p. 76).

Another agency problem is the fact that investment accounts are not a liability with a fixed claim on the company's assets and hence are only given a residual claim to the bank's earnings or assets *pari passu* with that of shareholders (Archer et al. 1998). The IAH has no formal right to show their disapproval of management actions except to 'vote with their feet' (Archer et al. 1998). Archer et al. (1998) explain that in that case, due to the inherent benefits of higher returns from funds invested by IAH, shareholders may 'vicariously' monitor for their other counterparts: the IAH. They state that the relationship between IAH and shareholders "exhibits some features of bilateral dependency, in that the IAH depend on shareholders for monitoring while the shareholders depend on IAH as a source of profits via the *muḍārib* share" (Archer et al. 1998, p. 164). The IAH, if it is comprised of Islamic investors would also be interested in the level of compliance of the bank with Islamic laws and principles.

Consequently, the extent of Sharīʿah compliance by an Islamic bank will depend on the level of monitoring in place to limit the divergence of interest between the principals who are particularly interested in Sharīʿah compliance of the bank and the agent which is the banks' management. Karim (1990) broadly classifies the three main types of shareholders of Islamic banks:

- Management
- Islamic investors[9]
- Economic investors[10] (Karim 1990).

The same categorisation could be used for classifying IAH perhaps with the exclusion of management shares. The segment most interested in the banks' compliance with Islamic laws and principles within this categorisation would be the Islamic investors. The greater the level of monitoring by Islamic investors, the greater the compliance of the Islamic bank with Islamic laws and principles. Hence, the extent of CSR disclosure could arguably depend on the level of monitoring by the Islamic investor group. Two major determinants of the level of monitoring are identified in the literature: monitoring mechanisms and ownership structure.

[9] Islamic investors invest in Islamic banks primarily for religious reasons but also for economic reasons.
[10] Economic investors invest in Islamic banks purely for economic reasons.

3.3.2 Hypothesis: Monitoring Mechanism

Islamic Governance: The Sharīʿah Supervisory Board

A number of Islamic banks employ a special form of monitoring to limit the divergence of interest between Islamic investors and the management of the Islamic bank. Sharīʿah supervisory boards (SSB) assure investors of the compliance of Islamic banks with Islamic laws and principles. The demand for the services of an SSB arises out of a "perceived need to constantly check innovations in banking practise [as well as in accounting] against the principles of Islamic orthodoxy" (Karim 1995, p. 287). It is not mandatory for an Islamic bank to have its own SSB. However, the AAOIFI require both the SSB and the financial auditors of Islamic banks to report on compliance with Sharīʿah doctrines (AAOIFI 2004). The AAOIFI standards explicitly state that the Sharīʿah supervision is "intended to investigate to what extent the financial institution has adhered to Sharīʿah rules and principles in all its activities" (Bakar 2002, p. 81). The investigation would include examination of the "bank's memorandum and articles of association, its contracts…its financial reports and various other reports…" (Bakar 2002, p. 81). Karim stresses that "in most cases, SSB's authority is equal to those of external auditors" (1995, p. 35).

Ideally, one would expect the SSB to represent orthodox Islamic laws and principles more so than management. The Islamic credentials of the members of the SSB are considered to be impeccable (Karim 1990). If SSBs are employed to ensure compliance of the Islamic bank to Islamic laws and principles, it can be deduced that they may play a role in mandating CSR activities and also CSR disclosure. However, the extent to which the SSB influences CSR disclosure depends on the function of the SSB in monitoring on behalf of investors.

It is generally expected that the existence of a SSB in an Islamic bank would lead to greater levels of CSR disclosures. However, while the existence of a SSB may lead to greater monitoring and thereby greater disclosures of CSR information, the degree to which the SSB would influence CSR disclosures may also depend on the characteristics of this corporate governance mechanism (Haniffa and Cooke 2002; Ho and Wong 2001). Hence, a multitude of factors that relate to the SSB's characteristics may determine how effectively the SSB conducts its function and subsequently the level of CSR information disclosed by Islamic banks. A number of characteristics are elaborated upon, after which a hypothesis is formulated.

Number of Board Members

An increase in the number of SSB members may lead to higher levels of CSR disclosure as the capacity for monitoring increases. With regard to the minimum number of members of any SSB, the AAOIFI standards have required at least three members. This is a common requirement in many Islamic banks such as Faysal Islamic Bank of Sudan. The greater the number of members in a SSB, the greater the amount of monitoring, implying a greater level of compliance with Islamic

laws and principles. The SSB would be able to allocate its functions across a larger group of members, allowing the SSB to review more aspects of the banks' activities and hence ensure greater compliance. One aspect of this compliance is more CSR disclosure. Further, synergies could also be present in boards with a large number of members pooling their ideas and perspectives to derive better applications of Islamic law, particularly with regards to disclosure. The AAOIFI recommends a number of different people from different professions to sit on the SSB, including bankers, economists and full-time member(s) (AAOIFI 2004). This allows for the implementation of diverse perspectives on the application of the Sharīʿah. To enable this to happen, a large SSB would be required to represent these sectional professions. The above analysis suggests that the SSB size should have a positive relationship with CSR disclosure.

Cross Memberships

Cross memberships of SSB members may also lead to higher disclosure of CSR information (Dahya, Lonie and Power, 1996). The literature suggests that cross-directorships increase transparency for two reasons: firstly, members with cross-directorships can make comparisons from knowledge gained in other companies; and secondly "decisions at one board become part of the raw material for decisions at other boards" (Haniffa and Cooke 2002, p. 321). SSB members with cross-memberships will be exposed to more discussions about the application of Islamic law in banking. This increased experience should enhance their knowledge about the application of Islamic principles to corporate reporting and in particular to CSR disclosure.

Secular Educational Qualifications

In the extant literature, the director's education has been proposed to influence the level of disclosure. Hambrick and Mason (1984) indicated that the more educated the director, the more likely he/she is to adopt innovative activities and accept ambiguity. The level of education of the SSB members may influence the level of CSR disclosure. Bakar states that "ideally a Sharīʿah adviser (board member) must be able to understand not only Sharīʿah issues but also issues pertaining to law and economics, because such issues in many cases are overlapping" (2002, p. 79). SSB members usually comprise scholars of Islamic law who may not be highly educated in secular studies. SSB members who are not highly educated may be undermined in their abilities as Islamic law scholars to fully apply theoretical Islamic laws and principles because of their lack of practical commercial knowledge (Bakar 2002; Bokhari 2002). Hence, scholars with a doctorate degree are arguably better informed of the current implications of Islam for financial institutions, particularly with regards to CSR disclosure.

Reputable Scholars

Some Sharīʿah scholars have a significant amount of tacit knowledge about the application of Islamic law. However, they may not have formally recognised

qualifications from secular educational institutions. Hussain and Mallin (2003) report that the factors influencing the appointment of directors in Bahraini companies are relevant skills, business experience and reputation. Following that reasoning, it is expected that reputation is a proxy for industry knowledge and hence reputable scholars are more likely to understand the current implications of Islamic banking, particularly with regards to disclosure. Hence, reputable scholars are more likely to emphasize CSR activities and the subsequent disclosure of CSR information.

IG-Score

A number of previous studies have combined corporate governance factors into an index which attempts to capture their aggregate effect. Gompers, Ishii and Metrick (2001) and Hanlon, Rajgopal and Shevlin (2003) combine a number of variables as proxy for governance factors to produce a g-score. Applying the same reasoning, this study develops an Islamic governance score (IG-SCORE). In particular, a score is constructed based on the existence and characteristics of the SSB as detailed above. The score sums the value of the dichotomous characteristics of the board, namely the existence of the SSB, the number of board members, the existence of members with cross-memberships, the existence of members with doctoral qualifications and the existence of reputable scholars presiding on the board. The method is elaborated in the research design. A positive relationship is expected between the Islamic governance score (IG-SCORE) and the level of CSR disclosure presented by an Islamic bank.

H_3: There is a positive association between the Islamic governance scores obtained and the level of CSR disclosure presented by Islamic banks in their annual reports.

3.3.3 Hypothesis: Ownership Structure

Investment Account Holders' (IAH)Rights

The structure of ownership also determines the level of monitoring and thereby the level of disclosure (Jensen and Meckling 1976). A number of prior studies look at the effect of ownership structure on voluntary disclosure (Ruland, Tung and George 1990; Eng and Mak 2003; El-Gazzar 1998; Mitchell, Chia and Loh 1995; McKinnon and Dalimunthe, 1993; Schadewitz and Blevins, 1998).

As elaborated above, Islamic investors determine the extent of compliance with Islamic principles and consequently the level of CSR disclosures. Islamic investors are more likely to invest their funds as IAH rather than as shareholders since Islamic investors are primarily interested in the services that Islamic banks offer, rather than share ownership of the Islamic banks per se. Further, investment accounts with Islamic banks are generally more accessible than shares of Islamic banks. In the context of SSB reports, Karim states that:

…If a negative report were to be published, it would be expected that this group (IAH) would begin to doubt management's commitment to Islam. Such a belief would have a detrimental impact on the bank since these clients are likely to refrain from dealing with the bank (1990, p. 41).

While the IAH do not have any formal voting rights, they nevertheless influence the level of monitoring of management 'vicariously' through shareholders (Archer et al. 1998). This is due to the fact that the profits of shareholders are determined by the profits earned through the utilisation of IAH funds.

If the IAH are more interested than the shareholders in the bank's compliance with Islamic laws and principles, then the relative influence of the IAH will determine the extent to which the bank complies with Islamic laws and principles and consequently the level of disclosure presented by the bank. This suggests that CSR disclosure is positively related to the relative size of IAH funds as a proportion of shareholder funds.

H_4: There is a positive association between the proportion of IAH funds to shareholder funds and the level of CSR disclosure presented by Islamic banks in their annual reports.

4. Data and Research Design

4.1 Sample and Data Description

In order to test the hypotheses, annual reports[11] of fully fledged Islamic banks from a number of countries were collected for the years ending 2002 or 2003. The collection of two years of annual reports improved the chances of achieving a larger sample size as a number of the banks had not published their 2003 annual report at the time of data collection.

Islamic banks are classified as any financial intermediary that claims to operate according to the laws and principles of Islam (IAIB, 2001). Therefore, the sample of Islamic banks contains service banks, investment banks, mortgage companies and leasing companies operating as either publicly listed companies, private companies or as government owned institutions. The structure of the banks and the types of services they offer are not significant in determining CSR disclosure, as the expectation to disclose CSR information is based on the fact that the banks claim to be Islamic. Hence, mission statements and/or information on their

[11] Annual reports may not be the only means by which Islamic banks communicate their CSR information. They may utilize other means such as advertising, public relations and internet sites to convey social information. Notwithstanding, Gray *et al.* (1995) state that the annual report is the only document produced regularly to comply with regulatory requirements and more importantly is central to the organisations construction of its own external image. Hence, this study only considers the information disclosed in annual reports.

websites are used to verify the banks' claim to operate according to Islamic laws and principles.

The initial sample population for the study comprised all Islamic banks in the world derived from a comprehensive list compiled by Archer and Karim (2002). These were cross-checked with the International Directory of Islamic Banks and Institutions (2000) issued by the Institute of Islamic Banking and Insurance in London and the relevant stock exchanges. Approximately 187 fully fledged Islamic banks in 29 countries were identified. The annual reports for Islamic banks were primarily obtained from their websites and the relevant stock exchange web-sites. Approximately 33 banks' annual reports were collected in this manner. To enlarge the sample size, another 48 banks were identified in the sample for which mailing addresses were available. Each bank was sent a letter requesting their 2002 and 2003 annual reports. In total, 14 Islamic banks' annual reports were received giving an overall response rate of 29.8%. This is somewhat lower than the response rates achieved for studies in which Islamic banks annual reports were used. Maali et al. (2003) achieved a response rate of 37.5% with an initial sample of 88 banks. The final sample consists of 47 banks from 14 countries with the distribution as follows: Bahrain (6), Bangladesh (5), Egypt (1), Iran (4), Jordan (2), Kuwait (5), Malaysia (2), Pakistan (8), Qatar (2), Saudi Arabia (5), Sudan (1), Turkey (2), United Arab Emirates (3), and Yemen (1).

4.2 Research Design

Ordinary least squares (OLS) regression is used to examine the relationship between CSR disclosure and the explanatory variables.[12] The regression equation is as follows:

$$\text{CSRDIS} = \alpha + \beta_1\text{PRCL} + \beta_2\text{MUSPOP} + \beta_3\ \text{IG-SCORE} + \beta_4\text{IAH} + \beta_5\text{SIZE} + \varepsilon$$

CSRDIS is the CSR disclosure index score of the bank. Table 1 provides a summary of the operationalisation of the independent variables.

[12] A number of tests were conducted to confirm the normality of the distribution. Normal probability plots and histograms of the distribution of the dependent variable (CSRDIS) and scatter plots of standardized residuals against standardized estimates of CSRDIS were reviewed on all models to verify that the normality and homoscedasticity assumptions were valid. Multicollinearity tests are also conducted on all models. The variance inflation factors (VIF) range from 1-2 and eigenvalues and condition indices were checked to ensure there was no excessive multicollinearity. However, caution must nonetheless be drawn in generalizing from these results as sample size may limit the significant findings in this study. Further, an expert statistician from the University of Technology, Sydney, was consulted to ensure that the data did not violate any assumptions that are usually sacrificed with small sample sizes.

Table 1: Summary of the source and operationalisation of independent variables

Hypothesis	Independent Variables		Operationalisation	Source of information of information
Socio-political context- Political economy				
H_1	PRCL	Political rights and civil liberties	Overall combined index scores of political rights and civil liberties based on work of Gastil (1978) for the given nation:1 (freedom) to 14 (repression)	Freedom House 'freedom in the world' Index http://www.freedomhouse.org/ratings/allscore04.xls
Socio-political context- Relevant publics				
H_2	MUSPOP	Proportion of Muslim population	Ratio of Muslim population to total population	CIA World Factbook, 2004 http://www.odci.gov/cia/publications/factbook/geos/
Corporate Governance- Shari'a Supervisory Board				
H_3	IG-SCORE	Islamic governance score	Existence of SSB + Number of SSB members + Cross memberships + Doctorate qualification of SSB member + Reputable scholars on SSB	Derived from sub-variables below
	SSB	Existence of SSB	Dichotomous; yes/no	Bank Annual Report
	NUM	Number of SSB members	Dichotomous; 1 for banks with 7 or more members and 0 otherwise	Bank Annual Report
	CROSS	Cross Memberships	Dichotomous; If any SSB member with cross-directorship: 1, otherwise: 0.	Bank Annual Report
	PHD	Doctoral qualification of SSB member	Dichotomous: If any SSB member with doctorate qualification: 1, otherwise: 0	Bank Annual Report and website
	REP	Reputable Scholars on SSB	Dichotomous: If any reputable SSB member: 1; otherwise: 0. Reputable scholar is one that has a position in the SSB of the AAOIFI and at least two Shari'a board memberships.	AAOIFI Standards and Bank Annual Report
Corporate Governance- Ownership Structure				
H_4	IAH	Investment Account Holders	Ratio of total amount of investment account funds to paid up capital in shareholders equity.	Bank Annual Report
Control				
	SIZE	Size	Natural Log of Book value of assets translated into USD	Bank Annual Report

Dependent Variable

The dependent variable was constructed using an index of expected CSR disclosure of Islamic banks operating in Muslim countries. The index was derived from Maali et al. (2003) and contains 32 items.[13] Following Inchausti (1997) and Maali et al. (2003), each item in the disclosure index was given the same weight (Barrett 1997). Items disclosed were given a weight of 1 while undisclosed items were weighted 0. The annual report of each bank was reviewed and a Judgement made by the author as to which items were relevant to each bank. Irrelevant items were not considered as part of the overall score for the respective bank. For instance, some banks are required by law to pay *zakāh*, while others are not. Hence, the CSR disclosure score was constructed as a ratio of the actual score achieved by the bank to the maximum possible value for each bank from the 32 disclosure items (Maali et al. 2003).

Independent Variables

The independent variables are categorized into three groups: socio-political context, corporate governance and control. Since a number of the variables were never considered in previously published research on disclosure and particularly CSR disclosure, the appropriateness of these variables was discussed with and confirmed by a Managing Director and a Sharīʿah supervisory board member of an Islamic bank in Australia.

Control Variable

Firm size (SIZE) – Log of total assets. This measure has been consistently found to influence CSR disclosure (Belkaoui and Karpik 1989; Roberts 1992; Williams 1999; Patten 1991). The arguments for larger firms disclosing higher levels of CSR flow from a number of different theoretical perspectives. Agency and positive accounting theories predict that managers use CSR disclosure as part of their overall strategy to reduce agency costs and in particular political costs (Watts & Zimmerman 1978). Large firms are more politically visible and therefore disclose more information. The legitimacy theory argument is that the more social exposure a firm receives by being larger, the greater the need to legitimize its existence to its relevant publics (Patten 1991). Hence, a significant positive relation is expected between firm size and voluntary disclosure.

Alternative Definitions of Explanatory Variables

There are a number of alternative definitions for the explanatory variables stated above. Therefore, sensitivity testing is carried out, the results of which are reported subsequent to the main regression model.

[13] Refer to Maali *et al.* (2003) for details on the construction of the disclosure index.

5. Results

5.1 Descriptive Statistics

The mean CSR disclosure for the 47 banks in the sample is approximately 16.8% of expected disclosure, representing an increase from Maali et al. (2003) who reported a mean disclosure of 13.3%. This is perhaps due to the fact that there are more banks in the sample used in this study. The maximum reported disclosure was 48.3% of expected disclosure. A number of the banks had no CSR disclosures.

The Pearson parametric and Spearman non-parametric correlation tests indicate that CSR disclosure is significantly related to size (SIZE), the Islamic governance score (IG-SCORE) and investment account holders' rights (IAH). Size is also significantly related to the Islamic governance score (IG-SCORE) and investment account holders' rights (IAH). This is intuitively appropriate since larger banks would have better monitoring mechanisms in place and would be funded to a greater extent by investment account holders rather than shareholders. The proportion of Muslim population (MUSPOP) is significantly related to the level of political rights and civil liberties (PRCL) in a country.

5.2 Main Regression Model

Table 2 shows the results of the multivariate regression analysis. The model is statistically significant at the 1% level and has an adjusted R-square of approximately 0.393, indicating that the model explains a significant amount of the variation in disclosure. The control variable SIZE (log total assets) is not statistically significant. This is inconsistent with prior studies which find size to be significantly related to CSR disclosure (Williams 1999). This may be due partly to the fact that the study is cross-national and log total assets is not a relative measure which captures the differences in relative size between countries.

Table 2 displays the regression results for the determinants of CSR disclosure. The coefficients are based on the following equation:

$$CSRDIS = \alpha + \beta_1 PRCL + \beta_2 MUSPOP + \beta_3 \text{IG-SCORE} + \beta_4 IAH + \beta_5 SIZE + \varepsilon$$

Table 2: Regression analysis main model

Independent Variables	Predicted Sign	Coefficients	*t*-statistics	*p*-value		VIF
Intercept		-0.517	-2.457	0.018		
PRCL	-	-0.001	-0.105	0.917		1.148
MUSPOP	+	0.373	2.298	0.027	*	1.168
IG-SCORE	+	0.046	3.625	0.001	**	1.376
IAH	+	0.003	1.927	0.061		1.362
SIZE	+	0.023	1.258	0.215		1.591
Std Error	0.100					
F value	6.950					
Sig. F (p-value)	0.000					
R	0.677					
R^2	0.459					
Adjusted R^2	0.393					

** Coefficient is significant at the 0.01 level (2-tailed).
* Coefficient is significant at the 0.05 level (2-tailed).

Variable Definitions:

PRCL	Political rights and civil liberties index scores from Freedom House ranging from 1 (highest amount of political rights and civil liberties) to 14 (lowest amount of political rights and civil liberties).
MUS POP	Proportion of Muslim population to total population of the given nation.
IG-SCORE	(SSB+NUM+CROSS+PHD+REP).
IAH	Ratio of investment account holders' funds to paid-up capital.
SIZE	Natural log of the bank's total assets.
CSR DIS	CSR disclosure index score of bank.
IG-SCORE consists of:	
SSB	1 for Islamic banks with *Shari'a* Supervisory boards and 0 otherwise.
NUM	2 for Islamic banks with 7 or more SSB members and 1 otherwise.
CROSS	1 for Islamic banks with one or more cross-members and 0 otherwise.
PHD	1 for Islamic banks with one or more members with doctorate qualifications and 0 otherwise.
REP	1 for Islamic banks with one or more reputable scholars as members of the SSB and 0 otherwise.

The political rights and civil liberties (PRCL) variable is in the predicted direction. However, it is not statistically significant (p-value=0.917), which is inconsistent with prior studies on disclosure and CSR disclosure (Archambault and Archambault 2003; Williams 1999). The proportion of Muslim population (MUSPOP) variable is in the predicted direction and statistically significant at the 5% level (p-value=0.027). This indicates that the size of the relative publics' proxying for their ability to influence and apply pressure on Islamic banks is a

significant factor in determining the level of CSR disclosure presented by these banks.

One of the corporate governance factors is significant at or below the 5% level. The combination of the SSB characteristics (IG-SCORE) is highly significant at the 1% level and in the predicted direction (p-value=0.001) while the investment account holders' rights (IAH) variable is in the predicted direction but only marginally significant at the 10% level (p-value=0.061). The highly significant IG-SCORE indicates that the SSB and its characteristics are important in influencing CSR disclosures. The insignificance of the IAH variable is contrary to H4.

Overall, the preliminary results suggest that the relevant publics and monitoring mechanisms such as the SSB increase the level of CSR disclosure by Islamic banks.

5.3 Sensitivity Testing

Since there is a degree of arbitrariness in selecting the proxies for the model variables, sensitivity tests are conducted to ensure the robustness of the results and to further enhance the empirical model. Replacing the measure of political rights and civil liberties with a relatively simpler index ranking countries from 'free' (1) to 'partially free' (2) to 'not free' (3), increases the adjusted R-square from 0.393 in the original model to 0.452 and the variable PRCL becomes significant at the 5% level (p-value=0.042). Since size was found to be insignificant contrary to expectations, a relative measure of size was used by dividing the total assets of the bank by the gross domestic product of countries and then logging the value. While this was done to adjust for the relative differences in size between countries, no significant results were found.

Two alternative measures of IAH were utilised. The first measure utilised was the ratio of total investment account holders' fund to total assets. The IAH variable increases in significance to the 5% level (p-value=0.029) and the adjusted R-square increases from 0.393 in the original model to 0.411. The second measure utilised is the ratio of the total investment account holders' funds to total shareholders' equity. The IAH variable loses its significance using this measure and the R-square decreases from 0.393 in the original model to 0.348. There are no significant changes in the other variables. Further, to ensure that the significant correlation between IAH rights and size is not introducing noise into the regression, tests were conducted excluding either IAH rights or size from the regression model. While each of the variables increase in significance when one of them are excluded from the model, excluding IAH from the model reduces the total R-square more than excluding size, indicating that the IAH contributes more significantly in explaining disclosure than SIZE. Hence, it may be inferred that the significance of the SIZE variable in the test conducted without IAH was only capturing the effect of an omitted correlated variable.

Since the IG-SCORE attempts to combine the effect of five difference sub-variables, it is not informative as to the effect of each sub-variable. Tests are run excluding each one of the sub-variables one at a time from the IG-SCORE to review the consequent effect on the significance of the IG-SCORE and the adjusted R-square of the total model. The IG-SCORE variable drops in significance and the R-square is vastly reduced at every instance a sub-variable is dropped except for when the sub-variable NUM is dropped indicating that the number of scholars is not an important factor in contributing to higher CSR disclosure.

Table 3 displays the optimal regression model derived from the sensitivity tests conducted utilising alternative measures of political rights and civil liberties (PRCL) and IAH rights (IAH).

The coefficients are based on the following equation:

$$CSRDIS = \alpha + \beta_1 \mathbf{PRCL} + \beta_2 MUSPOP + \beta_3 \text{ IG-SCORE} + \beta_4 \mathbf{IAH} + \beta_5 SIZE + \varepsilon$$

Table 3: Optimal regression model

Independent Variables	Predicted Sign	Coefficients	*t*-statistics	*p*-value		VIF
Intercept		-0.412	-2.092	0.043		
PRCL	-	-0.072	-2.187	0.034	*	1.448
MUSPOP	+	0.481	3.091	0.004	**	1.231
IG-SCORE	+	0.035	2.823	0.007	**	1.547
IAH	+	0.096	2.136	0.039	*	1.333
SIZE	+	0.020	1.166	0.250		1.629
Std Error	0.093					
F value	9.187					
Sig. F (p-value)	0.000					
R	0.727					
R^2	0.528					
Adjusted R^2	0.471					

** Coefficient is significant at the 0.01 level (2-tailed).
* Coefficient is significant at the 0.05 level (2-tailed).

Variable Definitions:

PRCL	Political rights and civil liberties index scores from Freedom House. 1: for countries classified free, 2: for countries classified partially free, 3: for countries classified not free.
MUSPOP	Proportion of Muslim population to total population of the given nation.
IG-SCORE	(SSB+NUM+CROSS+PHD+REP).
IAH	Ratio of investment account holders' funds to total assets.
SIZE	Natural log of the bank's total assets.
CSR DIS	CSR disclosure index score of bank.
IG-SCORE consists of:	
SSB	1 for Islamic banks with *Shari'a* Supervisory boards and 0 otherwise.
NUM	1 for Islamic banks with 7 or more SSB members and 0 otherwise.
CROSS	1 for Islamic banks with one or more cross-members and 0 otherwise.
PHD	1 for Islamic banks with one or more members with doctorate qualifications and 0 otherwise.
REP	1 for Islamic banks with one or more reputable scholars as members of the SSB and 0 otherwise.

5.3.1 Optimal Regression Model

Based on the sensitivity analysis conducted above, an optimal regression model is formed utilising two alternative measures derived from the sensitivity testing. The original political rights and civil liberties variable (PRCL) is replaced by the

measure elaborated in section 5.3. The IAH variable is replaced by the alternative IAH rights' measure elaborated in section 5.3 the ratio of total IAH funds to total assets. The results are reported in Table 3. The model provides an adjusted R-square of approximately 0.471 recording a significant increase from the original model which had an adjusted R-square of approximately 0.393. All variables except SIZE are significant with PRCL (p-value=0.034) and IAH (p-value=0.039) being significant at the 5% level and MUSPOP (p-value=0.005) and IG-SCORE (p-value=0.007) being significant at the 1% level.

6. Conclusions

Islamic banks have grown in size and significance in the past three decades. In line with Islamic principles, Islamic banks should fulfil an ethical role inherent in their character as an 'Islamic' bank. The objective of this study was to measure the CSR disclosure levels of Islamic banks and subsequently ascertain the likely determinants of that disclosure. Contrary to expectations of full disclosure and accountability, it was found that the majority of Islamic banks disclose very little about their CSR, with apparent differences in the levels of disclosure. To explain these differences a number of hypotheses were derived and subsequently tested.

The significance of the variable PRCL suggests that the extent of political and civil repression influences the level of CSR disclosure by Islamic banks. This gives weight to the view consistent with Williams (1999) that organisations operating in relatively repressed societies face lower social expectations while organisations operating in relatively open communities need to provide further justification to legitimize their existence. The significance of the variable MUSPOP lends weight to the hypothesis that the level of CSR activities and consequently disclosure will depend on the extent of influence that the 'relevant publics' have on the organisation. The combined results of these two hypotheses demonstrate the theoretical significance of applying 'levels of resolution of perception' to understand the complex interactions between organisations and society in the broader socio-political environment.

The significance of the corporate governance variables lends support to the view that Islamic banks are also driven by economic realities. In particular, the existence of Sharīʿah board members with cross memberships, doctorate qualifications and/or international repute results in greater monitoring and hence greater compliance with Islamic laws and principles, an output of which is higher levels of CSR disclosure. This implies that skilled scholars are required to decipher Islamic law to apply it to modern Islamic banks, particularly with regards to CSR disclosure. Further, the significance of IAH rights in influencing CSR disclosures imply that Islamic banks disclose CSR in order to bond their activities to their 'Islamic' investors.

Overall, the results suggest that there are a number of factors which contemporaneously influence CSR disclosure of Islamic banks including socio-political pressures and economic incentives.

The results here have a number of potential policy implications for Islamic banks and regulators. While socio-political factors may restrain the level of CSR disclosure presented by Islamic banks, increasing the level of monitoring within the banks, such as the installation of a SSB can counter that and lead to greater CSR disclosure. As highlighted in the literature, these results further emphasize the need for Islamic banks to invest more in monitoring mechanisms, such as greater training of SSB members to increase the confidence of the Islamic investors and society (Bakar 2002). Furthermore, these results also give weight to the contention that uniform accounting standards and Sharīʿah rulings across the globe need to be implemented in order to ensure a uniform level of disclosure by Islamic banks (Dudley 2004; Karim 2001).

A number of limitations are expressed about the generalisability of the results. The sample size of 47 observations is one such limitation. While a number of tests were conducted to ensure that the sample represented a normal distribution, there is the likelihood that the results represent a random occurrence or are biased towards the variables. Further, this study only uses Islamic banks' annual reports to measure CSR disclosure. It is likely that Islamic banks also use other forms of media to communicate with investors and greater society such as company websites, press releases, annual general meetings, special booklets and pamphlets detailing their contribution to society.

Using larger samples and a larger set of information or variables about the operating environment and individual characteristics of Islamic banks, future research can attempt to further generalise these results and enhance knowledge about the affect of other factors not theorised in this study, particularly regarding transparency and social responsibility and the ensuing CSR disclosures. Lastly, future research could also attempt to generalise the results of this study about the potential impact of the socio-political environment in determining the level of CSR disclosure using conventional organisations operating in diverse cross-national contexts rather than solely Islamic banks.

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Stakeholders' Perceptions of Corporate Social Responsibility of Islamic Banks: Evidence from Malaysian Economy

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Humayon Dar**

The Corporate Social Responsibility has been a subject of considerable debate in the West for several decades. It is becoming increasingly common practise for banks in the United Kingdom and other European countries today to have established guidelines on ethical and social responsible issues such as environmental, charitable giving and support for the community, human rights and reducing social and financial exclusion. The topic of social responsibility and ethical banking is of relevance especially for those involved in Islamic banking and finance who regard their ethics and social responsibility as being more enduring since they are ultimately based on divine revelation, whereas ethics derived from secularist morality are inevitably transitory. Using a sample of over 1500 respondents, this paper, therefore, aims to explore the perceptions of the various stakeholders of Islamic banks in Malaysia regarding the social responsibility of Islamic banks. The paper is based on data collected from multiple stakeholder groups of two full-fledged Islamic banks in Malaysia namely, Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB).

Introduction

The past three decades have witnessed the emergence of Corporate Social Responsibility (hereafter CSR) as a field of study and a framework for the role of business corporations and financial institutions in society. It outlines the standard of behaviour to which a firm must subscribe to impact society in a positive and a productive manner at the same time as abiding by values which exclude profit seeking at any cost. In United Kingdom the concern for ethical investment and socially responsible firm has grown in popularity since the mid-1970s. Since then, there have been significant developments in the field of CSR, not least within the

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financial sector. According to a research conducted by Ethical Investment Research Services (EIRIS) there are now more than 50 retail ethical investment funds in the UK. These funds all apply environmental, social and/or other ethical criteria to the selection of their investments. The estimated value of these funds stood at £4 billion in August 2001 (EIRIS 2003).

The emerging of ethical banking and finance along with the propagated doctrine of CSR in the West is really a phenomenon that requires an instructive examination from the Islamic perspective. The topic of social responsibility and ethical banking is of relevance for those involved in Islamic banking and finance who regard their ethics and social responsibility as being more enduring since they are ultimately based on divine revelation, whereas ethics derived from secularist morality are inevitably transitory (Wilson 2001).

This paper focuses on the fundamental issues like perception of CSR of Islamic banks from multiple stakeholder groups' perspectives. By adopting the stakeholder approach, we believe it will become a potential relevance for Islamic banks, particularly in their policies and dealings with the aim to identify and build on stakeholder synergies to secure benefits for the widest possible constituency. So far, study on CSR from an Islamic perspective or even to investigate the practise of social responsibilities of Islamic banks is almost non-existence. Thus, providing empirical evidence on CSR of Islamic banks from different perspectives of various stakeholder groups in Malaysia will certainly add a new dimension to the literature.

The remainder of the paper proceeds as follow: The following section describes the phenomenon of CSR in the West. The relevance of CSR to Islamic banks is further analysed in section three. Study questions and research methodology adopted in this study are discussed in section four. While the findings are offered in section 5, the conclusion is presented in the final section.

2. The Emergence of CSR in the West

The intensive ethical debate since 1950s has influenced businesses to be more humane, ethical and transparent (Maignan and Ferrell 2003), giving rise to conscience over sustainable development, [1] corporate citizenship, [2] sustainable

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[1] World Commission on Environment and Development defines sustainable development as the development that meets the needs of the present without compromising the ability for future generations to meet their own needs. See in Marrewijk (2003).

[2] Marsden and Andriof (2001) define good corporate citizenship as "understanding and managing a company's wider influences on society for the benefit of the company and society as a whole". See in Marrewijk (2003).

entrepreneurship, triple bottom line,[3] business ethics and CSR (Marrewijk 2003). This paper focuses on CSR.

CSR is constantly evolving and incorporates different approaches depending on circumstances and needs. Surge in interest in CSR doctrine partly reflects a continued discontentment amongst business communities with regards to the restrictive and sometimes misleading worldview entrenched in the self-interest, and secularist and hedonistic individualism underlying the Western economic worldview (Al-Attas 1991; Steidlmeier 1992; Al-Attas 1995, 1996; Haneef` 1997; Sardar 2003). This discontentment is in part exacerbated by increasing business scandals (e.g. Frauds, breach of trusts, misrepresentations and other unethical behaviours) involving large corporations such as Barings, Enron, Arthur Anderson, WorldCom and a number of others (Snider, Hill et al. 2003).

Moreover, the CSR started to figure prominently in public debate in the wake of increasing social problems such as poverty, unemployment, race, gender and religious discrimination, and pollution (Boatright 1993). These social problems are natural outcomes of continuous transformation in the market due to economic globalisation, technological revolution as well as demographic and political change (Dunning 2003).

CSR literature identifies several driving forces behind the growing trend towards CSR initiatives.[4] First, there is a growing market pressure whereby customers, employees, or capital markets exert some form of preference, pressure or signal. Social and ethical issues have received increasing public attention or as market signals apart from the traditional price and brand preferences.[5] The growth of the ethical investment industry is another indication of how much emphasis people are now apparently placing on the social and ethical behaviour of companies (EIRIS 2003). Second, there has been an increasing regulatory pressure ranging from reporting requirements to government regulations that introduce compulsory business standards upon which companies of all sizes have to abide.[6]

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[3] Elkington (1997) states that "Tripple Bottom Line" or "People, Planet, Profit", refers to a condition whereby companies focus not only on their economic viability and performance but also on their social and environmental impacts. See in Marrewijk (2003).

[4] Refer to CSR Europe (2000), (2001), European Union (2001), CSR Europe (2002), Porter and Kramer (2002), Davies (2003), Johnson (2003), Snider, Hill, et al. (2003), Vuontisjarvi (2004).

[5] Research carried out in 1998 by MORI showed that in the last 12 months, 17% of those questioned had boycotted a company's product on ethical grounds, while 19% had chosen a product or service because of a company's reputation. Again in 1998, 71% of the general public questioned felt that industry and commerce do not pay enough attention to their social responsibilities (see in Lunt (2001)).

[6] According to Davies (2003), many business standards in the industrialised Organization for Economic Cooperation and Development (OECD) countries were once voluntary in nature. Subsequently due to the changing circumstances, the standards have now become

Third, increased power of communications (e.g., internet, electronic media, and others) have driven consumers and pressure groups like social activists, non-governmental organisations (NGOs) and trade unions to scrutinise the activities of companies more effectively and develop strategies that may influence companies to act in a socially responsible way. Fourth, there is a competitive advantage that companies believe they can reap by being socially responsible. They foresee that by communicating effectively about their social, environmental and economic contributions, they can strengthen their brand, enhance their corporate reputation with customers and suppliers, and attract and retain a committed and skilled workforce. Indeed, extant literature asserts that, the commitment towards CSR will in turn lead to better performance in terms of profitability, competitiveness and risk management (Waddock and Graves 1997; O'Brien 2001; Porter and Kramer 2002; Brinkman 2003; Johnson 2003; Snider, Hill et al. 2003).

Consequently, these factors give rise to the issues of corporate risks, in the form of legal risks or what is emerging as moral risks. The former entails adverse consequences for the company or its officers arising from non-compliance with the law, while the latter is concerned with reputation which may not involve legal action. However, moral or reputation risks can exert intense pressure on management and damage business goodwill and its survival, if neglected or abandoned (Davies 2003). For example, if a company focuses only on efficiency and externalities as much of its costs as possible to the detriment of society, it will ultimately face social sanctions that will at the very least increase its costs or could put it out of business altogether.

In general, CSR is essentially a concept whereby companies decide voluntarily to contribute to a better society and a healthier environment. As stated in a Green Paper produced by the European Commission:

> "An increasing number of companies are promoting their corporate social responsibility strategies as a response to a variety of social, environmental and economic pressures. They aim to send a signal to the various stakeholders with whom they interact: employees, shareholders, investors, consumers, public authorities and NGOs. In doing so, companies are investing in their future and they expect that the voluntary commitment they adopt will help increase their profitability."(EU 2001)

Notwithstanding the conspicuous differences between the accounts of the concept and definitions of CSR offered by the literatures, there is wide agreement on the central features of what is commonly called the doctrine of CSR. In sum, CSR addresses some of the following areas: (1) the environmental dimension, (2) the human resource dimension, (3) the philanthropic dimension, and (4) the human

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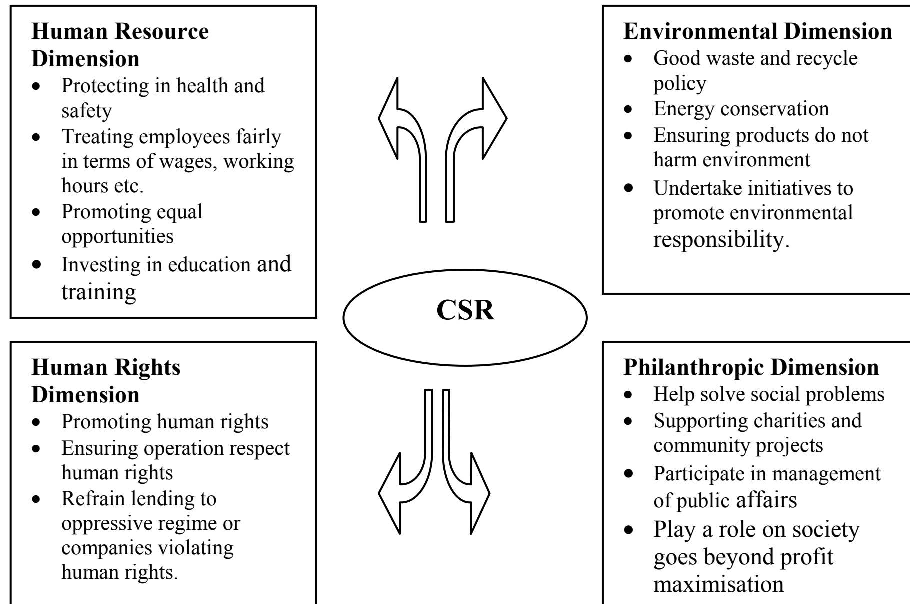
compulsory. The standards include provisions such as ethical behaviour, health and safety regulations, and minimum wages and working hours.

rights dimension. Figure 1 depicts the broad dimensions of CSR practises, as widely mentioned and adopted, as a research framework in the Western literature.

Figure 1: Dimensions of CSR Practice



The lists above, although they are not exhaustive, may provide a general overview of the meaning of CSR and serve as a framework for conducting research on it. The countless examples of activities and dimensions of CSR of the aforementioned lists are adopted in much literature on CSR.[7]

3. Implications of CSR to Islamic Banks

Although Islamic banks and Western banking and ethical institutions have dissimilar values and aspirations as they are operating in different philosophical constructs and environments, there are numerous lessons that each can gain from the other's experience. In particular, some of the dimensions of CSR in Islamic banks may also resemble those which have already been recognised in the West. Hence, this study finds that the areas and dimensions of CSR as proposed by many

[7] See for example Aurpele, Carroll, et al. (1985), Wartick and Cochran (1985), Wood (1991), Pikston and Carroll (1994), Lewin, Sakano, et al. (1995), Swanson (1995), Maignan (2001), Ruf, Muralidhar, et al. (2001), Maignan and Ferrell (2003), Angelidis and Ibrahim (2004), Goll and Rasheed (2004)

Western theoreticians and international bodies (refer to Figure 1) may well be applied to Islamic banking since most of them are consistent with the spirit and the teachings of Islam. Table 1 provides some selected sources from the Holy Qur'ān and the *Ḥadīth* of the Prophet (pbuh) to substantiate our claim.

Table 1: Islamic Perspectives on CSR Practises

Western Guidelines to CSR Practises	The Selected Corresponding Sources from the Qur'ān and *Ḥadīth* of the Prophet
1. Human Rights Dimension	▪ "I have made oppression unlawful for Me and for you, so do not commit oppression against one another" Sahih Muslim, Vol.3 *Ḥadīth* No. 6254. ▪ "help thy brother whether he is the oppressor or the oppressed i.e. If he is an oppressor he should prevent him from doing it, for that is his help and if he is oppressed he should be helped (against oppressor)" Sahih Muslim, Vol.3, *Ḥadīth* No. 6246.
2. Human Resource Dimension	▪ "Your employees are your brethren upon whom Allah has given you authority. So if one has one's brother under his control, one should feed him with the like of what one eats and clothe him with the like of what one wears. You should not overburden him with what he cannot bear, and if you do so, help him in his job." Sahih Muslim Vol. 3, *Ḥadīth* No.4093. ▪ "Allah (SWT) says: "I will be an opponent to three persons on the Day of Judgement: One who makes a covenant in My Name, but he proves treacherous, One who sells a free person (as slave) and eats the price, and one who employs a labourer and gets the full work done by him but does not pay him wages" Sahih al-Bukhari Vol. 3: *Ḥadīth* No. 2.

Western Guidelines to CSR Practises	The Selected Corresponding Sources from the Qur'ān and *Ḥadīth* of the Prophet
3. Environmental Dimension	▪ "And when he goes away, he strives throughout the land to cause destruction therein and destroy crops and animals. And Allah does not like mischievous act. (2:205). ▪ "And do no mischief on the earth, after it has been set in order, but call on Him with fear and aspiration. Indeed the mercy of Allah is near to the doers of good. (7:56).
4. Philanthropic Dimension	▪ "And fear Allah as much as you can, listen and obey; and spend in charity for the benefit of your own souls. And those saved from the covetousness of their own souls; they are the ones who achieve prosperity." (64:16) [8] ▪ "Every Muslim must pay *ṣadaqah* (charity). The companion asked, "What about someone who has nothing to give?" The Prophet replied, "Then let him do something with his two hands and benefit himself. That will be charity." The companion asked, "But what if he cannot do that?" The Prophet replied, "Then he can help someone who is needy." Again they asked, "But what if he cannot do that?" The Prophet replied, "Then he should enjoin the doing of good." Still again they asked, "But what if he cannot do that?" The Prophet replied, "Then he should give respite from evil, for that is a form of charity." Al-Bukhari's Adabul Mufrad, *Ḥadīth* No. 225.

Indeed, the philosophy of Islamic business as enshrined by the Sharīʿah requires Islamic bank to operate in morally, ethically and socially responsible manner i.e. Conforming to the Islamic norms of business and economic activities. Thus, the concept of CSR as discussed in preceding section is a natural commitment of Islamic institutions particularly Islamic banks whose objectives are directed towards making brotherhood, social equality and equitable distribution a reality in Muslim societies. Al-Omar and Abdel-haq (1996) indicate the duty of Islamic

[8] There are at least 64 different verses of the Qur'ān, in which Allah mentions the virtues and importance of charity and philanthropic effort. See in the Qur'ān (2:43, 83, 110, 177, 215, 263, 264, 270, 271, 273, 274, 276, 277, 280; 4:77, 114, 162; 5:12, 45, 55; 7:156 etc.) Also refer to Al-Bukhari (1980), (1997).

banks towards the society in which they operate by providing a clear expression outlined in the public statement of the International Association of Islamic Banks (IAIB):

> "The Islamic Banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or development activities, the Islamic bank takes into prime consideration the social implications that may be brought about any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected." (IAIB 1990 as quoted by ((Al-Omar and Abdel-Haq 1996) p.27)

This statement represents the core of what the theoretician of Islamic banking expects Islamic banks to do in terms of social responsibility. Clearly, Islamic banks operating on the Sharīʿah-based philosophy and principles differ significantly from their conventional counterparts that are deeply rooted to the capitalistic profit-maximisation philosophy. As for Islamic banks, the intense commitment of Islam to brotherhood and justice makes the well-being of all human beings the principle goal of Islam. This well-being includes both physical and spiritual satisfaction of the human personality encompassing the happiness in the present world and the hereafter. Therefore, maximisation of outputs cannot be sufficient goal of a Muslim society, rather it has to be accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness, and justice and fair-play at all levels of human interaction.

Having mentioned this, it is ill-conceived however for someone to believe that Islamic banks are charitable organisations which are obliged to provide monetary assistance as requested. Similarly, it is inappropriate for the management of Islamic banks to emphasise on the profit maximisation policies alone while neglecting other social obligations (Haron 1995). Instead, Islam which upholds the principle of justice strives for balance between profit objective and social objective. It is considered unjust for Islamic banks if they are unable to provide sufficient returns to the depositors as well as the shareholders who entrusted their money to Islamic banks. Likewise Islamic banks are prohibited from making excessive profits at the expense of their customers or the local community at large.

Patronage Studies of Islamic Banks

The previous sections have demonstrated how CSR should be naturally evidenced in the practise of Islamic banks. Even though much literature on Islamic

banking proclaims the unique and distinctive characteristics embodied in Islamic banks, particularly concerning their ethical norms and social commitments, studies on CSR from an Islamic perspective, or even investigation of the opinions and attitudes of various stakeholder groups of Islamic banks on the issue as extensively researched in the west today, are almost non-existent. Even a spectrum of related studies that exist on the topic of Islamic business ethics are mainly concerned with the conceptual and theoretical discussion, rather than providing actual empirical evidence on the perception, attitudes or behaviour of those involved in the Islamic banks. [9]

Furthermore, despite the claim most often made that the Islamic banks are a true reflection of Sharīʿah-compatible formulation, which the clients themselves respect and believe in, previous empirical studies found that religious motivation is not the only criterion for the selection of Islamic banking institutions or services. Many of the banking patronage studies have identified a number of factors, such as cost and benefits, service delivery (fast and efficient), size and reputation of the bank, convenience (location and ample parking), and friendliness of bank personnel, as either equally or more important criteria for the customers in selecting a particular Islamic bank. Table 2 provides a summary of the customers' selection criteria based on the patronage studies on Islamic banking.

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[9] There are quite a number of conceptual and theoretical types of literature linking the issue of ethics or other related topics to social and environmental aspects with the practice of business organisation and other economic endeavours from an Islamic point of view. See for examples, Naqvi (1981), Hasan (1983), AlHabshi (1987), Sattar (1988), Ansari (1989), Akhtar (1992), Pomeranz (1995), Akhtar (1996), AlHabshi (1996), Beekun (1996), Omar (1996), (1997), Al-'Alwani and El-Ansary (1999), Rice (1999), Ali (2000), Noor (2000), Naqvi (2001), Ahmad (2002), Hasan (2002), Musa and Salleh (2002), Ahmad (2003), El-Din (2003), Naqvi (2003), Rahman (2003). Some even contribute in making a comparative study between Islamic perspectives with other religions and ideological doctrines. See also Wilson (1997), (1997), (2001), Ahmad (2003).

Table 2: Patronage Studies on Islamic Banking[10]

Literature	Criteria in Banking Selection								
	A	B[a]	C[b]	D[c]	E[d]	F[e]	G[f]	H	I
Erol and El Bdour (1989)	-	+	+	+	+	+	+	+	+
Erol, Kaynak and El-Bdour (1990)	-	+	+	+	+	+	+	+	+
Haron, Ahmad et al. (1994)	-	+	+	+	+	+	+	+	+
Kader (1993)	+	-	+	+	n/a	+	n/a	+	+
Kader (1995)	+	-	+	+	n/a	+	n/a	+	+
Gerrard and Cunningham (1997)	±	+	+	+	+	+	+	+	+
Metawa and Almossawi (1998)	+	+	n/a	n/a	n/a	+	n/a	+	n/a
Naser, Jamal and Al-Khatib (1999)	+	+	+	+	+	+	+	+	n/a
Othman (2001)	-	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-
Othman and Owen (2002)	+	+	+	+	n/a	+	+	n/a	+
Ahmad and Haron (2002)	-	+	+	+	+	+	n/a	n/a	n/a
Omer (2002)	+	+	n/a	n/a	n/a	n/a	n/a	+	n/a
Abbas, Hamid et al. (2003)	±	+	+	n/a	+	+	+	+	n/a

Notes: + indicates a positive and important result, ± indicates an equivocal result, – indicates negative or no significant result and n/a indicates variable was not investigated/examined in the study.

A: Religious factor	F: Convenience
B: Cost/Benefit	G: Confidentiality
C: Service Delivery	H: Friends' and relatives' influence
D: Size and Reputation	I: Mass media Advertising
E: Staff factors	

[a] Cost/benefit factors include the cost of the services and products offered by the bank perceived by the customers e.g. Rate of return on deposits, investments etc.
[b] Service Delivery criteria include factors such as provision of a fast and efficient service e.g. Application process and a wide range of services offered.
[c] Size and reputation here imply the bank's reputation and image.
[d] Staff factors include the competence and courtesy of bank staff and their ability to convey trust and confidence. For example, politeness and friendliness of staff; efficiency and effectiveness in handling any transaction; and knowledgeable and preparedness in providing solutions and answers concerning bank's products and services.
[e] Convenience criteria include the location, ample parking space, the external appearance and interior comfort.
[f] Confidentiality means the extent customers can have trust in their transactions with the bank.

As depicted in Table 2, the patronage studies on Islamic banking so far have largely focused on the combination of various religious, reputation, commercial, service satisfaction, staff, confidentiality and convenience factors. Notwithstanding the progress made to date in the study of customers' perception towards various banking selection criteria, the more focused research studying the various CSR

[10] For details on the results of customers perception on selection and patronage factors, refer Erol and El-Bdour (1989), Erol, Kaynak, et al. (1990), Kader (1993), Haron, Ahmad, et al. (1994), Kader (1995), Gerrard and Cunningham (1997), Metawa and Almossawi (1998), Naser, Jamal, et al. (1999), Othman (2001), Ahmad and Haron (2002), Omer (2002), Othman and Owen (2002), Abbas, Hamid, et al. (2003).

dimensions of Islamic banks is almost non-existent. Even though much literature on Islamic banking proclaims the distinctive characteristics imbued in Islamic banks particularly concerning their ethical norms and social commitment, there is a paucity of empirical research on their actual commitment on social responsibility. Similarly, although the norms, beliefs and attributes of stakeholders and Islamic banks are believed to be similar, so far there is no empirical study investigating the stakeholders' perception and reaction to CSR practises of Islamic banks.

Therefore, it is imperative to study the perception of various stakeholder groups towards the practise of CSR in Islamic banking. This will further contribute to filling the gap in knowledge especially with regards to CSR of Islamic banks which has theoretically proven to be of significance and prevalent in their operation.

4. Research Methodology

The main purpose of the study is to poll the opinion of different stakeholder groups of Islamic banks in Malaysia regarding CSR of Islamic banks. In particular, the study sets out to provide answers whether CSR criteria constitute part of the patronage factors influencing selection decision by the stakeholders of Islamic banks.

For this reason, a survey was conducted to elicit the opinion of seven stakeholder groups of two full-fledged Islamic banks in Malaysia (namely Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad): financing customers, depositors, branch managers, employees, Sharīʿah advisors, regulators (Central Bank officers), and local communities. The choice of these groups was based on the grounds that they represent the primary groups of stakeholders of Islamic banks in Malaysia. The choice of these groups was also consistent with the popular definition of stakeholders which is defined as "*any group or individual who can affect or is affected by the achievement of the firm's objectives*" (Freeman 1984).

4.1 Survey Instrument

To minimise the element of bias that could emerge from the study, a structured questionnaire consisting of mainly close-ended types of questions with a few open-ended questions were carefully constructed for the study. The questionnaire content was adapted from many similar patronage studies of Islamic banks and other CSR-related studies. The questionnaire was originally prepared in English and then translated into Malay by using the backward translation method with an assistant from a third party who was fluent in both languages to avoid translation bias and error. Only minor discrepancies were observed between the original instrument and its back translated version and hence easily resolved by the translator.

Before the final version of the questionnaire was sent out, it was pilot tested to determine the appropriateness and relevance of the questions in the instrument. This early draft was circulated and piloted on lecturers at the Faculty of Economics

and Management Sciences, International Islamic University Malaysia, experienced researchers on CSR areas, businessmen, Islamic legal advisors and bank officers of the Islamic banks understudy. Based on the feedback from these respondents, several modifications were made to the wording of some questions, and some less important questions were deleted to reduce the length of the questionnaire. The final version of the questionnaire was then distributed to seven stakeholder groups of two main Islamic banks in Malaysia (namely Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad).

4.2 Data Collection

The process of data collection continued for three months, from May through July 2004. The data were collected through ordinary mail as well as self-administered questionnaires distributed by hand to individuals at the various Islamic banks' branches in the four chosen states representing four main regions of Malaysia; namely Kelantan (Eastern), Johor (Western), Penang (Northern) and Kuala Lumpur (Central). The mail survey was used in the study primarily on branch managers, regulators and Sharīʿah Advisors. As for the customers, depositors, local communities and employees, the questionnaire were distributed by hand at the various Islamic banks' branches in the four main regions. These efforts were deliberately taken in order to seek wider representation of bank stakeholders.

Respondents were randomly selected from among customers, depositors and local communities who visited the sampling locations during the chosen time intervals, in order to eliminate the sampling frame errors and to ensure the representation of the population under study in the sample units. Following the data collection procedures outlined by Kader (1993; 1995), Gerrard and Cunningham (1997), Metawa and Almossawi (1998), and Owusu-Frimpong (1999), the questionnaires were distributed during various working hours of the same day (morning and evenings), as well as various days of the week during the three month period, to avoid any potential bias owing to high concentration of bank customers, depositors and local communities during certain hours of the day, or certain days of the week or month.

Table 3 shows the number of questionnaires that were distributed; the number of usable returned and completed questionnaire (the response rate), the overall response rate and the strategy used in distributing the questionnaire for each group.

Table 3: Target Groups, Methodology Used and Response Rate

Target Groups	Distributed Questionnaire	Usable returned and completed Questionnaire	Response Rate (%)	Methodology Adopted in Distributing Questionnaire
Customers	400	367	92	By Hand (fieldwork)
Depositors	400	383	96	By Hand (fieldwork)
Local Communities	400	280	70	By Hand (fieldwork)
Employees	400	335	84	By Hand (fieldwork)
Branch Managers	134	100	75	Mail Questionnaire
Regulators	36	25	69	Mail Questionnaire
Sharīʿah Advisors	10	10	100	Mail Questionnaire
Total:	1780	1500	84.27	

In general from the total of 1780 questionnaires distributed, 1541 were returned, out of which 1500 were usable (completed), yielding a response rate of 84%. The number of response is considered large enough and sufficient for statistical reliability and generalization (Tabachnick and Fidell 1996; Stevens 2002). This high response rate would undoubtedly improve the validity and reliability of the survey since the greater the response, the more accurately it would estimate parameters in the population sampled(Pallant 2002). Hence, no further attempt was made to increase the samples.

5. Findings and Analysis

5.1 Respondents' Backgrounds

Table 4 summarises some basic statistics on gender, age, marital status, educational level and monthly income of the respondents. The respondents were predominantly male which constitute 64% of the respondents. There is quite a good mix of age group ranging from below 20 years of age to over 50, although a bulk of the respondents belongs to middle ages (20-40). Consequently, the opinions expressed in the survey could very well reflect the attitudes and perceptions of the middle-aged and younger respondents (that is if we consider those above 40 to be the older respondents). This again indicates that the sample is somewhat reflects the composition of the young and promising generation for the future of Islamic banking in Malaysia.

The results reported in Table 4 also indicate that the majority of respondents are well educated, with more than 23% holding college diploma, matriculation or A-level certificates and about 42% holding a bachelor degree or above. This information reflects the relative importance of paper qualifications especially for young generations to face the challenges in the present competitive world. Majority (48%) of the respondents were in the RM1000-RM3000 monthly income group. Eighteen percent of the surveyed respondents earned between RM3001-RM5000 per month. Combined together, the respondents in those two income groups represent approximately 66% of the total sample. This result indicates that most of the respondents can be classified as middle-class income earners since majority of them have monthly incomes within the range of RM1000 to RM5000. This finding captures closely the pattern of income distribution of Malaysian households which mainly (65%) consist of those with earnings between RM1000 to RM5000 or middle-class households.[11]

Table 4: Distribution of Respondents

		Frequency	Percent (%)
Gender	Male	951	64.0
	Female	534	36.0
Age Group	Below 20	65	4.4
	20 – 30	592	40.0
	31 – 40	478	32.3
	41 – 50	274	18.5
	Above 50	70	4.7
Marital Status	Single	455	30.9
	Married	1018	69.1
Educational Level	Primary/Secondary School	485	33.0
	College Diploma/Matriculation/A-Level	351	23.9
	Bachelor	406	27.7
	Professional Qualification	80	5.4
	Postgraduate (Master or Ph.D)	128	8.7
	Others	18	1.2
Monthly Income	Less than RM1,000	288	20.8
	RM1,000 – RM3,000	667	48.1
	RM3,001 – RM5,000	250	18.0
	RM5,001 – RM10,000	150	10.8
	RM10,001 – RM20,000	23	1.7
	More than RM20,000	8	0.6

[11] According to the definition given in the Eight Malaysian Plan (2001-2005), lower-income households were defined as those earnings less than RM1500 per month. The middle-income households, defined as those earnings between RM1500 and RM5000. While higher-income households, defined as those earnings between RM5000 and above.

5.2 Factor Analysis: Support for CSR across Stakeholder Groups

Scholars have demonstrated that people identify themselves with organisations when they perceive an overlap between organisational attributes and their personal attributes (Maignan and Ferrell 2004). As stakeholders perceive that key organisational features are in harmony with their self-identity, they are likely to patronise the organisation (Scott and Lane 2000).

Against these backdrops, since Islamic banks and their various stakeholders share the same norms, beliefs and values, it is therefore expected that the practise of CSR may have a positive consequence on the organisation. This is because Sharīʿah principles underpin the stakeholder norms, thus providing a common set of rules and behavioural expectations to be shared by the majority of the Islamic banks' stakeholders especially the Muslims. Since CSR is a natural outlook of an Islamic organisations prescribed by Sharīʿah, various stakeholder groups are expected to support and influence the practises of CSR of Islamic banks. Consequently, CSR factor should be evident in Islamic banking stakeholders' perception and attitude especially in making decisions whether to patronize Islamic banks. Hence, the null hypothesis reads:

> ***Ho:*** ***Stakeholders in Malaysia apply equal importance to the CSR factors along with other banking selection criteria when making a judgement about patronising Islamic banks.***

To test this hypothesis, an exploratory factor analysis was conducted. Factor analysis with separate varimax rotation was run on twelve variables representing various attributes of banking selection criteria. These banking selection criteria or patronage factors have been extensively investigated in the literature (see for example Erol and El Bdour, 1989,1990; Haron, Ahmad et al., 1994; Gerard and Cunningham, 1997; Metawa and Almossawi, 1998; Othman and Owen, 2001, 2002; Ahmad and Haron, 2002; and Abbas, Hamid et al., 2003). After a detailed review of these selection criteria and given the nature of this study, twelve basic attributes were selected and tested in the current study.

These widely investigated attributes from similar studies together with the newly created attributes related to CSR[12] are: financial product price, customer service quality (fast and efficient service), convenience (e.g. Available parking space, interior comfort), location being near home or work, friendly personnel, knowledgeable and competent personnel, Islamic working environment, economic and financial reputation, respect for human rights, Islamic reputation and image, involvement in the community and environmental practise and impact.

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[12] For the purpose of this factor analysis, we include some items representing CSR initiatives variables as widely acknowledged in the literature. See for example CSR Europe (2001), EIRIS (2001, 2003), Greenwood (2001); Al-Khater and Naser (2003) and others.

In this study, the perceptions of stakeholders on twelve attributes or banking selection criteria are examined using factor analysis: (1) to determine whether the CSR factor contributes to one of the important indicators in their banking selection criteria and (2) to ascertain which of these factors is the strongest motivation. The results will then be used to investigate whether there is any significant difference in perceptions among various stakeholder groups.

In testing whether factor analysis was appropriate for the banking selection criteria, KMO and Bartlett's Test of Sphericity were conducted. The KMO test revealed a value of 0.865 while the Bartlett's Test of Sphericity also reached statistical significance (0.000). Based on these favourable results, factor analysis was conducted using principal component analysis (PCA) and varimax rotation with Kaiser Normalisation. The resulting varimax rotated factors are given in Table 5 along with communality values of each variable; eigenvalues and percentage of explained variance.

Table 5: Rotated Component Matrix[a] on Banking Selection Criteria

Variable	Factor			Communality of Each Variable
	1 Reputation / service delivery	2 CSR of Islamic bank	3 Convenience/ product price	
X_6	.766			.633
X_{10}	.742			.642
X_5	.670			.579
X_7	.655			.545
X_8	.624			.511
X_2	.616		.434	.571
X_{12}		.790		.649
X_{11}		.715		.583
X_9	.416	.631		.589
X_4			.721	.646
X_1			.586	.432
X_3			.571	.548
Eigenvalue	3.191	2.148	1.589	
% of Variance	26.590	17.897	13.245	
Cumulative %	26.590	44.487	57.732	

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization.

[a] Rotation converged in 6 iterations.

Variables:

X_1	Product price factor
X_2	Customer Service quality (e.g. Fast and efficient services) factor
X_3	Convenience (e.g. Available parking space, interior comfort) factor
X_4	Location being near home or work factor
X_5	Friendly personnel factor
X_6	Knowledgeable and competent personnel factor
X_7	Islamic working environment factor
X_8	Economic and financial reputation factor
X_9	Respect for Human rights factor
X_{10}	Islamic reputation and image factor
X_{11}	Involve in community (e.g. Giving donation, scholarship) factor
X_{12}	Environmental practise and impact factor

The results in Table 5 reveal the presence of three factors with all 12 items of the banking selection criteria exhibit large factor loadings (above 0.3 significant levels). The eigenvalues for the three factors are above 1 (3.191, 2.148 and 1.589 respectively). These three factors explain a total of 57.73% of the variance. Specifically, Factor 1 has six significant loadings while both Factor 2 and 3 have three respectively.

Turning to an interpretation of independent dimensions based on the varimax rotated matrix as given in Table 5, one can see that the first factor delineates a cluster of relationships among the following attributes; '*knowledgeable and competent personnel*'(**X_6**), '*Islamic reputation and image*'(**X_{10}**), '*friendly personnel*'(**X_5**), '*Islamic working environment*'(**X_7**), '*service quality (fast and efficient service)*' (**X_2**) and '*economic and financial reputation*'(**X_8**). The nature of the highly loaded variables on this factor suggests that it can be named "*reputation and service delivery*". This "*reputation and service delivery*" factor contributes around 27% of the reasons for selecting Islamic banking. Since Factor 1 has the highest eigenvalue and variance, (eigenvalue = 3.19, variance = 26.59%) it necessarily represents the most important factor that has influenced stakeholders to patronise Islamic banking.

This result indicates that, the selection of Islamic banks appears to be predominantly a combination of Islamic and financial reputation and quality service offered by the bank. Therefore, Islamic banks must have good public relations to boost their reputation at the same time to foster good customer and employee relations in order to attract customers. The finding is consistent with many earlier Islamic banking patronage studies like Erol and El-Bdour (1989), Erol, Kaynak et al. (1990), Haron, Ahmad et al. (1994), Gerrard and Cunningham (1997) and Abbas, Hamid et al. (2003), in which reputation and the quality of service delivery including friendliness and competence personnel, fast and efficient service etc. Were found pertinent in influencing customers' banking selection.

Interestingly, the results of the factor analysis in Table 5 also reveal that the variables which have loadings on the second factor are '*environmental practise*'(**X_{12}**), '*involvement in community*'(**X_{11}**) and '*respect for human rights*'(**X_9**). The combination of these variables can be compositely grouped together under the proposed heading of "*CSR of Islamic banks*". The reasons are quite apparent especially when these variables were normally associated to dimensions under CSR in many previous studies (CSR-Europe 2001; EIRIS 2001; Greenwood 2001; Al-Khater and Naser 2003; EIRIS 2003). As shown in Table 4, Factor 2 "*CSR of Islamic banks*" accounts for 17.9% of the total variance and together with Factor 1 explains about 44.49% of the total variance. All three variables are moderately correlated with Factor 2 with factor loadings ranging from 0.631 to 0.790. The variables '*environmental practise*' (**X_{12}**), '*involvement in community*'(**X_{11}**) and '*respect for human rights*' (**X_9**) seem to indicate that CSR commitments of Islamic banks were also taken into consideration by stakeholders when making a judgement to patronise a bank. The fact that stakeholders were also influenced by CSR commitments suggests that Islamic banks should promote the practise of CSR. It also suggests the appropriateness of CSR as an instrument to strategically market the organisation to consumers and other relevant stakeholders.

The third factor defining stakeholder banking selection criteria relates to '*location is being near home or office*'(**X_4**), '*convenience (e.g. Available parking space and interior comfort)*' (**X_3**) and '*financial product price*'(**X_1**). For this factor, the suggested name for it is "*convenience and product price*" factor. The results of the factor analysis ranked "*convenience and product price*" as the least important factor compared with other variables, since it explains only 13.2% of the total variance for the variables in the data set. This result is somehow inconsistent with the previous conventional banking studies since convenience and product price factors have often emerged as the most common and important factors among the banking selection criteria. For example Almossawi (2001) and Gerrard and Cunningham (2001) found that convenience factors were of paramount importance in banking selection criteria compared to other factors based on their survey conducted on conventional banking customers in Bahrain and Singapore respectively (Almossawi 2001; Gerrard and Cunningham 2001).

Overall, the factor analysis reveals an important result indicating that CSR factor was considered as one of the important factors in making a judgement and decision whether to patronise Islamic banks. The ranking position of CSR factor as the second most important factor also suggests that the null hypothesis can be rejected. Moreover, it is also expected that the proportion of stakeholders influenced by this factor would be relatively high. This is confirmed by figures on Table 6, whereby high percentages of influence are evidenced for all the three variables constituting under CSR factors (X_9 = 93.7%, X_{11} = 90.2% and X_{12} = 82.9%).

Table 6: Frequency Distribution: Factor 2 Variables – Degree of influence on Stakeholders' Judgement on Islamic Bank

Degree of influence	Value	Environmental practise (X_{12}) (%)	Involvement in community (X_{11}) (%)	Respect for human rights (X_9) (%)
Not Important at all	1	.7	.3	.3
Not Important	2	8.4	4.8	2.2
Cumulative %		9.1	5.1	2.4
Important	4	58.3	56.6	53.0
Very important	5	24.6	33.6	40.7
Cumulative %		82.9	90.2	93.7
Neutral	3	8.0	4.7	3.9
Mean Value		3.9789	4.1823	4.3164
Median Value		4	4	4
Mode Value		4	4	4

5.3 Kruskall-Wallis Test: Comparing Stakeholder Groups' Perceptions

It is also imperative to investigate whether there is any significant difference in the perception of multiple stakeholder groups towards CSR as one of the banking selection criteria for Islamic banks. The null hypothesis reads:

Ho: There is no significant difference in the various stakeholder groups' opinions when considering CSR as an important patronage criterion of Islamic banks.

To test this particular hypothesis, the Kruskall-Wallis test was undertaken and the results are reproduced in the following Table 7.

Table 7: K-W Test Results Comparing the Mean Ranks of Banking Selection Criteria variable amongst the Stakeholder groups

Variable	Subgroup	N	Mean Rank	^{2}	Asymp. Sig. (*p*)
Reputation and Service Delivery Factor (V_1)			K-W Test:	^{2}= 19.183	0.004
	Employees	328	756.25		
	Customers	349	727.21		
	Managers	96	723.01		
	Depositors	352	722.26		
	Local Communities	266	645.81		
	Sharīʿah Advisors	9	605.06		
	Regulators	24	495.02		
CSR Factor (V_2)			K-W Test:	^{2}= 61.322	0.000
	Depositors	363	817.23		
	Customers	358	786.71		
	Local Communities	271	701.42		
	Employees	330	656.29		
	Sharīʿah Advisors	9	611.39		
	Managers	98	562.68		
	Regulators	25	487.30		
Convenience and Product Price Factor (V_3)			K-W Test:	^{2}= 10.439	0.107
	Employees	323	771.91		
	Customers	347	723.20		
	Sharīʿah Advisors	10	719.70		
	Depositors	360	697.33		
	Managers	99	696.40		
	Local Communities	268	683.28		
	Regulators	25	618.10		

Table 7 indicates that while there is a significant disagreement among the stakeholder groups on two out of three factors of banking selection criteria namely, '*reputation and service delivery quality'* factor (V_1) and '*CSR of Islamic Banks*' factor (V_2), no significant disagreement was found in the stakeholder groups regarding '*convenience and product price*' factor (V_3). The chi-square, χ^2 values for the two variables, V_1 and V_2 (19.183 and 61.322 respectively) are higher than the tabulated chi-square value, χ^2 = 12.59 at 0.05 confidence interval; 6 degrees of freedom. While χ^2 value for V_3 is 10.439, which is lower than the tabulated chi-square value. The observed significant level for V_3 (P_{V3}=0.107) is higher than the 0.05 confidence level, which implies no variations between the seven groups of stakeholders in the population. However, the observed significance level (P_{V1}=0.004, P_{V2}=0.000) for '*reputation and service delivery quality'* factor (V_1) and '*CSR of Islamic Banks*' factor (V_2) variables are lower than the 0.05 level, indicating the existence of variations between the seven groups in the population. Hence, the null hypothesis can be rejected. The findings clearly indicate that various stakeholder groups attach a different degree of importance especially towards the '*reputation and service delivery quality'* and '*CSR of Islamic Banks*' factors when making a judgement about Islamic banks based on the list of banking selection criteria.

To investigate which of the stakeholder group assigned highest or lowest in terms of importance with respect to the CSR factor of banking selection criteria, column 4 in Table 7 is reproduced. The result reveals the mean rank of depositors (817.23) and customers (786.71) exceeded that of other stakeholder categories. This suggests both depositors and customers are more likely to be attracted by CSR criteria than other stakeholder groups. In contrast, regulators were ranked lowest (487.30) in perceiving CSR as an important banking patronage factor based on the hierarchy of mean rank.

Two plausible explanations may account for this finding. Firstly, even though the commitment towards social responsibility is encouraged, there is no specific requirement by law or any official guideline or standards made available by the Central Bank (Bank Negara), especially for the regulators in overseeing CSR practises of Islamic banking operation. Secondly, it can be deduced from the results presented in Table 7, regulators are more concerned with the commercial aspects of Islamic banks particularly on the latter's ability and viability to compete and sustain in the dual banking system. This is not surprising since regulators are relatively more experienced and directly exposed to the actual scenario relating to stiff market competition in the dual-banking system. Perhaps, it is not that this stakeholder group do not care about CSR, but rather that they care and are concerned more about the bank's ability to compete, especially for Islamic banks which are still struggling to position themselves among the more established conventional banking system.

6. Conclusions

In this study, an attempt was made to investigate the perceptions of various stakeholder groups about CSR of Islamic banks in Malaysia. Seven stakeholder groups took part in the survey, namely customers, depositors, employees, branch managers, Sharī'ah advisors, regulators and local communities. Overall, the findings revealed that stakeholders of Islamic banks in Malaysia have generally positive views of CSR. One of the most important reflections of their positive attitude is that CSR factors are evidenced as one of the important criteria in their banking selection decisions. This implies that Islamic banks operating in a competitive dual-system like Malaysia can still create their own niche in the market for those who are committed and concerned with socially responsible and ethical banking.

The findings prove that the issue of CSR is therefore not foreign to Islamic banking. Rather, it shows the relevance of CSR as a globally accepted practise to Islamic banks. The Islamic banking system has an in-built dimension that promotes social responsibility, as it resides within a financial trajectory underpinned by the forces of Sharīʿah injunctions. These Sharīʿah injunctions interweave Islamic financial transactions with genuine concern for ethically and socially responsible

activities at the same time as prohibiting involvement in illegal activities which are detrimental to social and environmental well-being.

There are fundamental differences between Islamic banking and conventional banking, not only in the ways they practise their business, but above all the values which guide Islamic banking whole operation and outlook. The values as prevailed within the ambit of Sharīʿah are expressed not only in the minutiae of its transactions, but in the breadth of its role in society. This demands the internalisation of Sharīʿah principles on Islamic financial transactions, in its form, spirit and substance. By so doing, it epitomises the objectives of Sharīʿah in promoting economic and social justice. Hence, while the virtues of Islam have always advocated social responsibility, the challenge to Islamic banking communities lies in its application. For Islamic banks, good CSR practises should have already been embedded in all aspects of their operations.

Indeed, Islamic banking should endeavour to be the epicentre in the financial galaxy of promoting good CSR practises. In this respect, an assimilation of CSR and other Islamic ideals in fulfilling stakeholders' expectations deserves utmost consideration as it represents a fundamental difference between Islamic and conventional banking, and has the potential to propel Islamic banking to greater heights in securing stakeholders' recognition and acceptance.

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Evaluating the 'Social Responsibility' of Islamic Finance: Learning From the Experiences of Socially Responsible Investment Funds

Salma Sairally [*]

In order to fulfill the Sharīʿah objective of promoting the welfare of society, Islamic financial institutions (IFIs) are expected to consciously align their decisions and actions so that these are 'socially responsible'. An integral policy approach towards corporate social responsibility (CSR) would constitute assigning explicit social objectives to IFIs over and above their economic, legal, Sharīʿah, and ethical responsibilities. Alternatively, the task of undertaking socially oriented projects could be argued as being a discretionary responsibility of IFIs, with the objective of CSR being sought merely as a peripheral practice. Recent debates on the evolution of the practice of Islamic finance highlighted the profit and economic efficiency motives of IFIs rather than a concern for socio-economic equity and welfare. A divergence between the economics literature on Islamic finance and the course taken by the practical field of Islamic banking and finance has been argued to be arising over the years. An assessment of this contention motivates this study. It seeks to evaluate the Corporate Social Performance (CSP) of IFIs, thus determining how socially responsible IFIs are in their objectives, actions and commitments as a socio-economic contributor to human welfare. It also seeks to learn from the experiences of secular 'socially responsible' investment (SRI) funds which promote ethical finance in the West.

Introduction

The ethical credentials of Islamic financial institutions (IFIs) make them attractive to not only Muslims but to also a wide spectrum of ethically-conscious consumers who desire a socially just financial system. Banking on the ethical

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qualifications of Islamic finance, mainstream financial institutions in the West – like HSBC (UK), Citibank (USA), Banque Nationale de Paris (France) and UBS (Switzerland) – have embraced Islamic financial principles and offer Islamic financial products to Muslims who seek alternatives to the *ribā*-ridden conventional financial system whilst they still highlight the relevance of these products to the larger society, especially the ethically-concerned. To this end, Islamic finance as a concept has been compared with parallel appealing themes like socially responsible investments (SRI). Based on similar core values – such as individual responsibility, commitment to the social interest, promotion of human welfare, care for the environment, and concern for economic and social justice – Islamic finance has been promoted as a socially responsible paradigm rooted on religious tenets.

Inspired by other philosophical notions of 'human accountability before God' and 'man's role as a vicegerent on earth' (Ahmad, 1980: 178) which guide Islamic economic and financial practices, individual and institutional investors are led to be concerned with not just 'what' kinds of activities their money is financing but also with the 'way' projects and activities are funded. They seek the deployment of funds in a *ḥalāl* (Islamically permissible) way. Thus, the practice of Islamic finance would avoid investments in areas involving interest (*ribā*), uncertainty (*gharar*), alcohol, tobacco, drugs, pornography, prostitution, gambling, armaments, animal experimentation, genetic engineering, financial exploitation – areas which are considered to be "value destroyers" (Khan, 2001).

Founded on such socially laudable values, the practice of Islamic banking and finance has been institutionalised and has experienced impressive growth over the recent decades. As of 2004, Iqbal and Molyneux (2005: 1; 65-66) quote the prevalence of 70 Islamic banks (excluding those in Iran and Sudan), 40 conventional banks offering Islamic banking windows, 200 Islamic investment funds and 70 Islamic insurance companies, with a total market operation exceeding US$ 150 billion.

Despite the progress made and the growing maturity of the industry several criticisms have been levelled against the practice of Islamic finance, with discussions often comparing the promise of the Islamic economics literature with the performance (practice) of IFIs. For instance, the heavy bias of *murābaḥah* (mark-up) in the portfolio of Islamic banks – which is often explained by the financial necessity and economic rationality of the instrument (Yousef, 2004: 64) – relative to the use of profit-and-loss sharing arrangements as advocated in the literature, has subjected the practice of Islamic finance to various contentions. Islamic banks have, in this respect, been claimed to (i) mirror conventional finance by adopting interest-like fixed return instruments (Warde, 2000: 240); (ii) choose financial products so that they are as closest as possible to the efficiency level of conventional financial products while they neglect the equity criteria of concern to Islamic jurists (El-Gamal, 2000); (iii) direct financial resources into consumption

channels rather than into production (Hasan, 2005); (iv) direct the contribution of Islamic finance towards the growth of money rather than the growth of the economy (Badawi, 1996/1997: 20). In short, it is believed that the mere replacement of *ribā* with other fixed return modes of financing and the implied risk-averseness of Islamic banks do not show the socio-economic commitment on the part of the institutions.

In fact, the lack of deep felt commitment to the Islamic financial sector by some financial practitioners has been highlighted by Parker (2004: 2). Parker (2005: 2) further argued that the pursuit of profit maximisation and shareholder value by IFIs often overrides the supposed faith-based ethical principles, which turn into *"mere mechanisms for a means to an end"*.[1]

More recently, debates among academicians and practitioners have been directed towards the very objectives of the discipline: the practice of Islamic banking and finance is argued to be evolving along the same self-interest, profit-geared motive – the *homo-economicus* postulate of the neo-classical literature – that, in the first place, it was set to oppose. Islamic finance is observed to be developing in several countries as an *"elitist phenomenon without much grassroots level appeal"* (Dar, 2002: 48). Being in competition with mainstream financial institutions, IFIs are keeping pace with new financial developments. Siddiqi (2004a) in this respect observes the effort directed towards financial engineering as compared to social engineering. According to El-Gamal (2000), financial experts and practitioners appear to devote more attention to the achievement of 'economic efficiency' than be concerned with the principle of 'socio-economic equity'. A rift between the economics literature on Islamic finance and the course taken by the practical field of Islamic banking and finance is therefore argued to be arising over the years.

The apparent divergence in the practice of Islamic finance from its initial objective of targeting general human wellbeing – which inevitably has recourse to the *maqāṣid* al-Sharīʿah (objectives of Islamic law) – is the problem that motivates this study.[2] The aim is to appraise this contention and determine how 'socially

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[1] To draw attention to the quest for profit maximisation of Islamic banks, Parker (2005: 2) quoted one Islamic banker who stated: *"As far as (my bank) is concerned, we are very committed to the development of the Islamic financial market. It is a means to enhance our shareholders' value. From an institutional perspective we do not see Islamic banking either as a religious requirement or a social need. We see it more in terms of how we might enhance shareholders' value."*

[2] The *maqāṣid* al-sharīʿah provides a framework which encapsulates the concept of human wellbeing. According to al-Ghazali, the *maqāṣid* al-sharīʿah is deemed to promote the wellbeing of all mankind through the promotion, protection and enrichment of faith (*din*), human self (*nafs*), intellect (*ʿaql*), posterity (*nasl*) and wealth (*mal*) (quoted in Chapra, 2000: 118). Al-Shatibi equally emphasised the idea of welfare promotion by defining the

responsible' IFIs are in their objectives, actions and commitments as a socio-economic contributor to human welfare. To this end, the literature on corporate social responsibility (CSR) which defines social responsibility issues and theories of corporate social performance (CSP) which shed light on the assessment of corporations' social responsibility has been drawn upon. This study accordingly rises to the call of academicians like Ḥasan (2004) and Tag el-Din (2005: 45) who voiced out the need to evaluate the performance of IFIs with reference to their contribution in meeting their social responsibilities.

Concurrently, this study seeks to investigate how the socially responsible role of IFIs could be enhanced. The experiences of western SRI funds have been examined in our quest to promote human wellbeing.

2. Islamic Financial Institutions and Social Responsibility

Early contributors to the Islamic economics literature specifically assigned a key socio-economic role, above the principle of profit maximisation, to all the operators of the financial system – from the central bank to the private commercial Islamic banks and non-bank financial institutions (NBFIs). These views are held by economists like Chapra (1985) and Siddiqi (1983). According to Chapra (1985), the Islamic financial set-up imposes upon IFIs an extra parameter – a socio-economic purpose – in addition to the responsibilities assigned to them by conventional financial laws. The Handbook of Islamic Banking (International Association of Islamic Banks, 1982), cited by Warde (2000: 174-175), mentions a number of socio-economic objectives to be endorsed by IFIs. These are conventionally recognised objectives assigned to state banks and development agencies, hence attributed to IFIs as they are called upon to play a role in socio-economic development.

- Fulfilment of broad socio-economic benefits
- Focus on promising economic sectors
- Job creation and stimulation of entrepreneurship
- Maintenance and dispensation of social justice
- Establishment of equity and fairness
- Alleviation of poverty
- Promotion of regional distribution of investments.

Islamic commercial banks are thus expected to act as universal banks, being profit geared as well as catering for societal needs. They are exhorted to attribute public funds *"to serve the common interest and no individual gain"* (Lewis and Algaoud, 2001: 95).

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aims of the *maqāṣid* al-sharīʿah as the *"attainment of good, welfare, advantage, benefits and warding off evil, injury, loss for the creatures"*. (Khan and Ghifari, 1985)

In general, an Islamic firm – by extension an IFI – is believed to be distinctive in its behaviour, since according to Mannan (1992: 120), it can not be guided by the single objective of profit maximisation. It is argued that its behaviour *"needs to be guided, among others, by the consideration of altruism – a concern for others to be shown as a principle of action"* (Mannan, 1992: 120). In this respect, a concern for others – including all the stakeholders of the firm and not only the shareholders – is expected to be internalised within the operations of a firm, including IFIs.

This preceding argument is related to the discussion on corporate social responsibility (CSR) which has gained increased attention since the 1990s. CSR is generally associated with the concern of corporations of the impact of their actions on the welfare of society (Carroll and Buchholtz, 2006: 30; Gitman and McDaniel, 2002: 107).[3] One of the most widely accepted definitions of CSR is that provided by Carroll (1979: 499) who utilises a sophisticated approach in defining CSR in terms of four expectations that society has of corporations – that they will respectively fulfil their economic, legal, ethical and discretionary responsibilities.

- The economic responsibility is for the business to be foremost profitable, efficient and viable.
- The legal responsibility is to obey the laws and regulations of the land.
- The ethical responsibility covers society's expectations of businesses over and above the legal requirements – responsibilities that embody ethical norms which are not necessarily codified into law.
- The discretionary responsibility is the expectation that the firm will assume social roles over and above those already mentioned and be a good corporate citizen by caring for and investing in the society it operates in.

By attributing a social role to Islamic financial operators in the economy, where concern for the wider society is integral to the operations of the firm, early contributors to the discipline of Islamic economics and finance implicitly subscribed to the CSR model advocated by Carroll (1979). The model where businesses are focused on operating their core activities in a socially responsible

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[3] A variety of definitions of CSR can be found in the business and management literature (see Carroll and Buchholtz, 2006: 34-35). Different organisations and authors have submitted their respective definitions, with some focusing on the notion of sustainable development, increased economic welfare, attaining a balance between positive and negative impacts of the firm and the legal, ethical, social, and commercial responsibilities of businesses.

way for solid business case reasons is usually referred to as the "European model" (Baker, 2004; Worthington et. al., 2003).[4]

Being philanthropic is nonetheless perceived as the highest level of responsibility of a business, considered after the economic, legal and ethical responsibilities have been respectively met (Gitman and McDaniel, 2002: 110). In the case of financial institutions, they are evidently not considered to be charities. Yet, the trend observed since the 1990s has been an elevation in the provision of financial services to a prominent social role such that banks and NBFIs have been reengineering their products, processes and services in order to have a greater social impact (Mayo and Guene, 2001: 1). This trend can be recognised under the labels of "social banking", "ethical investment", "micro-financing" and "community reinvestment".

On the other hand, an alternative model has been proposed by academicians like Ismail (1986) and Tag el-Din (2003) who prefer to allocate IFIs as part of the commercial sector of the economy and instead assign morally motivated economic and financial activities to the third sector which is non-profitable. The proponents of this argument classify the economy into a distinctively three-sector financial system comprising the government sector, the market sector (also known as the commercial sector), and the philanthropic sector (also called the welfare or third sector). Consequently, as argued by Ismail (1986), Islamic banks which belong to the commercial sector will have responsibilities to their shareholders and depositors and not to the larger society. The task of fulfilling socio-economic objectives, like voluntary spending, institutionalising *zakāh* or investing in community projects, would not fall under the responsibility of IFIs. As an alternative, socially-oriented projects would be undertaken by NGOs and social organisations which situate themselves in the third sector.

This alternative approach in the role of IFIs could be compared with Friedman's (1970) view of operating a business. A socially responsible business, according to Friedman (1970: 126), is for it to *"use its resources and engage in activities designed to increase profits so long as it stays within the rules of the game, and engages in open and free competition without deception or fraud"*. The financial priorities, while undertaken within the limit of free competition and legal responsibility, should thus rank as the prime concern of a business. The social benefit of the business is viewed in terms of its contribution in the creation of wealth and employment. Charitable activities are thus not perceived as part of a

[4] The 'business case' for CSR has been increasingly recognised in the literature (see Davis (1973), Little (2003); Walter (2004: x); Diamantopoulou (2004: v)). Some of the recognised benefits for adopting CSR as a management strategy are argued to include: improved corporate reputation; better management of long term risks by protecting the business from being involved in irresponsible social and environmental scandals; increased employee satisfaction; stimulation of learning and innovation as companies identify new market opportunities; improved market positioning and long term profitability.

business' objectives. Conversely, Friedman would argue that managers have no right to dispense of shareholders' money in the form of overt charitable activities as their role is to increase wealth for shareholders rather than giving it away (cited in Boddy, 2002: 129). Philanthropy, in this case, would only be a peripheral practice of the business. This model is commonly referred to as the "American" or "philanthropic" model in the literature (Baker, 2004; Worthington et. al., 2003). Friedman's view that the social responsibility of businesses is to increase profits is also referred to as the "efficiency" view (Rodriguez et. al., n.d).

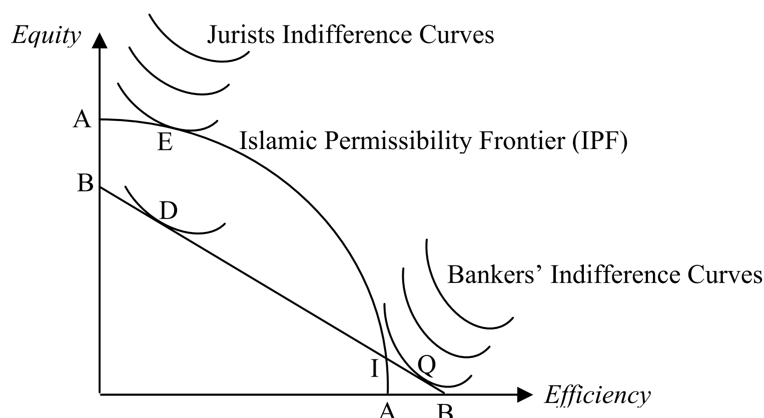
Following the above discussion, the question we pose is, firstly, how does the practice of Islamic finance compare with the theoretical promise of the discipline to create an innovative financial system for bringing about social and economic benefits? Secondly, it is asked whether the practice of Islamic finance subscribe to the integral European model or the peripheral American model of CSR.

3. Debates on the Practice of Islamic Banking and Finance

Evaluating the Performance (Practice) of Islamic Banking and Finance as an Alternative Source of Ethical Investment

Discussions by El-Gamal (2000) and Halim (2001) have highlighted a divergence occurring between the literature of Islamic economics – which emphasises the attainment of socio-economic goals by IFIs based on recourse to the *maqāṣid* al-Sharīʿah – and the contemporaneous practices of these institutions. El-Gamal (2000) argued that the preferences of Islamic financial practitioners are more biased towards considerations of profits and efficiency, similar to those operating in the conventional financial sector, and in contrast to the considerations of equity favoured by Islamic jurists. The author illustrated his argument through Figure 1 (reproduced with modifications) which portrays the position of jurists and bankers in their choice between equity and efficiency. These two parameters are subject to the permissible set of allocations allowed by Sharīʿah (curve AA) and the financial technological constraints (line BB). According to El-Gamal (2000), the "closest permissible point" that financial practitioners will choose is point I – which is situated along the Islamic Permissibility Frontier (IPF), is subjected to the current financial technology, and is as closest as possible to the efficiency level of conventional financial products. This point, however, substantially lacks the equity criteria, of concern to jurists.

Figure 1: Divergence between Islamic Economics and Islamic Finance



Point E: Tangency of the jurists' indifference curves with the IPF, reflecting jurists' ideal choice of high level of equity. This point is currently not achievable because of the current financial technology which is still evolving and requires more decades of trial and error. Financial technologies have been defined by El-Gamal (2000) as *"institutional frameworks that render certain types of contracts and transactions feasible"*.

Point Q: Represents the choice of high level of efficiency of mainstream bankers and financial experts.

Point D: Represents the choice of some Islamic financial practitioners, to maximise jurists' preferences of equity while being subjected to the financial technological constraints. However, point D is socially inefficient as it is inside the IPF.

Point I: Represents *"the closest permissible point subject to the current financial technology"* which many financial experts end up choosing. Financial products offered are therefore within the bounds of Shari'ah permissibility, of high efficiency but having lower equity characteristics.

Source: El-Gamal (2000)

Siddiqi (2004b) also alluded to the divergence occurring between the goals of Islamic finance and Islamic economics as he states *"modern finance tends to develop as an independent activity, complete with its objectives and methods, orchestrated by a distinct set of players. It is undoubtedly part of the economy but it does not necessarily share the goals of the economy. True to the conventional paradigm, its objective is to maximize profits"*. Siddiqi (2004b) partly ascribes this "alienation" of Islamic finance from Islamic economics on the overemphasis placed by jurists on *fiqh* (Islamic jurisprudence) in order to derive financial and economic rulings instead of complementing the *fiqh* approach with the *maqāṣid* al-Sharīʿah – which envisions the economic and financial system as part of the

Islamic way of life and not limits it to only the realm of Islamic law. He argues that the *"primacy of rules and regulations over goals and objectives"* is to be blamed for the unsolved social problems like poverty, inequality and corruption. Badawi (1997: 20) termed this practice as compliance to the "text of the law" while there is neglect of the "spirit of the law".

Siddiqi (2004b) further observed the emphasis placed on monetary gains by IFIs. He argues that modern financial institutions are much engaged in the "financial engineering" of products which is profit-driven whilst there is neglect of "social engineering" which is inspired by social goals. Some of the new developments in the industry, for instance, relate to the launching of Islamic bonds (*ṣukūk*), development of Islamic market indices, securitisation of assets, and the development of hedge funds. These latest financially engineered developments undeniably highlight the efforts made by Muslim jurisprudents and practitioners to evaluate whether new financial products could be absorbed in the Islamic financial system. At the same time, these developments indicate the move of Islamic finance towards sophisticated financial products and practices that target high-net-worth investors or institutional investors rather than small savers, and on the surface, point to the profit motive of IFIs.

Similarly, raising objections on the way the profits arising from Islamic funds are being channelled in the coffers of large institutions, Parker (1996:2) states: *"There has yet to be an Islamic fund launched which is aimed at the ordinary investor. All the numerous Islamic investment funds currently on the market are aimed at high net worth individuals and institutional investors."* The objective of empowering the larger society – in other words, the 'social responsibility' of financial institutions – is questioned in this respect.

Some empirical studies have been conducted to verify this statement. A study by Haron and Hisham (2005) on the fulfilment of socio-economic objectives by two Malaysian financial institutions, Bank Rakyat and Bank Islam Malaysia Berhad, found that the socio-economic development aspect of the institutions was lacking. The banks' socio-economic performance was measured in terms of (i) the proportion of *qarḍ ḥassanah* (benevolent loan) dispensed, (ii) the distribution of their financing by economic sector, (iii) their *zakāh* contribution, and (iv) the overdrafts they provide and activities they support to preserve Islamic culture. Haron and Hisham (2005) attributed the observed down-play in the socio-economic objectives of the banks on the fact that they are operating in a mixed economic-conventional banking systems environment, where their survival rests on how successfully they compete with their mainstream counterparts. As Islamic banking is "still in the making", their activities had to be "commercial as opposed to predominantly socio-economic". It would therefore be expected that social welfare activities of Islamic banks will increase as these institutions become more established.

Yet, retracing the developments of Islamic banking and finance since its early experimentation in the 1960s, Dar (2004) pointed out how the initial thinking had socio-economic development as its principal motive for establishing an alternative financial system based on the principles of justice and equity. The precursors to Islamic commercial banking involved the idea of social and community banking, institutionalised through the Mit Ghamr Savings Bank (1963-67) and the Nasr Social Bank (1971) in Egypt. The launch of the Islamic Development Bank (1973) in Jeddah also showed a concern for development banking at an international level.

In line with Siddiqi's (2004b) arguments, Dar (2004) also believed that the initial thinking on the discipline considered the practice of banking and finance as an integral part of the Islamic economic system, designed to achieve policy objectives like sustainable development. The modelling of Islamic banking and finance, Dar (2004) states, has however shifted the emphasis from social banking to profit-and-loss sharing and profit motive. To this end, the focus has been on such activities like product development, financial engineering, efficiency building, viability and profitability and, if a social role is to be endorsed, it is only made peripheral to the activities of the institutions.

4. Theoretical Concepts for Measuring the Social Responsibility of Islamic Financial Institutions

The practice of measuring the social responsibility of a corporation has been termed as Corporate Social Performance (CSP) in the literature. This has developed as thinking on CSR has matured, shifting from definition onto measurement aspects. Principally CSP measurement embraces three aspects, commonly denoted as CSR_1, CSR_2 and CSP (Frederick, 1978).

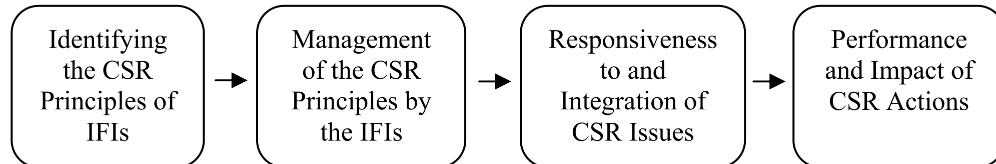
- CSR_1 defines the CSR principles as classified by Carroll (1979) in terms of the economic, legal, ethical and discretionary responsibilities expected of a firm by society.
- CSR_2 relates to "corporate social responsiveness", examining the response of firms towards the CSR principles.
- CSP discusses the "outcomes" of the implementation of CSR policies and their measurement.

These three facets of CSP measurement have been advanced by Wood (1991) who has fine-tuned other models like those of Carroll (1979) and Wartick and Cochran (1985). Wood (1991: 693) has defined these three stages as an evaluation of *"a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships"*.

A stakeholder approach has also been advocated by Clarkson (1995) and Donaldson and Preston (1995) who determined the CSR impact on the stakeholders

of a firm.[5] The main theoretical models of CSP are depicted in Table 1 in the Appendix.

Adopting Wood's (1991)[6] model of CSP measurement as a basis of assessing the social responsibility of IFIs, the following schema could be used to describe the assessment procedure in this empirical study.



The ensuing questions are posed as a way of finding proxies for the four stages of the assessment procedure.

4.1 Identifying the CSR Principles Endorsed by IFIs

In stage one, the understanding of and attitudes towards CSR issues by financial practitioners[7] are assessed. The CSR issues endorsed by the IFIs are also identified.

- What do financial practitioners understand by the term CSR?
- How do financial practitioners define Islamic finance? Is their view of Islamic finance comprehensive enough to cover CSR issues which impact on the community and the environment?

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[5] The stakeholders of a firm are classified mainly into two categories – internal and external. The National Association of Accountants (NAA) committee on accounting for corporate social performance defined the following actions of a firm which will have an impact on these stakeholder groups (Epstein et. al., 1977).

- *Human resource development*: This includes activities directed towards the welfare of internal stakeholders like employees and managers.
- *Community development*: This includes socially oriented activities that are of benefit to one major category of external stakeholders – the general public. Examples are financing housing construction, providing grant for educational purposes, scholarship to students, financing of health services, etc.
- *Product or service contribution*: This includes activities meant to improve service provision to another key category of external stakeholders – customers. Examples are improved product quality, good customer relations, customer security, protecting financial privacy, removing financial exclusion, etc.
- *Physical resources and environmental contribution*: This includes activities directed towards environmental conservation or alleviation of environmental deterioration – the environment being a further key external stakeholder to the firm.

[6] Wood's (1991) model has been chosen as the measurement model in this study as it is by far described in the literature as the key contribution to CSP modeling in the 1990s (Igalens and Gond, n.d.: 3).

[7] "Financial practitioners" is the general term used in this study to include bankers, investment or fund managers, and financial experts working in IFIs.

- Do financial practitioners assign a social responsibility function to financial institutions?
- Do they believe that IFIs should emulate the objectives of western SRI funds?
- What CSR issues are stipulated to be the concern of the IFI?

4.2 Assessing the Management of CSR Issues by IFIs

After identification of the CSR issues, their management and analysis are evaluated in stage two.

- How does the IFI rank financial gains vis-à-vis social objectives? Do financial practitioners place more emphasis on efficiency/profits or ethics/social responsibility/equity?
- Do financial practitioners perceive the existence of a conflict between profitability and the social objectives of their financial institution?
- Do financial practitioners believe that being socially responsible can create value for their organisation?
- Would financial practitioners rather shift the responsibility of undertaking morally motivated economic and financial activities to 'social organisations' instead of attributing the responsibility to IFIs?

4.3 Evaluating IFIs' Corporate Responsiveness to CSR Issues

In stage three, the ensuing questions are raised to evaluate whether IFIs are reactive, defensive, accommodative or proactive towards CSR issues, as defined by Carroll's (1979) processes of firms' responsiveness towards CSR issues.[8] An institution is defined as "reactive" when it fulfils its legal responsibilities; "defensive" when it meets its legal and economic responsibilities; "accommodative" when it accomplishes its legal, economic and ethical responsibilities; and lastly, "proactive" when it discharges the four expectations that society imposes upon it.

- Does the IFI publicize its criteria of investment selection?

[8] Faced with a CSR issue, a firm's initial "reaction" could be to resist a change in its behaviour, or at best, ensure that its actions are in the first instance strictly legal. According to Sethi (1979), "reactive" firms are motivated by the "search for legitimacy". If its actions are raising social pressures and turning into an economic issue where its profitability is at stake, it can "defend" these issues through public relations approaches. If the issue is however turning into an ethical and economic concern, it can perhaps adopt the "accommodative" stance by changing its response to conform to society's expectations. A "proactive" firm progresses to "solve the problem" and "lead the industry" through exemplary behaviour.

- Do financial practitioners classify their organisations as "socially responsible"?
- Does this declaration of "social responsibility" by the IFI reflect in a further declaration of socially responsible objectives, mission and vision statements?
- How far does the IFI report its social, ethical and environmental effects arising out of its economic activities to particular interest groups or to society at large? In other words, how well-grounded is "corporate social reporting" within the firm?

4.4 Measuring the Outcomes of CSR Actions for IFIs

Socially responsible actions of the financial institution could be measured through the firm's commitment of its resources towards such issues. Hence, in stage four the following questions are asked in an attempt to appraise the CSP of IFIs.

- If the IFI includes a social responsibility function among its objectives, does this reflect in the organisation's participation in activities which add positively to the community, human resource development, product or service contribution and/or environmental contribution?
- What percentage of its profits does the IFI attribute to activities which enhance community development, human resource development, product or service contribution and/or environmental contribution?
- Based on the activities the IFI is involved in, does CSR seem to constitute a peripheral or minimalist activity of the institution? Or does CSR appear to form part of an integral management strategy?

5. Research Methodology

As a means of drawing information on firms' activities and performance, Igalens and Gond (n.d.) quote Decock-Good (2001) who suggested the following five data sources: (i) annual reports; (ii) pollution indices as a measure for environmental impact; (iii) questionnaire-based surveys; (iv) corporate reputation indicators produced by magazines of international repute; and (v) data produced by specialised organisations assessing socially responsible corporate behaviour, for example in the form of indices. In this study, analysis will be based upon mainly the responses to a questionnaire-based survey. In addition, data cross checks will be carried out through the information made available on the institutions' websites and published in annual reports.

To this effect, the methodology employed in this study is empirical, including both qualitative and quantitative approaches. It has required the collection and gathering of data from a sample of IFIs. Around 250 Islamic banks and NBFIs,

from a wide number of countries, were contacted to complete a questionnaire-based survey which included mostly closed-ended questions. The questionnaire sought to gauge the financial practitioners' ethical and theoretical understanding of Islamic finance and establish the social responsibility function of the institutions by questioning, among others, the definition of Islamic finance, the role of IFIs in meeting social objectives, activities the IFIs are involved in and their screening criteria of investment selection. In this way financial practitioners' theoretical understanding of the discipline of Islamic economics and finance are assessed and compared to what they report about the practice of their IFIs. Thus, the study seeks to test the hypothesis as to whether there is occurring a divergence between the theory and practice of Islamic finance. About 20% of the questionnaires were completed. Respondents were from both banks and NBFIs from some 19 different countries.

The quantitative approach of the study involved the statistical analysis of the data received from the institutions using the statistical package SPSS. The qualitative approach emerged through discourse analysis of mission statements, annual reports and data posted on websites.

6. Gauging the Social Responsibility of Islamic Financial Institutions: An Empirical Analysis

Some 20% of the questionnaires (48 in total) were received from financial institutions from 19 different countries. 70% of the responses were from banks. The highest returns received were from the UK, Turkey, Pakistan and Bahrain. The age group of the respondents was mainly from the range 35-45 years (38.5%) and 25-35 years (26.9%). Most of the respondents were highly qualified with 46.2% holding a Masters degree and 30.8% PhDs.

6.1 Identifying the CSR Principles Endorsed By IFIs

About 41.7% of the respondents related the concept of 'social responsibility' to the role played by IFIs towards community development (Table 2). They utilised key wordings like "responsive to social needs", "community development", "civic awareness", "social obligation to the public and themselves", and "community oriented" in their definitions. The second largest group (27.8%) associated 'social responsibility' with social justice, against financial exploitation, concern of the haves for the have-nots. Key words like "ethical" were used by 13.9% of the respondents while "concern for the environment" or "sustainable development" was used by only 5.6%.

On the other hand, 70.8% of the respondents who defined 'Islamic finance' attributed a comprehensive definition to the discipline, equating it with the prohibition of *ribā*, trade without interest, a socially acceptable just financial system, and a human-oriented environmentally-friendly financial system (Table 3). The social responsibility of Islamic finance was therefore seen by the majority as

inclusive of community development, social justice, environmental policies, and anti-usury and pro-trade policies. Those who chose this response were mainly from the age group 25-35 (26.7%) and 35-45 (40.0%) years old, showing their agreement to the socially committed Islamic economics literature which evolved in the 1970s, some 30 years ago. The respondents were from countries like Pakistan, Bahrain, Brunei, and Malaysia. Those from the UK (62.5%) and Turkey (80%), for instance, attributed Islamic finance to the more limited definition of "trade without interest" and "a socially acceptable just financial system", excluding environmental policies and community-oriented policies. This corresponds to the fact that most of the IFIs in the UK and Turkey mainly pursue trade financing activities (Tables 4 and 5).

About 60.9% also tend to agree that Islamic finance is a third way between capitalism and socialism. Some 17.4% however remained neutral to the statement and 21.7% disagreed. Consistent with the earlier broad definition of Islamic finance, about 53.1% ranked "Islamic finance represents an integrated system of financial affairs which includes the civil society, the state and the private sector" as the first criterion for equating Islamic finance with the third way concept. Only 18.8% classified this criterion as fifth in the ranking they assigned to the definition of Islamic finance. This again shows that financial practitioners believe in conveying a larger responsibility to the role of Islamic finance. Another equally large group of 53.8% however also viewed the answer "Islamic finance prohibits *ribā* and encourages trade" as their first reason for the discipline to be defined as the third way. This reflects a more limited role being equated with Islamic finance. Table 6 in the Appendix provides more details of the results.

Further evaluating the theoretical understanding of Islamic finance by financial practitioners, the latter were queried whether they would attribute social responsibilities, in addition to financial and legal responsibilities, to IFIs. Some 80.9% of the respondents agreed to the statement of which 75.0% were from the age groups 25-35 and 35-45 years. It was further observed that those who strongly agreed or agreed to assign a social responsibility function to IFIs also favoured the broad definition of Islamic finance incorporating the prohibition of *ribā*, trade without interest, socially acceptable just financial system, and human-oriented, environmentally friendly financial system (70.2% as reflected in Table 7).

At the same time, those who strongly agreed or agreed to allocate a socio-economic responsibility attribute to IFIs (37 respondents out of 45 or 82.2%) equally favoured the idea that IFIs should emulate the social, ethical, environmental (SEE) objectives of SRI funds which are prevalent in the West (28 out of 37 or 75.6%). Overall, otherwise, 63.0% of Islamic financial practitioners agreed that IFIs should adopt the SEE objectives of SRI funds in their quest for sustainable development; 23.9% remained neutral to the idea and 13.0% disagreed.

Around 84.4% of the respondents also believed that IFIs should not hesitate to spell out their ethical policies in their mission statements – a practice which is

adopted by SRI funds. However, when questioned whether their financial institution publicize its ethical criteria for investment selection, a relatively lower percentage of 77.8% responded positively, indicating that one's belief is not always translated to practice. Around 79.2% of the respondents revealed the criteria of selection for their institutions' investments. These screening criteria are delineated in Table 8.

It is noticed from Table 8 that criteria like "not investing in impermissible activities", "not investing in *ribā*, and "not investing in the arms industry" ranked the highest in the IFIs' choice of screening criteria. This result reflects the common attitude of Muslims to primarily define Islam, and by extension Islamic finance, with what 'we should not do' as compared to being positive and proactive. It is interesting to note that even the western SRI movement initially started by defining negative screening criteria to determine the reasons for not investing in a company. Gradually, the movement shifted to positive screening and advanced to other proactive criteria like promoting "thematic investment" (selecting companies that represent industries of the future), "shareholder advocacy" (e.g. voicing out ethical concerns by accessing board meetings), and "community investment" (e.g. investing in projects that improve local areas). The results could therefore be said to be reflecting the early stage that Islamic finance is currently in. Yet the data would indicate a progressing state of the practice since, as observed from the table, a slightly significant percentage of 55.3% would choose investments in companies that contribute positively to society. This is suggestive of a move in the understanding of financial practitioners towards inclusion of positive screening or more proactive investments within Islamic finance.

A percentage of 44.7% would however still invest in forward currency transactions and not invest in profit-and-loss sharing instruments. The latter evidence supports the commonly cited criticism raised in the Islamic finance literature about the lesser prevalence of financing instruments like *mushārakah* and *muḍārabah* as compared to *murābaḥah* and *ijārah*. As regards the non-avoidance of forward currency instruments, a possible explanation could be the use of these instruments as hedging tools.

Environmental issues appear to be of minor concern to Islamic financial practitioners. As shown in Table 8, about 52.6% would not be concerned about investments in environmentally polluting economic activities and about 60.5% would not take initiatives for investing in environmentally friendly activities. Thus, it is observed that although Sharīʿah prohibits waste and excessive exploitation of non-renewable resources and encourages the maintenance of environmental and ecological balance, IFIs are yet to incorporate such essential values as a deliberate decision policy to be practiced within the Islamic financial arena.

6.2 Assessing the Management of CSR Issues by IFIs

On basis of the high percentage of respondents who agreed to allocate a social responsibility function to IFIs (80.9%), the survey queried whether financial practitioners perceived the existence of any conflict between profitability and the social objectives of their institutions. To the question "how does the financial institution rank financial gains vis-à-vis social objectives?" the majority (63.8%) said they are equally important. About 27.7% viewed financial gain as more important, 6.4% ranked it as less important and 2.1% were of the opinion that it is not important. Of those who viewed profits and social objectives as equally important, 82.7% were of the opinion that an IFI should be socially oriented. About 77.0% of those who considered financial gain as more important paradoxically still agreed/strongly agreed to this assertion. We would have believed that their inclination in favour of the profit motive would have resulted in a higher percentage disapproving the idea of ascribing a social mission to IFIs on the ground that community oriented projects may be less remunerative compared to projects focused on high-net-worth individuals or institutions. Instead, as reflected in Table 9, only 7.7% did so. As such, a socially responsible attribute to IFIs primed among the opinions of financial practitioners.

To further ascertain the abovementioned conflictive outcome, the financial practitioners were evaluated on whether they would prefer that 'social organisations' rather than 'financial institutions' be made responsible for undertaking morally-motivated economic and financial activities which have a socio-economic purpose. In general, 48.0% agreed/strongly agreed to this statement; 20.0% remained neutral; and 32.0% disagreed/strongly disagreed. Cross-tabulating the results of the "ranking of financial gains in comparison to the social objectives of IFIs" with the question relating "social organisations versus financial institutions to be made responsible for socially-oriented economic activities", it was observed that among those who considered financial gain as more important, 85.7% viewed social organisations as more suitable to carrying out socially-geared economic activities (agreed and strongly agreed). Although upon first perusal of the data, the respondents whose objective was high returns appeared to allocate a socio-economic responsibility to IFIs, they still seemed to prefer social organisations to take over this role. Consistently, among those who allocated equal importance to profits and social objectives, 46.7% disagreed/strongly disagreed with the statement that social organisations should be made responsible for morally-motivated economic transactions (Table 10).

Cross-checking whether those who disagreed to attribute morally-motivated socio-economic responsibilities to social organisations (and rather preferred that IFIs should shoulder these responsibilities) would indeed assign a socio-economic responsibility to IFIs, it was observed that 66.7% agreed/strongly agreed to do so (Table 11).

With a view to further evaluate how IFIs manage CSR issues the question "whether financial practitioners believe that acting in a socially responsible manner can create value for their organisation" was posed. 29.8% strongly agreed and 66.0% agreed. Nonetheless, 4.3% was neutral to the statement whilst nobody disagreed. In the light of this highly positive belief that there is a business case for CSR, the results were cross-tabulated with the earlier question "should IFIs adopt the SEE objectives of SRI funds". It was noticed that 65.1% approved that IFIs should assume such objectives. Still the results show that a significant 25.5% was neutral to this question. This could imply that a number of financial practitioners do not perceive a link between SRI funds and IFIs and therefore would not suggest the sharing of objectives by the institutions.

6.3 Evaluating IFIs' Corporate Responsiveness to CSR Issues

To verify how responsive IFIs are to CSR issues, we reiterate the financial practitioners' response to the question whether their organisation publicized their ethical screening criteria: although 84.4% believed that IFIs should emulate the approach of SRI funds and publicize their ethical policies, a relatively smaller percentage of 77.8% admitted that their institution publicized these criteria of investment selection.

This percentage was close to the number of respondents who classified their organisation as being 'socially responsible' – about 78.3% agreed/strongly agreed to this statement (Table 12). However, as mentioned earlier, although the financial practitioners categorised their organisation as being socially responsible, environmental issues ranked least within their investment policies. Similarly, 44.7% of the respondents do not invest in companies that contribute positively to society nor invest in profit sharing arrangements which have long term beneficial effects on society (Table 8).

To substantiate to what extent the social responsibility affirmation of the financial institutions, as pointed out by the respondents, reflected in an open or published declaration of socially responsible objectives, the vision and mission statements of the institutions were verified on their websites and through physical inspection of their annual reports. These were assessed in comparison to Carroll's (1979) definition of the processes of response to CSR issues which classified organisations as reactive, defensive, accommodative or proactive towards CSR.

All the financial institutions were concerned with financial gains and economic viability, making them reactive to CSR. Key words like "optimizing shareholders value", "improving efficiency", "aiming at superior financial performance" were commonly used in the mission statements of the financial institutions. Reference to Sharīʿah compliancy was also often made in the mission statements of the IFIs, signifying fulfilment of their legal responsibilities under Islamic law and to some extent their ethical responsibilities as they shun unjust principles like *ribā* and *gharar*. However, being Sharīʿah compliant does not necessarily imply being

ethical. Ethicality embraces consistency of financial products with Islamic legal principles as well as broader concepts involving processes which build good relations between management and employees, and steps to have a positive impact on the environment and larger society. Unless the institution has clearly specified 'ethical' principles such as 'ensuring equity and justice in economic activities', abidance by values like honesty, trust, integrity, accountability, transparency, it was not considered that they fulfilled their ethical responsibilities. Those who were accommodative to CSR issues (i.e. meeting their economic, legal and ethical responsibilities) totalled 30.6% of the respondents (Table 13). Nevertheless, none of the respondents – except for Emerging Markets Partnership, an infrastructure fund in Bahrain, which mentions investment in Greenfield ventures – make allusion to environmental issues as an ethical strategy adopted by their institution.

About 41.7% was classified as adopting a "defensive" approach to CSR as they only seemed to be meeting their economic and legal responsibilities (Table 13). One of the responding IFIs in particular emphasized the provision of innovative Sharīʿah compliant financial services to "affluent individuals, businesses and institutions", suggestive of a higher concern for efficiency gains which target an elite society than socio-economic development involving the larger society.

Still, 27.8% of the respondents were observed to be "proactive" towards CSR issues, specifically highlighting their roles in uplifting socio-economic development and fulfilling the needs of low-income communities. Some were even transparent about their community involvements, reporting these activities to the society at large. Examples of those classified as "proactive" in this study, on basis of their expressed social objectives, were Bahrain Islamic Bank (Bahrain), Arab Banking Corporation International Bank (Bahrain), Al Baraka Bank (South Africa), Islami Bank of Bangladesh (Bangladesh) and National Commercial Bank (Saudi Arabia). The Islami Bank Bangladesh has even established a foundation through which it operates its social activities. However, based on the information available on the IFIs, they did not appear to have a well-grounded corporate social reporting policy to promote their SEE policies.

6.4 Measuring the Outcomes of CSR Actions for IFIs

The financial institutions' commitment of resources towards socially geared activities was examined in an attempt to measure the outcomes of CSR actions. The assumption is that spending of a percentage of the institutions retained profits on social projects or philanthropic activities will have positive impacts on the wellbeing of society members.

The majority of the respondents (47.2%) stated that their institutions spend about 0-2% of the annual profits on community enhancing activities (Table 14). The results equally revealed that 33.3% spend 2-5% of the annual profits; 11.1% spend 5-7%; and 8.3% spend 7-10%. The 0-2% range ranked the highest even among the 76.5% respondents who believed that Islamic finance should be defined

in broad terms incorporating a human-oriented socially-acceptable just financial system. The 0-2% range also corresponded with 76.4% of the respondents who agreed/strongly agreed that their organisations were socially responsible. The small percentage of retained profits that is attributed to activities which improve community development would indicate that being socially responsible tends in practice to be connoted to “donations related activities” by financial practitioners. It could also be suggestive of a peripheral practice of CSR management by IFIs where CSR issues entail a limited commitment of resources. This view conflicts with the financial practitioners’ earlier belief and understanding of social responsibility where “community development” scored the highest ranking.

The contention that socially responsible activities are related in practice to donations-like activities could also be seen from the main activities chosen by respondents in which their institutions participate, delineated in Table 15. Apart from abstention to false advertising (ranked 3rd) and promotion of ethical values among staff (ranked 4th), other core activities included donations to charities, donations to community causes, staff welfare, and sponsorship of community events. Again, from Table 15, it is noted that environmental causes ranked among the last observations in the list of activities subscribed by IFIs. Equally, of relatively minor importance were investments in deprived areas, support to employees for their involvement in community causes and even application of fair recruitment practices.

7. Comparing the Theory and Practice of Islamic Banking and Finance

To reiterate, the aim of the study was to assess the internalisation of socially responsible practices by IFIs based on the contention of academicians that the social commitment emphasised by the Islamic economics literature is being neglected within the practice of Islamic finance which appears to focus more on the efficiency/profit aspects and less on equity/social aspects. The responses to a questionnaire-based survey of a sample of 48 IFIs from different parts of the world were used to analyse this argument.

According to the data, the theoretical understanding and ethical implications of Islamic finance by Islamic financial practitioners were observed to be consistent with the emphasis placed on social responsibility by the Islamic economics literature. The discipline of Islamic finance appeared to be broadly defined by the financial practitioners, embracing the common understanding of *ribā* elimination, trade encouragement and efficiency as well as social objectives such as a social justice and environmentally-friendly financial policies, thus advancing a human oriented approach and encouraging the participation of the civil society, the state and the private sector. Thus defined, most of the respondents would attribute a socio-economic role to IFIs, in addition to the responsibilities assigned to them by the conventional financial laws as well as the Sharīʿah. Being profitable was

viewed by the majority of the respondents as being of equal importance to the social objectives of the institutions. Acting in a socially responsible manner was strongly perceived as creating value for IFIs. A number of the respondents however saw the objectives of profitability and social concerns as conflictive, preferring social organisations to undertake morally motivated economic and financial activities. However, as Professor Nejatullah Siddiqi (2004a) stated in an interview we conducted on this subject, *"finance has an important role which can not be taken over by social organisations in toto….the socio-economic purpose has to be an inalienable feature of Islamic finance. It can not be outsourced"*. He called for an internalisation of Islamic moral and social values by individual members of society, which by extension should reflect in the policy decisions of financial institutions.

The practice of Islamic finance, as reflected by the empirical analysis of the activities of IFIs, was not thought to be as socially responsible as the views voiced out by financial practitioners. This assertion is based on several observations. First, with regard to the practice of IFIs, it was observed that all the IFIs did not disseminate the ethical screening criteria of their investment selection, despite a high percentage of about 84% believed in publicizing their ethical policies. Publicizing the institution in broad terms as being Sharīʿah compliant does not explicitly reveal details of the areas of involvement or disengagement of the institution. An explanation of the underlying ethical principles is deemed necessary to express Islam's concern for a socially just financial system, thus advancing cooperation between people of other faith who equally advocate this goal.

Second, from the screening criteria disclosed by the respondents, it was further observed that negative criteria like prohibition of *ribā* and impermissible activities ranked the highest whilst positive criteria like investment in companies that contribute positively to society or investment in environmentally-friendly activities were the least endorsed by the IFIs. Issues like avoidance of *ribā* contribute certainly to building a socially responsible financial system – albeit at a higher analytical level. Popular secularist ethical concerns like sustainability of the environment or lobbying for an ethical cause were, nonetheless, of little concern to IFIs as reported by the activities in which the institutions participate.

Third, the reported practices also showed little commitment towards ethical employment policies and community involvement, except for making donations to charities, community and staff causes. The concept of CSR thus seemed to be more associated with the idea of corporate philanthropy instead of being perceived as an integral business policy of responsible practices.

Fourth, the amount the IFIs spent on community causes ranged mostly between 0-2% of their profits despite the fact that the financial practitioners labelled their institutions as being 'socially responsible'.[9]

Fifth, an analysis of the mission and vision statements of the IFIs further classified the majority (41.7%) as embracing a 'defensive' approach to CSR, fulfilling primarily their economic and legal responsibilities (Table 13). A smaller percentage of 27.8% was nonetheless proactive in their practice of CSR. This finding corresponds with Parker's (2005: 2) observation that IFIs lacked a proactive CSR culture in the light of their slow and disappointing response to the 2004 tsunami disaster which struck the Indian Ocean Rim countries.

These results are indicative of a peripheral approach assumed by IFIs towards CSR issues, compared to a more integral and deliberate ethical policy that SRI funds appear to embrace. Sharīʿah compliance and efficiency gains appear to remain largely the concern of IFIs; yet the more comprehensive objective of welfare of the society, which would equally include social values, seems to be neglected within the practice (according to what financial practitioners say their institutions do). Given the enduring Islamic values upon which Islamic finance is founded, and guided by the belief in the multiplied rewards in the Hereafter for every pound spent for the pleasure of God, it is believed that IFIs should have higher motivations to act more proactively in the social interest – to deliver what the literature promises.

8. Conclusions

Both IFIs and SRI funds target a niche market, particularly those who wish to place their investments in line with their ethical or religious values. Like the institutionalisation of Islamic finance which developed in the 1970s out of the search for an alternative financial system away from the prohibited *ribā* and other Islamically impermissible transactions, the modern origins of the SRI movement is said to have evolved as early as the 1920s and is related to the longstanding concerns of religious institutions which sought to avoid so-called "sin industries" involved in alcohol, gambling or tobacco (Schlegelmilch, 1997: 49). Driven by several major social, economic, political, legal and regulatory changes in society, the SRI movement has expanded from its originally US base to include the UK as

[9] This can be compared with the statement of a UK company which offers financial advice on SRI: *"Ethical Investors Group is unique in that we pledge to distribute at least 50% of our business profits each year to charities and socially responsible groups working in the areas nominated by our clients. To date this distribution amounts to £390,000. I take the view that financial advisers should share some of the commission their businesses earn from ethical investment advice, in order to help the groups and charities working in the front line, trying to build a better society and environment for us all"* (Lee V. Coates, Chartered Insurance Practitioner, Ethical Investors Group, 2005).

the most developed institutional SRI market in Europe and other growing European markets like Germany, France, the Netherlands, Switzerland as well as surfacing in Asia and Australia (Eurosif, 2003). Today, the SRI industry is said to encompass a US$ 2.4 trillion worldwide industry, incorporating 760 retail funds and a larger and more complex SRI institutional market (Hamid, 2003). SRI providers comprise high street banks, building societies, mutual societies, investment groups, insurance companies, pension funds, foundations, cooperatives, community development funds, venture capital funds and several speciality ethical funds and banks – taken to equate to the terms 'SRI funds' in this research.

IFIs could usefully emulate the successful dissemination of the ethical and socially responsible values endorsed by SRI funds so that the moral teachings central to the Islamic approach to financing would be easily accessible to prospective clients. Friends Provident Stewardship Ethical Investments, the first ethically-screened fund set up in the UK in 1984, in a document introducing the fund uses catching marketing phrases as well as positive messages like *"the world's a better place with Friends"* and *"Friends take responsibility"* to promote its ethical values, in addition to detailing information such as *"what Friends will and won't do"*, *"how Stewardship applies its ethical policy"*, *"some examples of Stewardship approved companies"* (www.friendsprovident.co.uk/doclib/xg15.pdf). Publicizing a "statement of ethical investment policy" is even common among religious investment groups like that of The Church of England's Ethical Investment Advisory Group (www.cofe.anglican.org). On the other hand, HSBC Amanah Finance which started to offer Islamic home financing in the UK since 2004, describes its services in its brochure in a few words as *"entirely ḥalāl"*, *"in accordance with* Sharīʿah*"* but lengthily delineates the high qualifications of its Sharīʿah supervisory committee which validates its financial products (HSBC Bank plc, HSBC Amanah Finance brochure). This emphasis placed by Islamic banks on *"the standing of their* Sharīʿah *regulators rather than stressing the moral teaching that governs Islamic finance"* was pinpointed by Wilson (2000). Five years after Wilson's paper, HSBC Amanah Finance could have positively learnt from the practical experiences of its counterparts which operate within a similar business environment.[10]

In view of the institutionalisation of the practice of Islamic finance, IFIs should further see a commitment towards CSR as an act that brings benefit to the institution. Similar to reputable organisations like Ford and Toyota which set up trusts or foundations as part of their businesses' philanthropic activities, IFIs should endeavour to follow such a strategy to benefit society.[11] In the light of the

[10] It is however noted that HSBC, the mainstream bank, has been seen to publicise its CSR initiatives more vigorously since the mid-1990s through the publication of special CSR reports (see HSBC, 2003: 11-12).

[11] One IFI, namely the Islami Bank of Bangladesh, has been noted to operate its welfare services from the separate foundation it has set up.

highly positive attitude of respondents (95.8%) who believed that acting in a socially responsible way would create value for IFIs, it is expected that IFIs' commitment towards community involvement should in practice draw closer to the belief held by financial practitioners. SRI funds explicitly cite inclusion or exclusion of issues of social concerns to show their commitment towards the welfare of the community. IFIs should follow suit. IFIs could further learn from the more proactive engagement practices of SRI funds whereby they encourage companies to be more responsive to society's expectations of them.

At the same time, it may be argued that the lack of transparency in data reporting, especially regarding funds spent on community causes, could be the cause for the lower reported profits spent on community enhancing activities. This corresponds to the results drawn from the survey whereby about 87.5% of the respondents failed to allocate a percentage of profits to the communal activities their institutions participate in. The underlying belief could be that it is best to keep charitable donations undisclosed. If this assessment were correct, it would to some extent lend further support to the claim that CSR is considered only as a peripheral practice of IFIs. If, on the other hand, it were treated as part of business policy, it would have been included within corporate reporting and made aware to the members of staff. Nonetheless, in line with modern developments in corporate social reporting, IFIs could opt for greater transparency in their activities – a practice that would certainly enhance confidence and trust among users and the public at large.

Another worthwhile experience that could be learnt from the SRI movement is in respect of the qualitative screening of the social responsibility performance of companies. Within Islamic finance, progress has been made in the development of quantitative measures that help to establish whether a company suits Islamic investments. The Dow Jones Islamic Index (DJII) and the FTSE Global Islamic Index, introduced in 1996 and 1999 respectively, have laid out cut-off rules that determine Sharīʿah permissibility based on the financial ratios of companies. These indices are also designed to track the financial performance of publicly traded sharīʿah compliant companies. An index to track the social performance of companies whose activities are consistent with Sharīʿah principles is yet to be introduced. Given that welfare of the society is the prime objective of Islamic law, establishing principles that can gauge whether IFIs are contributing significantly to this objective is deemed essential. This call to measure the performance of IFIs with reference to their social responsibilities has been recently made by Ḥasan (2004) and Tag el-Din (2005).

Within the SRI literature, we note that Business in the Community (BITC) – a movement with a core membership of 650 companies across the UK – has

established since 2002 a corporate responsibility index.[12] The BITC Index supplements other major ethical and social indices like FTSE4Good, Dow Jones Sustainability Index and Domini 400 Social Index, which publicly rank major international companies according to their SEE performance (Hopkins, 2004: 9). It is deemed desirable that comparable social indices be developed within the field of Islamic finance to benchmark the responsible business practices of Islamic institutions.

These would require allowing more time for the Islamic finance industry to become more firm-footed, education of the financial community as well as Muslim investors, and certainly more resources to take on the challenge.

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[12] The BITC corporate responsibility index has been defined as *"a business management tool, which has been developed to support companies in improving their impact on society and the environment. By participating in the Index companies are able to assess the extent to which their corporate responsibility strategy is translated into responsible practice throughout the organisation, in managing four key areas – Community, Environment, Marketplace and Workplace"* (Business in the Community, 2004).

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Appendix

Table 1: Models of Corporate Social Performance

Author	Definition of CSP	Modelling Approach
Carroll (1979)	"The articulation and interaction between (a) different categories of social responsibilities; (b) specific issues relating to such responsibilities; and (c) the philosophies of the answers to such issues" (p. 499)	Principles of CSR (CSR_1) Economic, Legal, Ethical and Discretionary Responsibilities Identification of CSR Issues. E.g. Profitability, viability, product safety, employee safety, environment, fair recruitment, community investment Philosophy of Responsiveness (CSR_2) Reactive, Defensive, Accommodative, Proactive
Wartick and Cochran (1985)	"The underlying interaction among the principles of social responsibility, the process of social responsiveness and the policies developed to address social issues" (p.758)	Principles of CSR (CSR_1) Economic, Legal, Ethical and Discretionary Responsibilities Social Issues Management Identification of CSR Issues Analysis of CSR Issues Response to CSR Issues Philosophy of Responsiveness (CSR_2) Reactive, Defensive, Accommodative, Proactive
Wood (1991, 1997)	"A business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships"	Principles of CSR (CSR_1) Economic, Legal, Ethical and Discretionary Responsibilities Levels of CSR Actions Institutional level: Society grants legitimacy and power to businesses and businesses must use their power in a way that society considers responsible Organisational level: Businesses are responsible for outcomes related to their primary and secondary areas of

Author	Definition of CSP	Modelling Approach
		involvement with society Individual level: Managers are moral actors and are expected to act towards bringing about socially responsible outcomes <u>Processes of Corporate Social Responsiveness (CSR$_2$)</u> Identification of CSR Issues Analysis & Management of CSR Issues Environmental Assessment & Analysis (e.g. Gather information about the external environment) Stakeholder Management (e.g. Managing the corporation's relationships with its different stakeholders which affect or are affected by its operations) Issues Management (e.g. Developing responses to issues that may affect the corporation) <u>Outcomes of Corporate Behaviour (CSP)</u> Societal Impacts, Corporate Social Programmes and Policies
Clarkson (1995)	"The ability to manage and satisfy the different corporate stakeholders"	Model adopts a stakeholder approach whereby it distinguishes the specific CSR problems and impacts on each of the stakeholder categories, including employees, shareholders, consumers, suppliers, state, competitors, the community, etc.

Table 2

Key words to describe social responsibility

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Ethical	5	10.4	13.9	13.9
	Pro Community	15	31.3	41.7	55.6
	Divine based or shariah compliant	2	4.2	5.6	61.1
	Not only profit geared	1	2.1	2.8	63.9
	Social justice	10	20.8	27.8	91.7
	Not socially irresponsible	1	2.1	2.8	94.4
	Sustainable development	2	4.2	5.6	100.0
	Total	36	75.0	100.0	
Missing	System	12	25.0		
Total		48	100.0		

Table 3

What Islamic finance is Equal to?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Only Prohibition of Riba	1	2.1	2.1	2.1
	Trade without interest	6	12.5	12.5	14.6
	Socially Acceptable Just Financial System	5	10.4	10.4	25.0
	Human oriented, environmental friendly financial system	2	4.2	4.2	29.2
	All the above	34	70.8	70.8	100.0
	Total	48	100.0	100.0	

Table 4: Financing Methods in Turkey

Method	2000
Murābaḥah	74%
Muḍārabah	15%
Ijārah	10%

Source: Baskan (2004: 227)

Table 5: The Core Businesses of Islamic Financial Institutions in the UK

Institution	Status	Core Business
Islamic Finance Unit, Dawnay Day Global Investments Ltd	Investment Bank	Trade Finance, Realty
Islamic Banking Unit, ANZ Investment Bank	Investment Bank	Trade Finance, Leasing
HSBC Amanah Finance	London Office	Trade Finance, Leasing
Islamic Banking Unit, UBS Warburg	Investment Bank	Trade Finance/Asset Mgt
ABCIB Islamic Asset Management Ltd	Bank Subsidiary	Trade, Leasing, Realty
Islamic Finance, United Bank of Kuwait	General Bank	Leasing, Mortgages
Islamic Finance, Corporate Banking, Citibank Plc	General Bank	Trade Finance
AlBaraka Investment Company	Investment Company	Trade Finance
Dallah AlBaraka (UK) Limited	Finance Company	Trade Finance
Faisal Finance (Jersey) Limited	Mutual Fund Vehicle	Equities
Parsoli (UK) Ltd.	Commercial Company	Equities
I-hilal (UK) Limited	London Office	Financial Platform

Source: Islamic Banker (2002: 10)

Table 6: Islamic Finance is a Third Way between Capitalism and Socialism because it is…

	Against *ribā* and Pro-Trade (%)	Pro-Equity Finance (%)	Against Speculation and Pro-Production (%)	Efficient Financial System (%)	Integrated System of Financial Affairs (%)	Highest Scores in Rank 1 to 5
Rank 1	53.8	12.5	8.3	8.0	53.1	Against *ribā* and pro-trade
Rank 2	26.9	16.7	20.8	16.0	12.5	Against *ribā* and pro-trade
Rank 3	3.8	25.0	20.8	36.0	6.3	Efficient financial system
Rank 4	11.5	20.8	25.0	24.0	9.4	Against speculation and pro-production
Rank 5	3.8	25.0	25.9	16.0	18.8	Against speculation and pro-production
Total	100.0	100.0	100.0	100.0	100.0	

Table 7

Socio-economic responsibility attribute to IFIs * What Islamic finance is Equal to? Crosstabulation

			What Islamic finance is Equal to?					
			Only Prohibition of Riba	Trade without interest	Socially Acceptable Just Financial System	Human oriented, environmental friendly financial system	All the above	Total
Socio-econom responsibility attribute to IFIs	Strongly agree	Count		3	1	1	11	16
		% within Socio-econo responsibility attribute IFIs		18.8%	6.3%	6.3%	68.8%	100.0%
	Agree	Count	1	2	3		16	22
		% within Socio-econo responsibility attribute IFIs	4.5%	9.1%	13.6%		72.7%	100.0%
	Neutral	Count		1		1	6	8
		% within Socio-econo responsibility attribute IFIs		12.5%		12.5%	75.0%	100.0%
	Strongly disagr	Count			1			1
		% within Socio-econo responsibility attribute IFIs			100.0%			100.0%
Total		Count	1	6	5	2	33	47
		% within Socio-econo responsibility attribute IFIs	2.1%	12.8%	10.6%	4.3%	70.2%	100.0%

Table 8: Screening Criteria for Selecting Investments

	YES		NO	
Screening Criteria	Frequency	Valid %	Frequency	Valid %
Not investing in impermissible activities	37	97.4	1	2.6
Not investing in *ribā*	34	89.5	4	10.5
Not investing in the arms industry	28	73.7	10	26.3
Not investing in forward currency transactions	21	55.3	17	44.7
Investing in companies that contribute positively to society	21	55.3	17	44.7
Investing in profit and loss sharing arrangements	21	55.3	17	44.7
Not investing in environmentally polluting economic activities	18	47.4	20	52.6
Investing in environmentally friendly activities	15	39.5	23	60.5
Other screening criteria, e.g., o Not investing in conventional banking and insurance o Seeking high return investments o Not investing in companies that promote religions other than Islam o Investing in care home for elderly people o Investing in trade related transactions o Investing in real transactions	9	23.1	30	76.9

Table 9

Ranking of financial gain in comparison to social objectives of IFI * Socio-economic responsibility attribute to IFIs Crosstabulation

			Socio-economic responsibility attribute to IFIs				
			Strongly agree	Agree	Neutral	Strongly disagree	Total
Ranking of financial gain in comparison to social objectives of IFI	Less important	Count	1	1	1		3
		% within Ranking of financial gain in comparison to social objectives of IFI	33.3%	33.3%	33.3%		100.0%
	Equally important	Count	11	13	5		29
		% within Ranking of financial gain in comparison to social objectives of IFI	37.9%	44.8%	17.2%		100.0%
	More important	Count	4	6	2	1	13
		% within Ranking of financial gain in comparison to social objectives of IFI	30.8%	46.2%	15.4%	7.7%	100.0%
	Not important	Count		1			1
		% within Ranking of financial gain in comparison to social objectives of IFI		100.0%			100.0%
Total		Count	16	21	8	1	46
		% within Ranking of financial gain in comparison to social objectives of IFI	34.8%	45.7%	17.4%	2.2%	100.0%

Table 10

financial gain in comparison to social objectives of IFI * Whether social org should be responsible for morally motivatec activities Crosstabulation

			ether social org should be responsible for morally motiva ec and fin activities					
			Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Total
Ranking of financia gain in comparison to social objectives of IFI	Less important	Count		1			1	2
		% within Ranking of financial gain in comparison to socia objectives of IFI		50.0%			50.0%	100.0%
	Equally importan	Count	3	2	3	6	1	15
		% within Ranking of financial gain in comparison to socia objectives of IFI	20.0%	13.3%	20.0%	40.0%	6.7%	100.0%
	More important	Count	1	5	1			7
		% within Ranking of financial gain in comparison to socia objectives of IFI	14.3%	71.4%	14.3%			100.0%
	Not important	Count			1			1
		% within Ranking of financial gain in comparison to socia objectives of IFI			100.0%			100.0%
Total		Count	4	8	5	6	2	25
		% within Ranking of financial gain in comparison to socia objectives of IFI	16.0%	32.0%	20.0%	24.0%	8.0%	100.0%

Table 11

Whether social org should be responsible for morally motivated ec and fin activities * Socio-economic responsibility attribute to IFIs Crosstabulation

			Socio-economic responsibility attribute to IFIs			Total
			Strongly agree	Agree	Neutral	
Whether social org should be responsible for morally motivated ec and fin activities	Strongly agree	Count		3		3
		% within Whether social org should be responsible for morally motivated ec and fin activities		100.0%		100.0%
	Agree	Count	3	4	1	8
		% within Whether social org should be responsible for morally motivated ec and fin activities	37.5%	50.0%	12.5%	100.0%
	Neutral	Count		4	1	5
		% within Whether social org should be responsible for morally motivated ec and fin activities		80.0%	20.0%	100.0%
	Disagree	Count	3	1	2	6
		% within Whether social org should be responsible for morally motivated ec and fin activities	50.0%	16.7%	33.3%	100.0%
	Strongly disagree	Count	1		1	2
		% within Whether social org should be responsible for morally motivated ec and fin activities	50.0%		50.0%	100.0%
Total		Count	7	12	5	24
		% within Whether social org should be responsible for morally motivated ec and fin activities	29.2%	50.0%	20.8%	100.0%

Table 12

Whether IFI is socially responsible?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	11	22.9	23.9	23.9
	Agree	25	52.1	54.3	78.3
	Neutral	7	14.6	15.2	93.5
	Disagree	3	6.3	6.5	100.0
	Total	46	95.8	100.0	
Missing	System	2	4.2		
Total		48	100.0		

Table 13

Is the Institution Reactive, Defensive, Accommodative or Proactive to CSR?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Defensive	15	31.3	41.7	41.7
	Accommodative	11	22.9	30.6	72.2
	Proactive	10	20.8	27.8	100.0
	Total	36	75.0	100.0	
Missing	System	12	25.0		
Total		48	100.0		

Note that by definition, the IFIs are reactive as they are legal identities

Table 14

Percentage of profits spent on community enhancing activities * Whether IFI is socially responsible? Crosstabulation

Count

		Whether IFI is socially responsible?				Total
		Strongly agree	Agree	Neutral	Disagree	
Percentage of profits spent on community enhancing activities	0-2 %	6	7	3	1	17
	2-5 %	1	9	2		12
	5-7 %		3	1		4
	7-10 %	1	2			3
Total		8	21	6	1	36

Table 15

Types of activities in which organisations would get involved	Yes	Valid %	No	Valid %	Total Response	Missing
1. Staff welfare (loans, health schemes, etc.)	34	94.4	2	5.6	36	12
2. Donations to charities	33	86.8	5	13.2	38	10
3. Abstaining from false advertising	33	97.1	1	2.9	34	14
4. Promoting ethical values among staff (e.g. Against-bribery, corruption, conflict; pro-honesty, trust, brotherhood, justice)	32	100	-	-	32	16
5. Donations to community causes	30	81.1	7	18.9	37	11
6. Sponsorship of community events	26	74.3	9	25.7	35	13
7. Provision of benevolent loans (*qarḍ al-hassanah*)	24	72.7	9	27.3	33	15
8. Sharing best practise on social, ethical and environmental responsibility with other organisations	24	85.7	4	14.3	28	20
9. Investment in Research & Development	23	76.7	7	23.3	30	18
10. Working with local schools, colleges, universities	22	66.7	11	33.3	33	15
11. Investing according to ethical guidelines	22	78.6	6	21.4	28	20
12. Scholarship to students	20	64.5	11	35.5	31	17

Types of activities in which organisations would get involved	Yes	Valid %	No	Valid %	Total Response	Missing
13. Establishing fair recruitment practises, including engaging people traditionally excluded from the labour market e.g. Disabled, homeless, ethnically discriminated	19	76.0	6	24.0	25	23
14. Supporting employee involvement with community causes	16	64.0	9	36.0	25	23
15. Commitment to sustainable development	16	66.7	8	33.3	24	24
16. Investing or encouraging investment in deprived areas	15	60.0	10	40.0	25	23
17. Taking initiatives to protect the environment (e.g. Recycling) or enhance environmental management	14	60.9	9	39.1	23	25
18. Working with NGOs for sustainable development	13	52.0	12	48.0	25	23
19. *Zakāh* collection and distribution	11	45.8	13	54.2	24	24
20. Lobbying for a particular social, ethical or environmental cause	7	30.4	16	69.6	23	25

Comments

on Corporate Social Responsibility Papers by Farook and Lanis; and Sirally

Sultan Abou-Ali[*]

Corporate social responsibility (CSR) is a subject which was dealt with by economists and thinkers from other disciplines since long time. It attracted recently increasing attention. There is a proliferation of literature on this topic especially from accountants, politicians and economists. This recent concern about CSR might be due to the process of contemporary globalization which preaches organizing the economy on the basis of private ownership and allocating resources according to market forces, among other things. Various phenomena were associated with this globalization, which have some negative and positive effects on producers, consumers and on countries developed and developing. Two negative aspects are related to our topic, CSR, might explain the reasons behind this increased attention. These are income distribution and failure of many big corporations which were believed to be financially viable and sound.

First, inequality of income distribution, both within and between countries, worsened in the last fifteen years or so, i.e. since the beginning of present day globalization. The multiple of the share of rich to poor countries in world GDP increased from 30 to almost 100. Within countries gini coefficients substantially increased denoting greater inequality of income distribution between high and low income groups. While income distribution is the result of the interaction of many variables, it is believed that a higher share of profits to GDP means greater inequality of distribution. Corporate profits have been multiplying all over the world in recent years.[1] Hence, these corporations should have a responsibility towards the society in which they reside to correct this distortion.

Second, the last decade of the twentieth century witnessed the collapse of many big corporations such as Enron, and others. These companies were believed to be financially sound. Their distributed profits were quite high. Their sudden bankruptcy and collapse caused wide range of social problems. One of them is a

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[1] It is not strange to note that the richest person in the world is the owner of one of the biggest corporations of the global. The source of his wealth is corporate profit either current or capital gains.

deep financial crisis which resulted in a rise in unemployment. The slow rate of economic growth negatively affected the poor. The whole international economy was harmed in a chain reaction, especially in Korea, Japan and the United States of America. In brief, it could be said that these corporations did not meet their social responsibilities. To the contrary, they inflicted harm on the people and societies. Consequently, it is important to make sure, as much as possible, that corporations clear their social responsibilities and have good governance and avoid excessive risks. This could be mainly achieved through striking a balance between social interests and corporations interest. That is to say between profits on one side and growth and equity on the other side.

The previous remarks were said by way of introduction to our review of Sairally, Dusuki & Dar and Farook & Lanis[2] papers, since they mainly deal with the same topic. The rest of this review will be organized as follow, the next section will discuss the meaning of corporate social responsibility. It will distinguish the concept of "corporate governance" from the concept of CSR. It will be followed by a presentation of Islamic banks (IB) practises with respect to CSR in addition to Islamic financial institutions (IFI) in general. The next two sections will deal with the measurement of social responsibility and the methodology and sampling techniques adopted by the authors. Next, we shall discuss the findings and results of the papers. We shall end by a brief conclusion on the subject.

1. The Meaning of Corporate Social Responsibility and IFI Practises

The three papers, especially that of Sairally, went into great details in the literature to review and define the concept of CSR. There seems to be a, general consensus on adopting Carroll's definition of CSR,[3] which relies on determining the components of this SR. This functional definition contains four categories. These are:

1. Economic (which I prefer for our present purpose to coin it as financial for obvious reasons to economists) responsibility which could be quantified by viability, profit maximization and growth of the corporation (firm) over time.
2. Legal responsibility, i.e. to abide to the rule of law.

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[2] These papers are: Salma Sairally, "Evaluating the Social Responsibility of Islamic Finance: Learning from the experiences of Socially Responsible Investment Funds"; Asyraf Wajdi Dusuki & Humayon Dar, "Stakeholders" Perception of Corporate Social Responsibility of Islamic Banks: Evidence from Malaysia Economy"; and Sayed Farook & Roman Lanis," Banking on Islam: Determinants of Corporate Social Responsibility Disclosure".

[3] A.B. Carroll (1979), "A Three Dimensional Conceptual Model of Corporate Social Performance" *Academy of Management Review*, 4: 497-505.

3. Ethical responsibility, that it is to follow the ethical and cultural principles acceptable to the society.
4. "Discretionary" or "philanthropic" responsibility. That is to say, factors which are not, in the opinion of the authors, directly related to profit maximization.

As for the applicability of CSR concept to Islamic businesses, Dusuki and Dar go into length to cite the Qur'ānic verses which support these 4 dimensions (p.8).

From the legal and Sharīʿah points of view, IFI should follow the generally agreed upon tenets of Islam. If they do not they will lose their credibility as the application of Islamic way of life is the raison d'etre of their existence. Hence, theoretically we would expect IB and IFI in general to abide by the principles of Islam. If some of these institutions do not strictly follow the Islamic rule, it is only normal and happens under any social system. This does not justify the indication of some researchers (such as Metwally 1992 and Maali, et.al (2003)[4] that "Islamic banks did not completely fulfil their social role in accordance with the prescriptions of Islam". This diversion, if it exists, might be due to several factors and circumstances:

a. It might be due to differences in opinions and perceptions to what conform and that does not conform to Islamic principles. That is to say that it is a matter of value judgement, which differs among researchers, institutions and scholars.
b. This diversion in my opinion might be due to the various difficulties facing IB in carrying out their business according to the optimal Islamic modes of transactions (*mushārakah*). The preferences of the two parties to the banking intermediation might be different. Savers (depositors or sources of funds) might prefer to invest on the basis of *mushārakah* (profit sharing) while investors (borrowers or users of funds) do not prefer this method. They usually prefer to borrow money especially at a fixed interest rate. This dilemma might force IB to use a second best solution which is much better than turning these banking to just safe boxes for money.
c. The third possible explanation for the allegation of non-compliance of IB to their SR in accordance with Islamic principles might be due to the lack of disclosure on their side. Non disclosure does not necessarily mean that the observance of SR according to Islamic principles is violated. It needs more effort from both sides the researchers and IB. The lack of disclosure on the part of IFI might be stemming from some cultural practises. Namely, concealing charitable and good social deeds. The Qurān says "If you

[4] Metwally, S, 1992, "The Aggregate Balance Sheet and the Results of Transactions and Financial Indicators for Islamic Banks and Financial Institutions, "Journal of Islamic Banking and Finance; Maali,.B, Casson, P. And Napier, C. (2003) "Social Reporting by Islamic Banks", Discussion Papers in Accounting and Finance, University of Southampton.

> disclose the act of giving charities they are accepted, and if you conceal them and give them to the poor it would be better for you."[5]

Hence, researchers might not be fully justified to state that IB did not fulfil their SR according to Islamic principles. From the Sharīʿah point of view, some SR actions are a must (*wājib*). Others are preferred (*mustaḥab*), which corporations are encouraged to observe. Their violation does not justify condemning IFI of breaching the principles of Islam.

Describing the discretionary dimension as philanthropic, seems to me as incorrect. Charity is a one side transaction, doing business should be distinct from charity. CSR requires, however, that Islamic corporations do some acts on a non quid-pro-quo basis. It is recommended to classify these acts as "non-price competition.[6] A better social image for a corporation will certainly be reflected on the demand curve which it faces. It will enable them to increase their market share. This would benefit the corporations as a result of economies of scale and greater profits.

On the other side, the concept of corporate social responsibility should not be mixed with the other concept of "corporate governance" (CG). One of the components of good CG is disclosure of financial position. As was said before corporations might not disclose information about their SR, while they carry these responsibilities very well. Although CG and CSR might intersect and overlap, it is much better to distinguish one from the other. CG, as well known, requires transparency and accountability in addition to disclosure. Maali et. al.,[7] as reported in Farook & Lanis (P.5), found that Islamic banks disclose less information far below the expected level. This again pertains to CG and not CSR, and it does not necessarily mean that they are less committed to SR.

Generally the three papers consider CG as a subset of CSR. From the analytical point of view, they should be kept separate. This would be reflected on the variables to be considered in measuring the determinants of CSR.

2. Research Methodology

Research methodology applied in the three papers is generally sound and advanced. There are, however, some remarks and suggestions regarding sampling and the coverage of Islamic financial institutions. The three papers base their analysis mainly on a sample of IFI to assess their commitment to SR. Nonetheless, the process of sampling is not presented in details. This should have been done in order to gauge the validity and exactness of the sampling techniques and results. Sairally identified a sample of 250 IFI, and received 20% responses, of which 70%

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[5] The Holly Qur'ān, *Sūrah Al-baqarah*, verse 27.
[6] See any book on intermediate microeconomics.
[7] Maali, B., Casson, P. Napier, C., op. cit.

were banks. Dusuki and Dar, on other hand, distributed 1780 questionnaires and obtained 84% responses. The questionnaires were distributed to IFI stakeholders, i.e., customers, depositors, local communities, employees, branch managers, regulators and Sharīʿah advisors. They consider the sample to be very large. The soundness of the sampling process could not be assessed as no enough information on the population of which the sample was drawn were given.

Farook and Lanis use a sample of 47 observations. They consider this as a limitation on obtained results. Again, the questions regarding how representative the sample is and its randomness could not be answered. This paper depended on published annual reports by IB (P.12). This might seriously affect the results. It is common that these reports do not contain enough detailed information on SR matters as well as other variables. It should be noted, that the number of banks included in the sample differ from one country to the other. How representative these banks for each country is hard to determine. The sample included 5 Saudi banks. It is known that there is no bank in Saudi Arabia which bears the word "Islamic" on its title. It is assumed that all banks functioning in the kingdom are Islamic. It will be illuminating to know the basis of choosing these banks. This remark would also apply to the other countries included in the sample.

In sum, the three papers should give more details about data selection and sampling techniques in order to correctly assess the results and conclusions reached.

On the other hand, it is known that IFI, like the other institutions include banks and non-banking entities. Sairally's sample included 30% of non-bank intermediaries. Theoretically, it is expected that they will differ from IB with respect to SR practises. Several reasons could be mentioned. Regulators for banking institutions usually ask for more information than in the case of the NBI (nonbanking institutions). NBI are in general smaller in size compared to banking institutions. They also rely more on personal and direct contacts. These circumstance would lead NBI to reveal less information about their SR practises. Therefore, it would have been illuminating had these two groups of institutions been analyzed separately, and the significance of the differences, if any, were reported in the paper. Both Farook & Lanis and Dusuki & Dar analyze banking institutions only. The former paper covers 14 countries while the latter relates only to Malaysia. It is recognized now more than ever, that culture matters from one society to the other although all would be Islamic. The universality of Islam can absorb different cultures applying the agreed upon general Sharīʿah principles. Therefore, I believe that a more relevant variable would have been an index representing cultural difference rather than the proportion of Muslims to total population (MSPOP p.37). It would have been very useful to assess in details the variability among banks in these 14 countries. The questionnaires were directed to stakeholders including managers. It is not clear whether this was done in their personal capacity or as representing the institutions. If the case is the former, then it

might be better to include these institutions as a legal entity in the questionnaires. It is also known in the theory of "Principal – Agency" that agents do not necessarily follow the instructions of the principals and consistently act in their interest. Farook & Lanis point briefly to the agency problem in their paper (p.13). Directing the questionnaire to the principals might contribute to more disclosure on the side of IFI and how they evaluate their social responsibility role.

Furthermore, these studies could have included a control sample of non-IFI in the same communities with almost the same financial circumstances and characteristics. This would make better comparisons rather than relying on the results of other papers.

3. CSR Measurement

The results of quantitative analysis could be seriously affected by the quality of data and the degree of clarity of the concepts used. Hence, the question of the way social responsibility is measured is crucial. Sairally's cites the variables used by Haron & Hisham[8] which measure SR (p.9). These are: proportion of *qarḍ ḥasan*, distribution of financing by sector, *zakāh* contribution and overdraft they provide to preserve Islamic culture. I disagree with most of these variables as a measure for SR. *qarḍ ḥasan* should not be the basis of doing financial activities. An IB might have small proportion of *qarḍ ḥasan* and carry a high degree of SR. Similarly, the distribution of financing by sector depends on the institution's policies rather than their SR. *zakāh* is determined by Sharīʿah, and IFI has nothing to do with that.

Dusuki and Dar cites 12 elements for the measurement of CSR (P.17). These are: product price, customer service quality, convenience, vicinity to work, friendly personnel, knowledge and competence of personnel, Islamic working environment, reputation, respect of human rights, Islamic image, involvement in the community, and environment impact. These variables were grouped in four categories relating to environment, human resources philanthropic and human rights. Sairally's (p.15) cites similar variables. Those who responded to Sairally's questionnaire seem to expect a gigantic role to be played by IFI. This could be seen in responses such as community development, ethical, sustainable development etc.

The dependent variable in Farook and Lanis paper is "an index of expected CSR disclosure of Islamic banks operating in Muslim countries. Again, as was said earlier we are trying to explain CSR and not just its disclosure. The independent variables in his model are quantifiable, however, they do not fully represent the determinants of CSR. This will be seen, as discussed in the next section, by the small coefficient of determination, R^2, although there are 6 explanatory factors.

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[8] Haron, S. and Hisham, B. (2003), "Wealth Mobilization by Islamic Banks: The Malaysian Case", paper presented at the International Seminar on Islamic Wealth Creation, University of Durham.

On the whole, the papers did big effort to measure the dependent and independent variables in the study of CSR. They conform to the general stream of papers on the subject. It seems to me that there is a need for more efforts to be directed to clearly measure the meaning of SR. The limitations mentioned above obviously might seriously affect the findings and results.

4. Findings and Results

The three papers under review confirm the generally agreed upon phenomenon of the growth of Islamic banks and financial institutions during the last three decades. Theoretically they also expect that these institutions would fulfil their social role inherent in the Islamic social system. They, however, try to test somewhat different aspects of the subject. Farook and Lanis on one hand, was trying to "measure the CSR disclosure levels… and subsequently ascertain their likely determinants". They tried to test four null hypothesis which are listed in table 1 with the results:

Table 1: Null-Hypothesis Testing Results

Null-Hypothesis	Results	
	Direction the relationship	Significance
No.1. There is a negative association between the level of political and civil repression and the level of CSR disclosures.	as expected	non-significant
No.2. There is a positive association between the proportion of adherent Muslims and the level of CSR disclosure	as expected	significant at 5% level
No.3. There is a positive association between Islamic governance scores and the level of CSR disclosure.	as expected	significant at 1% level
No.4. There is a positive association between the proportion of investment account holders (IAH) to shareholder funds and the level of CSR disclosure	as expected	significant at 10% level

It should be noted that the regression equation used by Farook and Lanis has 6 independent variables. The determination coefficient, R^2 in both the main and optimal models (0.459 and 0.528) are relatively small. About 50% of the variability in CSR disclosure is not explained by these variables. The authors should have looked for other factors substituting IAH which is marginally significant. The paper should have also tested for multicolinearity between Islamic governance score and the proportion of adherent Muslim. It is a bit strange that the association between the level of political civil repression and the level of CSR disclosure was

not significant. Did the author make a run for the regression omitting this variable? The general conclusion that "the majority" of Islamic banks disclose less than expected would be due either to measurement deficiencies or to cultural and social factors. The recommendation to Islamic banks to disclose more should be acceptable.

As for the findings of Dusuki and Dar they found that:

1. Stakeholders in Malaysia apply more importance to IB reputation and the quality of service as factors of CSR compared to the other factors in banking selection criteria.
2. There is a significant disagreement among stakeholder groups on reputation & service delivery quality and CSR. There were, however, no significant disagreement among then regarding convenience and product price.

These results are expected.

The finding of Sairally reveal that 80.9% of respondents allocate SR to IFI, of which 63.8% equate the importance of financial gains with social objectives, 27.7% see the former more important to the latter. As for financial practitioners response to the responsibility of morally- motivated economic and financial activities 48% agreed or strongly agreed that this should be the responsibility of "social organization", while 32% disagreed and 20% were neutral. About 96% of the responding financial practitioners agreed that SR creates value for IFI. The statement, "The practise of Islamic finance was not thought to be as socially responsible as the views voiced out by financial practitioners" p.23 needs more substantiations. In general, we would agree that IFI should disclose more information on their social activities and be more transparent.

5. Conclusion

The papers under review dealt with the subject of CSR from various angles. One of the questions which were raised relates to the possible contradiction between profit motives and social responsibilities. Other questions were about disclosure, the elements of CSR, stakeholders view about their priorities in patronizing IB, and how Islamic financial practitioners evaluate the conformity of these institutions practises to Islamic principle. The general consensus seems to be that IFI are not philanthropic entities. They are commercial institutions which seek to realize profit, either on the basis of profit maximization or any other goal. This practise does not mean that they do not observe SR, which does not contradict with profit maximization. All firms and corporations under various social systems, including Islam, are required to abide by these social responsibilities. This SR might be looked upon as "a constraint" in the process of profit maximization. From another angle it seems that the right classification of SR should be an element of "non-price competition" rather than "philanthropic action".

As for the differences in the evaluation among stakeholders it is only natural that human perceptions and preferences would differ from one individual to the other. The lack of disclosure does not negate that IFI meet their SR. It is recommended to separate the concept of CSR from corporate governance although disclosure might be a common element to both.

The three papers pointed to the limitations of their conclusions. Further research is required to arrive at definite answers which would greatly benefit Islamic financial institutions, economists, accountants and the public in general.

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Comments

on Corporate Social Responsibility Papers by Farook and Lanis; and Sirally

Abulhasan M Sadeq [*]

This Discussion Report deals with three papers on corporate social responsibility (CSR) of Islamic banks. Islamic banks are essentially financial organizations whose objective is basically to make profits in a *ḥalāl* (permissible) way. However, in line with the normative principle of a "sharing and caring society" in the Islamic code of life, it becomes a social responsibility on the part of Islamic banks to shoulder social responsibility along with personal interests. Not only in Islamic banks, CSR has now been emphasized even in the conventional business enterprises as well. Although the emphasis on CSR is a recent phenomenon in the conventional wisdom, it has been emphasized right from the beginning of the concept of Islamic banking. The research and inquiry into the extent of CSR with respect to Islamic banking is, however, quite a new endeavour. The authors of the three papers under consideration deserve credit for delving into this new and important area of investigation. The three papers under consideration are as follows.

1. Sayd Farook and Roman Lanis, "Banking on Islam? Determinants of Corporate Social Responsibility Disclosure."
2. Asyraf Wajdi Dusuki and Humayon Dar, "Stakeholders' Perception of Corporate Social Responsibility of Islamic Banks: Evidence From Malaysian Economy."
3. Salma Sairally, "Evaluating The 'Social Responsibility' of Islamic Finance: Learning From The Experiences of Socially Responsible Investment Funds."

All three papers seem to agree on a single point that Islamic banks must shoulder social responsibility. But the specific areas of their enquiry are different. Following the thematic sequence of the papers, the third paper "seeks to evaluate

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the Corporate Social Responsibility (SRC)" of Islamic banks or Islamic financial institutions (IFIs), thus determining how socially responsible IFIs are in their objectives, actions and commitments as a socio-economic contributor to human welfare". The second paper aims to explore the perceptions of the various stakeholders of Islamic banks regarding their social responsibility with special reference to Malaysia. The first paper examines the degree of CRS disclosure of Islamic banks in their annual reports and its possible determinants.

We would like to make some comments on these papers and then contribute to this discussion by clarifying the degree of Sharīʿah imperative of CRS of Islamic banks vis-a-vis the authors' perceptions.

1. Comments on the Paper by Farook and Lanis

1. The authors propose to investigate corporate social responsibility (CSR) of Islamic banks by studying CSR disclosure. To them, Islamic banks operate in accordance with Sharīʿah principles and "Merged with this function is the social role of Islamic banks that entails social justice and accountability, requiring the banks to disclose corporate social responsibility (CSR) information" (p. 1). This view is indicative of a problem in the basic premise of the study. CSR role does not require CSR disclosure, which may even be negatively related. Higher levels of piety and Islamicity, which lead to higher levels of CSR, may lead to lower levels of CSR disclosure since, to many, CSR disclosure may seem to amount to "showing off" or "*riyā*" which is discouraged in Islam. Methodologically, this may defeat the whole purpose of the study since, if this has some bearing on the scale of CSR disclosure, lower CSR disclosure may be indicative of higher Islamicity of Islamic bankers with higher corporate social performance (CSP).

2. The question is this: Is CSR disclosure more important or CSP? If the objective is to study the CSP of Islamic banks, which is expected to be so, then it is more relevant to collect data on social welfare activities of Islamic banks and study their determinants, rather than CSR disclosure. This is because, due to the reason mentioned above, CSR disclosure is not expected to give a true picture of CSP of Islamic banks.

3. The authors collected data on CSR disclosure from Islamic banks. Even if one intends to base it on CSR disclosure, the annual reports alone may not be enough to provide information on CSR. Apparently, it seems to be a tradition of Islamic banks to report their CSR activities separately in brochures and "Activity Reports," rather than annual reports, which are mainly meant to report accounts instead of functions. Thus, depending on the annual reports alone will not give correct picture of even the CSR disclosure, thus under-reporting the scale of CSR disclosure. For example, Islami Bank Bangladesh Limited (IBBL) is very active in social welfare activities, which has a separate foundation by the name of Islamic Bank Foundation to perform functions related to CSR. The examination of its Annual Report 2004 shows that it does not present much information on its CSR

activities. The report consists of a few lines on social welfare activities, giving merely the titles of major activities, and consisting of just one figure of Tk. 109.43 million[1] that was spent in 2004. It did not even mention the *zakāh* that it distributed. Besides provisions for payment of *zakāh* on deposits, and other income and assets through this bank, IBBL pays *zakāh* at the rate of 2.5% on share premium, statutory reserve, general reserve, investment loss offsetting reserve, exchange equalization, and dividend equalization accounts. These *zakāh* payments are definitely related to social welfare activities.

4. The authors' findings show, "The mean disclosure for the 47 banks in the sample is approximately 16.8% of expected disclosure"[2] (p. 24). Does it mean that their CSR is under-disclosed? If yes, it is under-disclosed or under-reported by more than 83%. That is, Islamic banks disclose CSR significantly less than expected. Two options are possible:

i) Islamic banks disclose CSR less than what they do, that is, an under-statement of CSR performance. It is a good sign since the actual performance is better than disclosures in the annual reports.

ii) Disclosure is the real picture of actual CSR performance, which is less than expected. If this were the case, it would not be desirable CSR performance on the part of Islamic banks.

However, the probability of the second option is slim. This is because if the disclosure is the real picture of the actual CSR performance of Islamic banks, there is no justification of investigating the determinants of disclosures, since the only determinant is the actual CSR performance. The study shows that the factors determining levels of CSR disclosure are: (i) levels of repressions and openness of societies under which the organizations operate; (ii) the degree of influence of the "relevant publics" on the organizations, and (iii) the existence of Sharīʿah Board's monitoring resulting in greater Sharīʿah compliance.

In other words, irrespective of the actual CSR performance, the levels of CSR disclosures will depend on the above factors. The author's findings show that Islamic banks actually disclose less than expected, or they fail to disclose the full extent of their CSR performance. In other words, they under-disclose their CSR performance.

2. Comments on the Paper by Dusuki and Dar

1. A reconsideration of the structure of the paper will probably improve the paper. After some discussion on the relevance of corporate social responsibility (CSR) in Section 3, the learned authors move directly to research methodology (Section 4) and research findings (Section 5). It would be useful to have a formal *a*

[1] The exchange rate is around US$ 1 = TK. 65.

[2] It is not made clear in the paper how is the size of the expectations determined.

priori analysis leading to objectives and hypotheses[3] for testing by empirical studies, followed by testing of the hypotheses as to their probable acceptance or rejection based on the findings.

2. CSR variables are voluntary as rightly mentioned by the authors, "In general, CSR is essentially a concept whereby companies decide voluntarily to contribute to a better society and a healthier environment" (p. 5). However, three out of four CSR dimensions mentioned by the authors are not voluntary in the Islamic or Islamic banking sense, but rather these are compulsory and binding from Sharīʿah point of view, and hence these are Sharīʿah imperatives instead of voluntary CSR imperatives. These are built in the Islamic system, without which the Islamic banking will not be Islamic. There cannot be a "balance between profit objective and these social objective" (p. 9), since these Sharīʿah imperatives are binding. These three Sharīʿah imperatives are human resource dimension, human rights dimension, and environmental dimension, and the voluntary CSR aspect is the philanthropic dimension (p. 6).

The authors' findings suggest that the stakeholders value CSR factors positively for banking patronage along with other factors, which is a commendable finding. Although it seems that the stakeholders will not abandon Islamic banks even if their CSR performance is not as satisfactory,[4] Islamic banks should always keep in view their social responsibly in order to uphold the Islamic principle of establishing a "caring and sharing society".

3. Comments on Salma Sairally's Paper

1. Some structural modifications will probably improve the paper. After introducing the subject, the learned author provides literature review in Sections 2 and 3. Thereafter, she presents Wood's[5] concept of CSP measurement consisting of three facets, followed by research methodology and an empirical analysis. It would be useful to provide, in addition to a modified version of the literature review, a formal theoretical exposition and an *a priori* analysis of the position taken by the author on the issue under consideration, a formal hypothesis to be tested by empirical investigation, research methodology, empirical investigation, followed by findings and conclusions.

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[3] The authors have, however, mentioned null hypothesis in the Section on Research Methodology. It is better to mention hypotheses formally and separately and then proceed to discuss how to test them (Research Methodology), rather than null hypotheses alone, which is to nullify. It is a rational sequence to start with what, followed by how; rather than how followed by what.

[4] This is because the Islamic banks seem to have succeeded in attracting patronage by professionalism rather than by emotional belief alone.

[5] D. J. Wood (1991), "Corporate Social Performance Revisited", *Academy of Management Review,* 16 (4): 691-718.

2. Although a formal theoretical exposition and an *a priori* analysis of the position taken by the author on the issue under consideration are missing, the author's view can be understood from her passing remarks here and there. Let us look at some of the statements:

"The apparent divergence in the practise of Islamic finance from its initial objectives of targeting general human well-being is the problem that motivates this study" (p. 5).

"... How does the practise of Islamic finance compare with the theoretical promise of the discipline to create an innovative financial system for bringing about social and economic benefits to the Islamic world?" (p. 9)

Such statements of the author bears testimony to the fact that, according to her, the objectives of Islamic banks or Islamic financial institutions (IFIs) are mainly "general human well-being" or "to create an innovative financial system for bringing about social and economic benefits to the Islamic world".

Now the question arises, "Are these objectives and targets Islamically binding?" If this is claimed, "How to substantiate such a claim"? And, "Who sets objectives for whom?" Has any IFI set such targets or objectives? The Islamic bankers are essentially businessmen who do business by raising financial capital by following the Sharīʿah-approved methods of finance. Is it Islamically permissible for a person to set objectives and targets for somebody else?

Obviously, such targets and objectives of banks are similar to those of specialized financial institutions set up by governments without consideration of any direct economic gain, profit, or even economic efficiency and viability. In case of such specialized financial institutions set up by governments, any losses are borne by the government. This fact seems to have been perceived and understood even by the author herself when she mentions, "These are conventionally recognized objectives assigned to state banks and development agencies, hence attributed to IFIs as they are called upon to play a role in socio-economic development" (p. 5).

Now one may ask, "Would it be permissible to impose such welfare type objective of specialized public and charitable organizations to private business?" Would such impositions violate human rights or *ḥuqūqul ʿibād, which* the CSR functions are supposed to safeguard? Assigning such responsibilities to some private business organizations (just because they are IFIs) by excluding other Muslim businessmen would probably involve injustice (*zulm*),[6] which is not permissible in Islam.

[6] This is because as a Muslim, each and every businessman has similar CSR. Imposing something extra on somebody excluding other similar category of people is against objectivity and justice.

3. In empirical analysis, the author found that the IFIs do appreciate social responsibility. She states, "According to the data, the theoretical understanding and ethical implications of Islamic finance by Islamic financial practitioners were observed to be consistent with the emphasis placed on social responsibility by the Islamic economics literature" (p. 25). However, according to the author, their behaviour was not consistent with declared perceptions. This is because, although almost all the IFIs spend some amount for shouldering social responsibilities, the amount spent as percentages of their earned income is not encouragingly large.

A closer look into the matter will not probably justify the author's view that the perceptions of IFIs and their behaviour are really conflicting. This is because a positive attitude towards social responsibility does not require a certain minimum of spending for the purpose. Spending for social welfare, no matter how much is the amount, proves compliance of social responsibilities. Besides, Islamic methods of finance in themselves have positive implications for social welfare (elimination of interest has equity and other welfare implications, financing only the permissible activities, and other practises of IFIs produce social benefits).

4. Sharīʿah Imperative of CSR of Islamic Banks

In this Section, I would like to supplement and complement in the discussion of the present topic with respect to corporate social responsibility (CSR) of Islamic banks.

There is a general trend in the discussions of Islamic banking to assign such responsibilities to Islamic banks that are normally assigned to public sector welfare organizations, specialized development institutions in the public sector, charitable organizations, or Islamic *daʿwah* organizations. Such a notion can also be perceived from different statements of the three papers under consideration. Let us consider some statements of these papers and other authors.

Sairally mentions in her paper: "The apparent divergence in the practise of Islamic finance from its initial objectives of targeting general human well-being is the problem that motivates this study" (p. 5). "... How does the practise of Islamic finance compare with the theoretical promise of the discipline to create an innovative financial system for bringing about social and economic benefits to the Islamic world?" (p. 9). In addition, "the practise of Islamic banking and finance is argued to be evolving along the same self-interest, profit-geared motive .... That, in the first place, it was set to oppose" (p. 4). These financial institutions are often blamed for mission statements with a view for "optimizing shareholders value", "improving efficiency", and "aiming at superior financial performance" (p. 22)

To Dusuki and Dar, "Thus, the concept of CSR ...... Is a natural commitment of Islamic institutions particularly Islamic banks whose objectives are directed towards making brotherhood, social equality and equitable distribution a reality in Muslim societies." (p. 7)

According to Farook and Lanis, “Merged with this function is the social role of Islamic Banks that entails social justice and accountability, requiring the banks to disclose corporate social responsibility (CSR) information” (p. 1).

Some other authors seem to subscribe to similar views about CSR of Islamic banks. For example, Usmani asserts that the philosophy behind Islamic banking was “aimed at establishing distributive justice free from all sorts of exploitation”[7]. Islamic banks “were supposed to adopt new financing policies and to explore new channels of investment which may encourage development and support of small scale traders to lift up their economic level”.[8]

“Islamic banks are expected to disclose relevant CSR information to discharge their responsibility and to earn legitimacy for their continued existence”.[9]

According to such views, the prime objectives and functions of Islamic banks boil down to the achievement of general human well-being; bringing about social and economic benefits to the Islamic world; making brotherhood, social equality and equitable distribution a reality in Muslim societies; establishment of distributive justice; development and support of small scale enterprises; discharging of corporate social responsibility (CSR), including its disclosure. To some, these seem to be such strict obligations that these are not merely moral responsibility, but rather these are necessary for the legitimacy of their existence. Furthermore, not only they must do it, but they must also prove it by disclosing the relevant information that they have done it. Otherwise, they loose right to exist (and hence they should probably be closed down).

On the hand, the Islamic banks have been blamed for self-interest, profit motive, profit maximization, economic efficiency, and for aiming at superior financial performance.

To me, these are serious issues which should be addressed carefully with Islamic objectivity rather than emotions, following the Sharīʿah perspective without being loaded with one’s personal spirit of altruism, which is highly valued in Islam, without making it obligatory, and without imposing one’s high level of piety on others as long as they remain within the Sharīʿah boundaries. We need to determine the boundaries, insist on all concerns to remain within the boundaries, and encourage them to approach the level of perfection without imposing it upon them. We need to understand that there is a large range and space of permissibility within the boundaries with different levels of piety and altruism, from a very high level in which one may spend for the society everything beyond his/her one-day’s needs, to a level where one limits his/her societal obligation to the payment of *zakāh*.

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[7] Usmani 2002, p. 113 quoted in Farook and Lanis, p. 1.

[8] Usmani (2002, p. 116, quoted in Farook and Lanis, p. 2.

[9] Sadeghzadeh 1995; Baydoun and Willett 2000; Haniffa 2001; Lewis 2001; Maali *et al.* 2003, quoted by Farook and Lanis, p. 9.

With this introductory note, I would like to make some comments on some specific issues, without addressing them fully due to space constraint.

Self-interest: Safeguarding or pursuit of interest of the self or self-interest is one of the objectives of Sharīʿah (*maqāṣid* al-sharīʿah). After all, *īmān, aʿmāl, ʿibādah,* and refraining from many attractive things of the world are for self-interest of achieving *falāḥ* in the *ākhirah*. Similarly, Islamic banking or any other business is for self-interest of earning profits, which has been made not only permissible, but also obligatory in Islam. However, it has to be achieved by following the permissible ways, without affecting the interests of others and the society. Besides, one is required to share the "personal interest (income and wealth)" with the society during its utilization through the institution of *zakāh* and through other channels. This Islamic concept of self-interest is different from the western one, which allows self-interest at the cost of social interest.

Profit motive: Earning profit and hence profit motive is not only allowed, but rather it is encouraged, in Islam. Man has been commanded to search for the bounty of Allah after prayers, and honest and trustworthy businessmen have been assigned very high status in Islam. Without any doubt and hesitation, all these activities are to earn *ḥalāl* living by making profits. In fact, sometimes we speak against profit maximization due to lack of understanding of the term. Profit maximization simply means, if we have several options (strategies), we accept the one that gives maximum possible benefits (profits), without violating the constraints.[10] I am not aware of anything in Islam that prohibits or even discourages this.

Economic efficiency: It is not permissible in Islam to adopt a strategy that is less efficient, if more efficient strategies are available, known, and accessible. The Prophet (saw) advised us to do a job in an efficient way, and even in slaughtering an animal by sharpening the knife. Therefore, each and everybody must strive to achieve efficiency, including economic efficiency in all economic activities along with Islamic banking, by aiming at superior financial performance. Obviously, this economic efficiency would of course be without affecting the others (without affecting *ḥuqūq al-ʿibād*). Such economic efficiency is an Islamic and Sharīʿah imperative, rather than being discouraged in Islam.

It is asserted that jurists are in favour of equity as against efficiency.[11] This has been explained by a diagram, to show that jurists' preferred indifference curve would be inclined to "Equity-axis"; while the bankers' preferred indifference curves would be inclined to "Efficiency-axis" in an indifference map, as in the following diagram.

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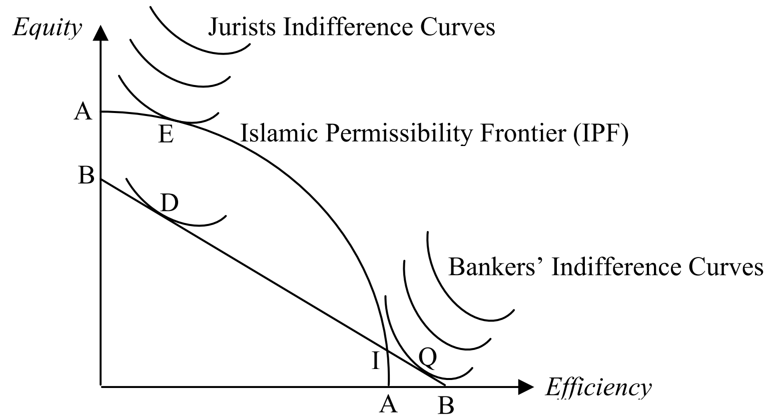
[10] In Islamic economics, both economic and moral constrains will be effective, while in conventional economics, only the economic constraints are considered.

[11] El-Gamal (2000), quoted by Sairally, p. 10.



This assertion may not be true. This is because the jurists emphasize justice and permissibility, which is given by the Islamic Permissibility Frontier (IPF), AA. Jurists' emphasis on the principle of *ʿadl* (justice) may go away from equity, while the Islamic principle of *iḥsān* may take it closer to equity. Let us take an example of two friends, X and Y, going out together for fishing, but catching fish separately (it is not a sharing or joint activity, and hence everybody will get his own fish). Incidentally, Mr X catches 10 kilograms of fish, while Mr Y is unable to catch any fish. The justice-verdict of the jurists will be that Mr X will get all the fish, while Mr Y will get nothing. Clearly, this juristic verdict makes the fish distribution perfectly un-equal. Now, the role of *iḥsān* comes in. The Islamic principle of *iḥsān* may motivate Mr X to give some fish to Mr Y for his family members, who are waiting for fish. Thus, the jurists' verdict emphasizes justice leading to the Islamic Permissibility Frontier, which does not contradict with efficiency.

We need also to understand that Islamic banks should stand on its professionalism and efficiency in order to succeed, instead of being based on Islamic emotions of the clients for their patronage and survival. Islamic banks should be able to pass the efficiency test to justify that the Islamic system is superior to other systems.

Social Responsibility: Islam recognizes private ownership, encourages *ḥalāl* earning, and it does not put any limit to earnings and wealth provided these are earned by *ḥalāl* means, without affecting *ḥuqūq al-ʿibād*.[12] However, in the disposition of the earned income and wealth, Islam does assign a societal share and right. A minimum level of this share and right is given by the institution of *zakāh*,

[12] *Ḥuqūq al-ʿibād* consist of rights of all concerned involved in the production process, including just pricing of the factors of production, rights of all those who are not directly involved in the production process but are indirectly affected through environment, externalities, and so on.

while no upper limit to social responsibility has been fixed. The upper limit will depend on the level of one's *taqwā,* piety, and Islamicity. The minimum level will be imposed and enforced by the state agency, while the other levels will be left to the persons concerned, although the state may impose something officially beyond the minimum under certain circumstances.

This social responsibility is applicable to individuals as well as business enterprises including Islamic banks. There is no reason why one business will be different from others. Thus, corporate social responsibility (CSR) of Islamic Banks is not supposed to be different from other businesses run by Muslims. If it is claimed to be different, or if Islamic banks are required to behave like a social welfare or charitable organization, this position must be substantiated. Otherwise, it may turn out to be violating *ḥuqūq al-ʿibād* (denying the due rights of Islamic banks), which is not permissible in Islam. It is not also allowed to insist *nafl* (spending beyond *zakāh*) over *farḍ* (Sharīʿah imperative of safeguarding the rights of Islamic banks).

It is observed that many of us tend to assign such functions to Islamic banks, which are really the functions of specialized organizations, social welfare organizations, or charitable organizations. For example, some assign to Islamic banks such functions as fulfilment of broad socio-economic benefits, focus on promising economic sectors, job creation and stimulation of entrepreneurship, maintenance and dispensation of social justice, establishment of equity and fairness, alleviation of poverty, promotion of regional distribution of investments (Sairally, pp. 5-6).

Obviously, these are not functions of a commercial bank or any private business organization, but rather of specially established social welfare or charitable organizations, which cannot be imposed on any private business enterprise, including Islamic banks.

One need to go deeper into these issues. In this context, the basic questions that we need to ask are: Is business allowed? If yes, is it allowed to make profits? If yes, is it allowed to adopt a strategy of economic efficiency in business? Is it allowed for the business partners to benefit from the business, or is it necessary to commit everything for the society? What is the "MINIMUM" that a Muslim "MUST" commit for the society?

Once such questions are addressed, we need to further ask the following questions: In what sense a banking business is different from any other business? In what sense the social responsibility of Islamic banking business is different from any other business run by Muslims? Or, under what justification, Islamic banking must be a social welfare or charitable organization (if this is not required for any other business)?

It seems that the degree of emphasis on CSR of Islamic banks in the existing literature are based, at least, to some extent on personal religious emotions

motivated by the spirit of altruism, rather than objective Sharīʿah imperatives, which needs clarification, justification and substantiation. In this context, we need to refer to the fact that the level of *ʿazīmah* is not binding, but rather optional, and there is a need to consider the boundaries consisting of the level of *rukhṣah* (the level of permissibility).

To conclude, it is important to address these issues for a clear perception regarding the degree of CSR on the part of Islamic banks that are binding, including the extent of their CSP and its disclosure. Once the parameters, which are binding from Sharīʿah point of view, are substantiated from the basic Islamic sources, rather than just quoting from different authors, one may proceed to investigate compliance between Sharīʿah imperatives and Islamic banking practise in the real world situation.

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Reply to Comments by

Sayd Zubair Farook

The following reply to the comments of Abou Ali (2005) and Sadeq (2005) shall attempt to address what the authors, Farook and Lanis believe are the essential points captured by one or both of the commentators.

At the onset, it is pertinent to note the fundamentals of this paper. Particularly, this paper deals specifically with disclosure of corporate social responsibility (CSR) rather than the actual activities of the corporation. While both are invariably linked with each other (as alluded to in the first part of this paper), it is important to de-construct each of them on their own when analysing their levels and determinants. This paper was only an attempt at analysing one of those two: CSR disclosure.

Another fundamental point to note is that this paper does not prescribe a set of CSR disclosure standards that all Islamic banks should adhere to. Rather, it merely sets out to find the likely determinants of the variation in the level of CSR disclosure by Islamic banks. In that regard, an index is formulated (Maali *et al.* 2003) which contains all the possible types of disclosure that Islamic banks could make. It is not an objective of this study to prescribe a 100% disclosure of all these items as that would be unreasonable for Islamic banks to comply if those particular items don't apply.

Replies to specific points are addressed below:

Firstly, Abou Ali mentions that such an important factor such as culture should not have been excluded from the research design. For instance, a number of studies have shown that different attributes of Islam are adopted in similar situations in different cultures. A widely held example is that of mourning in Islam (Wikan 1988). Wikan (1988) finds that Balinese Muslim mothers will react much more passively than will Egyptian Muslim mothers in response to the bereavement of a child, even though they both follow the same religion.

As with most research, the authors have attempted to do as much as they could with the available firm level and country level data. For this obvious practical reason, determinants such as culture and other social factors, while theoretically crucial, were not included in the list of variables. For instance, both the most

widely known variables of culture: Hofstede four elements of culture and Schwartz five elements do not cover such diverse countries as in those found in the sample of this study. Other variables covering culture are not as theoretically grounded nor are they as generalizable to the unique countries as the two models of culture from Hofstede and Schwartz.

Secondly, other social factors could have been variables in this study, but since they were not going to be theoretically grounded, they would lack scientific justification.

Thirdly, Abou Ali (2005) mentions that corporate governance (CG) should be kept analytically distinguished from CSR. While the authors agree with this point, the primary reason why CG was included in the model was because of the fundamental role that 'Islamic' governance plays in any 'Islamic' institution, whether it is a financial institution, a manufacturing firm or a charitable organisation. In that light, it is only intuitively appropriate to expect that the stronger the 'Islamic' governance in an organisation, the better it will be able to manage the 'Islamic' responsibilities of the organisations, one of these outcomes better accountability through greater disclosures and particularly CSR disclosure. In that light, it cannot be said that the authors consider CG as a subset of CSR. Rather, it is quite the opposite. Good 'Islamic' governance is seen as a leading indicator or determinant of other 'Islamic' CSR activities and hence CSR is seen as a subset of CG in this case, as in the case of conventional institutions.

Thirdly, both commentators mention that non-disclosure does not necessarily mean that Islamic banks are not performing their CSR activities. They support this statement by utilising the Islamic principle of concealing charitable and good social deeds. However, they forget to distinguish between Muslim individuals and Islamic organisations or organisations that claim to be Islamic. If, as is stated in the paper, personal accountability of individuals is a fundamental facet of Islamic teachings, then who should organisations, as a collection of individual stakeholders be accountable to? Organisations can only be accountable to stakeholders, as they are not real being accountable to God. These stakeholders themselves will be personally accountable for where they invest their money, their time or other resources. However, how will these stakeholders know to what extent their investment of resources has been 'Islamically' fruitful if the organisations that hold *in trust* their resources do not disclose any information?

Further, countless historical examples exist at the time of the Prophet (PBUH) and the four caliphs that followed him which demonstrate the existence of accountability by the institutions and organisations that controlled government, such as the seat of the governor of Syria for example. These administrative organisations were not only responsible to God in the hereafter, but had to demonstrate their responsibility to God by being responsible for their actions to their constituents, their stakeholders. In that light, it is important to distinguish between individual social responsibility and organisational social responsibility.

With regards to research methods, it is noted that the method of data collection is an important limitation of this study as it suffers from survival bias. Notwithstanding, countless other small-scale studies suffer from the same problem as a result of a small number of observations or limited data availability. It should also be noted that tests were run excluding each variable or two variables at a time to ensure that

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Performance Evaluation

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11

Evaluation of Islamic Banking Performance: On the Current Use of Econometric Models

Zubair Hasan *

This paper provides an appraisal of some of the researches conducted in recent years for evaluating the efficiency of Islamic banks. It is restricted to studies using parametric (SFA) and non-parametric (DEA) models. It finds that these models leave much to be desired and the conclusions they arrive at are of suspect validity for a variety of reasons. On a more important side, the criteria – cost or profit – they invariably use for measuring efficiency albeit valid miss the essence of what Islamic banking aims to achieve. These banks must of course pay their way but more than that they have to meet certain social objectives and priorities. The fulfilment of social responsibilities even at the expense of reduction in profits has to be the main justification for their existence.

Key words: Islamic banking, Efficiency criteria, SFA, DEA, Social priorities.

Introduction

There has been a fast expansion of banking institutions – conventional and Islamic – over the decades. But so has also been the proliferation of financial crises and banks' non-performance. The phenomenon prompted investigations into various aspects of financial services including the determinants of bank performance and the criteria for its evaluation. Thus, recent years have witnessed a flood of writings on the subject in mainstream economics. Islamic economists and policy makers largely followed the footmarks of their secular forerunners.

The main argument of this paper is that Islamic scholars are in a measure attempting to fix round pegs in square holes. One must see Islamic banking as an on-going process in a social milieu characterized with mass poverty and gross inequalities in the distribution of wealth, income, and opportunities. The mainstream transactional approach to the organization or performance evaluation

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of Islamic financial institutions is rather misplaced. But one cannot turn the tide all at once. This work, therefore, proceeds on the assumption that the criteria and models used in Islamic literature on the subject are acceptable in so far as they go. Our task is to provide an appraisal of the main writings in the area, especially the way the models have been handled and the results they yield.

Most of the writings have employed mathematical models: parametric or non-parametric.[1] They have used several criteria but cost and profit considerations dominate the scene. From the determinants of efficiency used in numerous mainstream studies, Islamic scholars have generally picked up the scale of operations, market diversification, and productivity growth.[2] Again, time series data are seldom used in their works; though panel modelling is not uncommon. The models presented do not always spell out their theoretical underpinnings or explain policy significance of their findings. In sum, they leave much to be desired on their own terms with rare exceptions

The paper is divided into five sections including the introduction. Section 2 discusses in a broad way the criteria and theoretical framework models generally use for evaluating the performance of banks. In Section 3 we provide an appraisal of some recent contributions made to the subject in Islamic economics. Section 4 argues that Islamic banking must be viewed as a phenomenon meant for integrating with the dynamics of the reformist movement in Muslim societies. The process of such integration – not the transactional view – must determine both the structure and performance evaluation criteria of Islamic financial institutions including banks. Finally, Section 5 contains some concluding comments.

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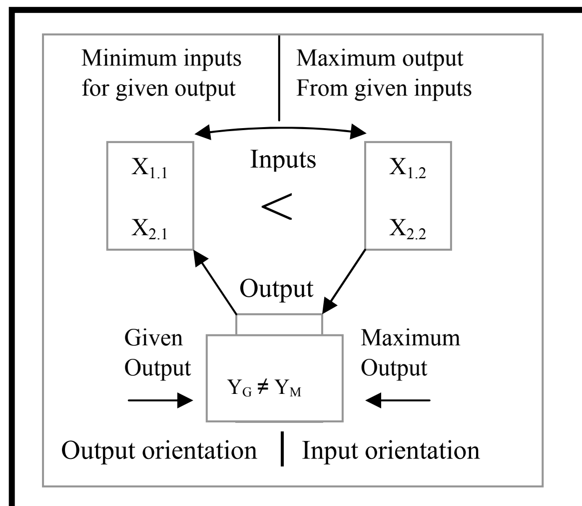
[1] One notable exception using ratio analysis is Munawar Iqbal (2001). Detailed comments on his paper are available in Hasan (2004). Suffice here to say that his reliance on conclusions arrived at on the ratios without providing the data they are calculated from is untenable: ratios and absolute values they rest on need not always move in the same direction Also, ratios fail to capture the long-run business dynamics; they lump together many aspects of performance relating to operations, marketing, and finance suppressing vital details. Comparing ratios and means concerning profit, liquidity, and loans for Islamic and conventional banks, Samad (2004) arrives at similar inconclusive results for Bahrain. Another work where econometric modelling relies purely on ratios affected by a wild variety of intractable factors over time and space is of Hassan and Bashir (2005).

[2] Other variables used for the purpose include the location of the firms, taxation levels, public expenditure, economic stability, investment patterns, stock price variations, foreign capital flows, export performance, market share changes, political climate environmental factors and so on. Since the technique has infinite applications all influences operating on efficiency can rarely be imagined or listed.

2. Criteria and Models

All models employed for evaluating the performance of a firm including banks invariably seek to construct an appropriate benchmark or frontier for the purpose. The distance of the firm from the frontier measures the extent of its inefficiency. The frontier indicating maximum attainable efficiency is set to have unit value in each case, and estimation is made of what are called the 'scores' for individual firms under study The closer is the score of a firm to one the higher it sits relative to others on the efficiency ladder. But opposite is the case the farther away is its score from the frontier. In mainstream economics the primary objective of business firms is the maximization of profit for their owners. Criteria for efficient performance are invariably geared to this norm. In principle, the norm is possible to achieve in two ways. First, a firm can aim at producing maximum output with given inputs. This is called an input orientation approach and helps measure a firm's economic or cost efficiency. Alternatively, the firm may attempt to obtain a given output using minimum inputs. This is referred to as an output orientation approach and links efficiency to resource allocation. In the first case, we employ an input or cost (C) frontier while in the second a production or output (Y) frontier for measuring efficiency. The two approaches if applied to the same case may not yield identical results. Figure 1 juxtaposes the two approaches to clarify the position.

Figure 1: Results need not be identical



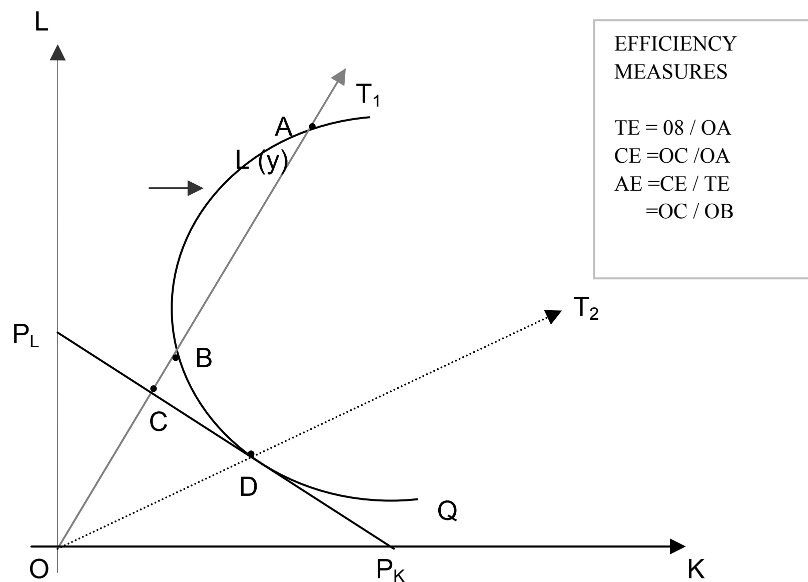
Also, the equations for estimating numerical values of efficiency scores, and policy implications of the results need not be the same in the two approaches.

Cost efficiency consists of two elements. First is the purely physical or technical element that refers to the ability of a firm to produce as much output as the given

input use would permit. Thus, the technical element focuses on optimal use of given resources; it has an output maximization goal. The second is the price element requiring the firm to produce a given output with minimum input expense. The approach insists on efficient resource allocation. Allocation here refers to selecting the least expensive combination of the given inputs to produce technically efficient output.

The first element is defined as the maximum possible reduction in the input use that would allow continual production of the same output as before. Such input use level is put equal to unity and specifies the technical efficiency frontier because no further input reduction is feasible. Thus, a firm having a score equal to one is technically efficient, but one with a lower score is inefficient. Figure 2 illustrates the basic concepts. Here L(y) is an input requirement set representing the collection of L and K input vectors that yield at least Q output. The firm is producing Q using an input combination defined by point A in time T_1. The firm could have produced the same amount of output by contracting both labour (L) and capital (K) back to point B that lies on the frontier.

Figure 2: Input-oriented Technical and Allocative Efficiency



The input oriented technical efficiency is defined as TE = OB / OA. However, it is point D where the marginal rate of technical substitution equals the input price ratio P_L / P_K that gives the least cost combination of inputs for producing Q. Notice that total cost at C and D is equal, both points lying on the same price line. To achieve the same level of cost, i.e. the expenditure on inputs, would need A to be

contracted further to point C. Hence, the overall *cost* efficiency is to be defined as OC / OA. If we know the ratio of input prices i.e. the slope of the $P_L P_K$ line, we can have also the allocative efficiency of the firm operating at A defined as AE = OC / OB. Now, if we take the product of efficient quantity and input price ratios, we can get a measure of overall cost / economic efficiency (OE). The terms EE, OE and CE are interchangeably used in the literature. Thus,

$$EE = OE = (TE).\ (AE) = (OB / OA)\ (OC / OB) \text{ that reduces to } OC / OA = CE \quad (2.1)$$

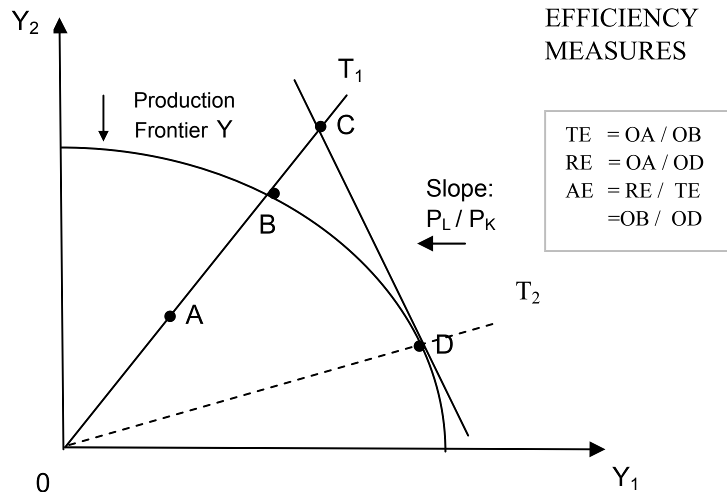
As (a) CE = OC / OA is less than one, (b) the gap [1 – (OC / OA)] measures the overall cost inefficiency (CIE) of the firm.[3] The gap can vanish if technological improvement over time (T_2) leads the firm to produce at point D, input prices remaining unchanged.

The above explanation of the conceptual framework for efficiency measurement is provided in terms of cost criterion. Even though it implies profit maximization, a number of studies target profit directly as the focus of their attention. Both cost or profit criteria are used to study the impact on them of a host of identifiable factors (referred to earlier) via the efficiency route.

Compare the above input oriented approach to the efficiency measurements with the minimal input use for producing a given output. Here we construct a production frontier for explaining the various efficiency notions. Figure 3 helps such comparison. Mark that point A depicting a departure from efficiency was above the cost frontier Q in Figure 2 but here it is below the production frontier implying that more could have been produced with the same cost at B. The price line passing through C and D implies that more could have been produced in time T_1 as at D in time T_2 but for the current inferior technology. Thus, here OA / OD measures RE, the revenue efficiency.

[3] These definitions would put CE and CIE in a logical relationship: CE + CIE = 1, However, in the literature CIE has come to be conceived as a ratio of CE i.e. (c) CIE = (1 – CE) / CE. Alternatively, we may state the relationship as: CE = 1 / (1 + CIE). In some cases, the use of (b) may help avoid inconsistencies the insistence on using (c) may create.

Figure 3: Output oriented technical and allocative efficiency



There are two basic models that are widely used as tools in efficiency studies with all sorts of variants in the field of applied research. There are parametric models that rely on sophisticated regression analyses. Since probability estimation lies at their heart to erect the efficiency frontiers and obtain firms' scores they constitute the stochastic frontier approach or the SFA to efficiency evaluation. The majority of these studies were confined to the US financial sector There the large number of banks has traditionally facilitated econometric modelling (Avkiran 1999). Then there are models that employ the non-parametric linear programming or the data envelopment analysis, in short DEA, for measuring efficiency.

Using the SFA for estimating cost efficiency requires the specification of a functional form. The translog cost frontier is often considered appropriate for studying efficiency issues of the banking firms. It is a very general and flexible function form and encompasses also some other approaches like the Cobb-Douglas. SFA looks in finance area at the question of efficiency in terms of cost minimization for a given output rather than maximization of output from given inputs.

SFA models vary according to the type of data used for the study i.e. Cross sectional or panel. Studies on efficiency of Islamic banks we shall be evaluating use cross sectional input data and seek resource conserving cost minimization given the output to be produced. Early cost efficiency studies typically included more than one output and jointly estimated the function with the associated input

share equations derived using the Shephard's Lemma.[4] The derivation of these equations implies that the firms are using their long-run efficient input mix: the firms are assumed allocatively efficient. This is possible because many firms, in fact, produce a single output, and others can aggregate their multiple outputs into a single output index (Kebede 2001, 13).

In a simple single output and multiple inputs case, we estimate the frontier using the functional relationships:

$$C_{it} = f(y_{it}, w_{kt}) + \varepsilon_{it} \quad \text{where } \varepsilon_{it} = v_i - u_i \tag{4.1}$$

In (4.1) C_{it} is the total cost of firms in a period t, y_{jt} and w_{kt} are vectors of output and input prices respectively f (y_{it} ; w_{kt}) provides the cost frontier. The random disturbance term ε_{it} allows the function to vary stochastically. It has two components: the v_{it}'s are independently and identically distributed (iid) elements; they are truly uncorrelated with the regression. In contrast, the u_{it}'s are non-negative variations associated with the technical inefficiency of firm i. Thus, the error term ε is not symmetric as $u_{it} \geq 0$.[5]

Estimating the firm-specific inefficiency is the ultimate objective of the model. This requires the extraction of separate estimates for v_i and u_i from the values of ε_i for each firm. For this we need distributional assumptions on the two error components additional to those underpinning the OLS, and also a different estimation technique to obtain a consistent estimator of the intercept and the TE for each firm. The required distributional assumptions are: v_i's are normally distributed, u_i's follow non-negative half-normal. Both v_i and u_i are distributed independently of each other and regression.[6] Avoiding mathematical intricacies that replete the literature, suffice to pointed out that cost efficiency of a firm is defined as [exp ($-u_i$)]. But as u_i cannot really be observed, it is estimated by using the conditional E [exp ($- u_i \mid \varepsilon_i$)] as the best predictor of u_{it} at time t. Curtiss (2000, 11) provides the relevant estimation equations for E [exp ($- u_i \mid \varepsilon_i$)].

Thus, in an SFA output oriented approach where the objective is to minimize cost for given output exp($-u_i$) has to be minimized not maximized. It is maximized in an input oriented approach where the objective is to produce as much as possible from the given inputs. Jemric and Vujcic (2002, 5-7) clarify the point in their work. The easier way to find the maximum or minimum value of exp($-u_i$) is to use the maximization likelihood method (MLM) which is automated in several computer

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[4] See, for example, Saaid et al (2003, 131, and 134) who use the technique to extract share equations for capital and deposits but it is unclear why did they drop the one for labor prior to estimation (n.11, 139).

[5] If u_i is equal to zero in fact or by assumption, SFA is reduced to central tendency analysis.

[6] Kebede 2001, pp. 15-17 illustrates the argument with the aid of appropriate normal distribution curves.

programs. The general problem is often solved by the minimization of [–log(L)] where L is the likelihood function.[7]

The relative merits and limitations of SFA and DEA approaches have often been discussed in the literature. Put briefly, one disadvantage of the econometric SFA models is that they impose a function form and distribution assumptions on the data prior to estimation.[8] In contrast, DEA does not require any assumptions about the function form, and is, therefore, less open to misspecification. Also, DEA being non-parametric does not take into account random errors. As such, there is no problem of assuming subsequently an underlying distribution form for the error term. However, for this very ability to avoid statistical noise, the efficiency estimates the approach provides could well be biased, if the production process is largely characterized with stochastic elements.

The SFA and DEA techniques are mostly used in two stages. First, each seeks to estimate efficiency or inefficiency scores relevant to the objectives of the study. As stated earlier, these scores can be used to rank the firms on the efficiency scale to indicate their relative performance. In the second stage, attempt is made to search for the nature and extent of causal relationship between inefficiency estimates and other relevant variables such as size of the firms, their location, taxation, public expenditure, stability, investment, profits, stock prices, and so on. Use is made of logarithmic conversion of data to straighten the selected production function. The application could focus on individual entities e.g. Firms or farms or their aggregation. The frontier approach is a tool that can be used in any field of inquiry where variables yield to measurement.

3. Some Recent Studies

Muslim scholars consider the same conventional criteria appropriate for measuring the performance of Islamic banks and often find them more efficient than their mainstream counterparts. They have usually employed either SFA or DEA for the purpose: Our appraisal includes the works of Majid et al (2005), Saaid et al (2003), Hassan and Hussein (2003), and the article of Darrat et al (2002) who use the DEA for their work. These are seminal works; and deserve credit for introducing Islamic economics to some new methods of analysis that made their appearance rather late even in mainstream applied economics. We may begin with a few general remarks though they need not apply to the works under review uniformly.

A common feature of these writings, as alluded to earlier, is the insufficiency of background information they provide about the nature of the economy, and the

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[7] For details of the method see Bock (1998) pp. 1-5. Information on relevant software is available in Herrero and Pascoe (2002).

[8] Usually the condition of linear homogeneity and symmetry is imposed on the data prior to estimation exercise implying constant returns to scale.

state of its monetary and fiscal policies affecting the financial sector. Even discussion on the structure, growth and place of Islamic banking in the overall financial setup of a country often leaves much to be desired. Their conclusions too require special attention for they apparently seem to defy both popular perception and experience.

Another difficulty with these exercises is that they do not provide clear explanations on the sources, nature, limitations and editing of data used. The definitions and contents, at times even the number of outputs and inputs chosen for the study remain unclear. Furthermore, appropriate, and unambiguous explanations of methods used are lacking. Reasons supporting the conclusions arrived at are at times missing, their policy implications are seldom adequately clarified.

Majid et al

Majid et al (2005) measure the cost efficiency of 34 commercial banks in Malaysia panelling the data for the period 1993-2000 with a view to comparing the relative performance of two bank sets – Islamic and mainstream.[9] On the basis of their results, the authors claim that “the efficiency of Islamic banks is not statistically different from the conventional banks”. Also, they find “no evidence to suggest that bank efficiency is a function of ownership status i.e. Public or private, foreign or local” (p.1). These conclusions are quite interesting and invite closer attention.

The authors employ the familiar translog cost frontier function for ascertaining the efficiency scores for the selected banks, individually as well as for different bank groupings. Their model specification and its details are mostly in order. Still, a few things raise some queries. To begin with, the study covers a fairly long period – 1993 to 2000 – but the results have no time dimension: obviously the authors have used panel modelling for their work. Since the total number of banks they cover (34) is quite large, one wonders if the post-crisis data with greater homogeneity and handling ease would not have served the purpose better. Or the data could have been used for a dynamic study of inefficiency i.e. Changes in it over time as in Hassan and Hussein (2003)

Again, only two Islamic banks appear in the sample and the results do not highlight their comparison with mainstream banks as promised. This makes the title of the paper a bit misleading. Also, what about the Islamic windows operating in the mainstream banks? How have the authors dealt with the impact of this phenomenon on the efficiency of banking in the country, Islamic or otherwise? This is a difficult question, yet those measuring efficiency of banks in Malaysia can hardly afford to bypass it.[10] One is expected to at least discuss it as a limitation of the study.

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[9] For detailed comments on this work see Hasan (2005).

[10] It is a difficult question because the mainstream banks do not maintain separate full cost

The data set for 34 banks – 24 local and 10 foreign – for the paper is created using the banks' annual reports and the ABM Bankers Directory to fill gaps in information on the number of employees in some cases. The banks have been categorized as local and foreign, Islamic and conventional, private and public, and as large and small (p.10) to study the impact, if any, of ownership forms, interest-free financing, and scale on bank efficiency in the country. Of course, the categories overlap. Had the authors provided the edited data file as an appendix to their work as for example in Bisha (2004) one could appreciate their contribution better and future researchers might have benefited from it.

Also, the paper does not reveal the component details of the outputs or inputs selected for modelling. One finds a general sort of discussion on the issue on page 9 of the paper. It is hinted that total cost (C) includes all labour and capital expenses plus interest. In the case of Islamic banks interest is replaced with income distributed to the depositors. What has been included in labour expense or how is capital expense estimated is not clear. The authors refer to a paper of Al-Habshi (1999) for bank differences. The paper is not readily available. In any case, it does not contain the needed explanations. Preferably, the explanation of this crucial point in the paper should have been full and complete. The authors mention three outputs: loans, advances, and financing, but provide little details on their nature or content or inter-bank differences. Financing in particular is a dubious category unless clearly explained. The corresponding input prices include (i) staff expenses per employee, (ii) expenses on land, building and equipment per Ringgit of assets, and (iii) expenses on interest or income distributed per Ringgit of deposits. Here also the paper has no explanatory discussion. For example, in (i) for averaging expenses of labour, all employees cannot be treated at the same footing; the proportion of officials to clerks is not the same in all banks. In foreign banks it is found generally loaded in favour of the officials as opposed to clerks.. Also, foreign banks earn a significantly larger share of their revenue from non-interest sources, through activities like derivatives trading, and merchant banking. Such matters are not given weight in the condensed data the work uses. Likewise, in (ii) historical and current costs differences between items and banks may have considerably distorted the aggregation.

Finally, in their use of the translog cost frontier model Majid et al did not explain, crucial though it was, the way they used the maximum likelihood method MLM for obtaining $E[\exp(-u_i \mid \varepsilon_i)]$.[11]

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statements for the Islamic windows e.g. their share in the overheads is not available to researchers. May be, it is because of this missing component of significance or its underestimation that authors arrived at the elating conclusions.

[11] The authors present in Table 2 of their work some regression coefficient. How they used MLM for their determination is not explained.

Saaid et al

Their paper deals with the performance of banks in Sudan. The country is claimed to have the distinction of initiating a total transformation of its financial system to observe Islamic injunctions in the conducting of business after the year 1989. This has put, as the authors say, the spot light on the performance of Islamic banks in Sudan, and lends significance to the present effort. The study employs the SFA cost frontier approach decomposing the error term ε into random noise and possible inefficiency. The model specifications are almost flawless.[12]

The paper finds that the Islamic banks in Sudan have low efficiency – both technical and allocative: they were not optimizing their input usage. Furthermore, the authors claim that inefficiency is more in resource allocation than in their technical use. Based on these broad findings, the study ventures a few policy prescriptions for improving the performance of Islamic banks in Sudan.

The effort of the authors is laudable in so far as it goes. The difficulty is that it does not go far enough, nor always stays on course It could have been prefaced with the details, even if brief, of the evolution, expansion, transformation and ownership or scale structures of Islamic banks in Sudan. Is it that no foreign banks operate in the country or interest-based financing is at zero level there? The input-output numbers, let alone their composition details, are unclear. The section on data and variable specifications for the most part talks of what the mainstream writings on the subject contain; what the study is based on is scantly mentioned. The section is overloaded with methodological explanations though even these are not devoid of gaps. For example, the authors decompose the error term ε_i into random noise (ν_i) and possible inefficiency (μ_i) components in our equation (4.1). Setting $\bar{\varepsilon} = \sum \hat{\varepsilon}_i$ they defined $\hat{\zeta}_i = \max \hat{\varepsilon}_i - \bar{\varepsilon}$ where maximum is introduced in order to provide positive values of $\hat{\zeta}s$. The authors then set up $TE = -(\zeta)$. (130). The statement needs elaboration to clarify why is the function maximized and not minimized? For, apparently maximization is required, as explained earlier, when efficiency measurement is not input but output oriented. But this is not the case here.

Shortfall of the estimated efficiency scores from one - the frontier - is not exceptional; it is common. The central elements of frontier analysis, to reiterate, consist of (i) the ranking of firms on the efficiency scale to compare their relative performance, and (ii) to test the hypotheses that claim a causal relationship between efficiency and its perceived determinants. The work of Saaid et al is distinct from others under review in that it falls in neither of the categories.

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[12] The symmetry and linear homogeneity conditions could have better been separately stated in n. 8 p. 139 for clarity. Some of the parameters in Table 2, p.134 do not seem to satisfy the specified conditions.

Therefore, it is uncertain what significance one can attach to their conclusion: "The study as a whole shows 78 percent overall efficiency (OE), meaning that 28 percent[13] of the Sudanese Islamic banks' total cost was inefficiently used compared to (if) the banks were on the frontier (p. 137)". But the Sudanese Islamic banks could still be found more efficient in comparison with those in other countries. Again, the claim that technical component is the main source of overall inefficiency seems to conflict with the suggestion that public policy forced the banks to divert more of finance to the less productive agricultural sector of the economy (p. 137).[14] If that were true, allocative component, not the technical, should have been the main culprit in lowering the overall efficiency scores which the results show it is not. Thus, question marks may be put on the reliability of the model results and the policy prescriptions that are based on them.

Finally, Saaid et al refer to the two alternative methods for estimating the overall cost efficiency of banks: (i) by averaging of the ζ, or (ii) by the deviation of the cost ratio of a bank from the stochastic frontier. However, (ii) provides a measure of inefficiency (1- OE), not of OE. Thus the statement is inconsistent with their equation (4): $OE = C / C^* = e^{-bt}$. (p.130).[15] Also, the authors do not clarify if the results the two alternative methods would yield be the same. Nor do they say what methods they have used to obtain their own results. Thus, much faux pas characterizes their treatment of the issues. However, despite the blemishes Saaid et al have produced a neat work that we believe would help open the doors for further research in an important area of Islamic banking.

Close on the heels of the above work appeared one more study that of Hassan and Hussein (2004) on the performance of Islamic banks in Sudan. Like Saaid et al they too employ a panel data modelling but attempt to cover a host of topics in a short space. The authors estimate efficiency measures based on costs, resource allocation, technical variants, profit and scale. Interestingly, they employ both SFA and DEA techniques to obtain their results even though their distinctive roles in the work have not been made explicit. The paper has the merit of providing adequate and revealing facts in tables concerning the banks in Sudan but its explanation of variable definitions and the process of their estimation in the text is rather sketchy.

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[13] It may be indicated that the SFA does not directly provide the allocative efficiency estimates AEi; the same are estimated through division of the CE (= OEi) by the corresponding TEi, As such, the authors could have well kept the inefficiency scores shown in their Table 4 p.135 as (1 – CE); alternatively, they could have clarified that discrepancy arises due to the relationship between efficiency CE and inefficiency CIE. (See n. 5 above).

[14] The authors could have easily tested the validity of their claim regarding the adverse efficiency effect of forced diversion of finance to agriculture using a fixed effects model.

[15] The equation could be valid for an output oriented formulation where $C^* > C$. But in the cost-oriented approach as Saaid et al have taken, we find $OE = C^* / C$ (See Kebede p.13). For, as $C > C^*$, OE remains ≤ 1. Compare the authors' formulation with that in our Figures 2 and 3.

The authors have done well in using Malmquist Index to measure productivity changes (Table 10).The index has many useful features. One is that it decomposes results into a "technical efficiency change" and "technological change' components. Under the assumption of constant returns to scale, the first component can be broken into a 'pure' technical change index, a scale efficiency change index, and a congestion change index (Fare at al 2003). However, one must warn that the index is in jeopardy even at the theoretical plane (Douglas et al 1982). For example, circularity is a desirable property of a productivity index. It is seldom satisfied in the available bilateral indices including the Mamquist. Hassan and Hussein need not detain us here any longer. Suffice to say that they present to the reader an assortment of ideas to choose from according to his taste.

Darrat et al

This work focuses on assessing the cost and technical efficiency of eight of the nine banks in Kuwait -- all owned fully by the locals -- in view of the increasingly competitive environment in the financing industry the world over but especially in the developing countries. The study covers a period of four years from 1994 to 1997. It does not resort to data panelling and produces results for each of the year separately. It uses the non-parametric DEA (variable returns)[16] model that has the advantage, among others, of allowing the direct calculation of allocative efficiency. Mamquist measure of bank efficiency supplements the use of the DEA.

Generally speaking, the product of the input output numbers in a DEA application should optimally be less than the sample size for effectively discriminating among the banks. The authors, therefore, employ three inputs – labor, capital, and deposits – and two outputs, loans and investments. The analysis incorporates also the unit prices of inputs to measure cost efficiency. The contents of each item and method of its calculation is made explicit. Unlike many other writings, Table 1 of the paper presents the complete data file. The analysis it presents is both static and dynamic: the paper provides efficiency scores of individual banks for each year of study and also measures the impact of technical change over time. The main conclusions derived from the exercise are:

The most striking conclusion from the ranking in their Table 2 is that the smallest bank in Kuwait is consistently the most efficient of all banks in the country.

Going through their Table 3 giving efficiency scores over the estimation period one finds an unmistakable upward trend in the cost efficiency of banks, probably because of decreasing cost of funds.

Interestingly, technical efficiency of banks in Kuwait is consistently higher than their allocative efficiency over the estimation period suggesting that the main

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[16] The authors impose on their model the restriction $\sum \lambda_I = 1$.

source of cost inefficiencies, as Saaid et al found for Sudan, is most likely regulatory not managerial in nature: Kuwiti banks do a better job in utilizing available inputs than in choosing the proper input mix.

Scale efficiency is also persistently higher than pure technical efficiency in Kuwaiti banks over the period of study.

Finally Kuwaiti banks seem to have improved in terms of all types of efficiency over the period save 1996.

The work of Darrat et al is short but well organized and adequately documented. Their explanations are clear, conclusions fruitful. The various appendices they provide are enlightening, are an integral part of their argument, and above all lend transparency to their work. However, there are limitations as well. For a work presented in 2002, the period of study 1994-1997 looks too far back in the past; their conclusions are at best monumental. Finally, the work lacks an Islamic dimension or should one assume that there are no banks in Kuwait run on interest free basis?

4. Efficiency Criteria and Social Priorities

It would be naïve to dispute the relevance of cost efficiency for Islamic banks. Nevertheless, we shall argue that the conventional criteria need not be the sine qua non for evaluating their performance. In mainstream economics, where in principle the promotion of individual interest is primal for enhancing social well-being, efficiency requirements for firms, including banking, had to remain focused on profit, the reason of their being in business. For Islamic banks too profit adequacy is a survival constraint.[17] But if we look at the bigger picture a more basic question that stares us in the face is: could a business performance appraisal be independent of the broader priorities of a social organism? Past history and current practise both answer in the negative.

Mainstream economics primarily does not look beyond the cost-profit criteria in evaluating the efficiency of a productive unit simply because private enterprise operating through the market is the raison d'être of a capitalist society. Islam does accommodate many features of capitalism, and yet it aims at establishing a

[17] Some studies directly adopt profit as the efficiency criterion. It may be mentioned that profitability "can be characterizes as a performance indicator of single unit and it is calculated without the need for benchmark, whereas efficiency is based on relativity and can only be calculated with respect to a reference point" (Stavarek, 2003). Again, cost or output approach to efficiency measurement implies profit criterion. For example, Table 2 in Fat and Hua (1998) provides both the X-efficiency and profit efficiency scores for each of the six Singaporean banks from 1992-1996. Using the information as panel data we find that PE is a quadratic function of CE with adjusted R^2 = 0.82, with relevant coefficients significant at 5%.

distinctive social order responding to its imperatives. The requirement demands not only the formal abolition of interest but on a more important side the eradication of the urges that prompt its seeking.

All societal institutions including banks must help in the building of that system and eschew providing the Islamic cover for interest.[18] The social organization in Islam is inspired by its all important notion of *amānah* that focuses on fulfilling the basic needs of human beings, promotes mutual help and cooperation, makes the seeking of professional skills and enterprise a *farḍ kifāyyah*—the societal sufficiency obligation -- and insists on observing justice in all facets of human existence, especially in the distribution of wealth and incomes.

The performance of Islamic banks must primarily be judged with reference to the extent they help in building up this sort of society. Once they cross and can stay above the breakeven points, profit efficiency can be, in a measure, traded off for promoting the stated Islamic norms. We need not judge the Islamic banks performance entirely on the mainstream criteria or compare them with conventional institutions on the latter's grounds. Social objectives of business in Islam moderate worldly temptations; people are required to overpower the relentless pursuit of profit in business.

Islamic financial institutions have mostly been designed on the pattern of usual commercial banks in terms of their outlook, objectives, procedures, training and modus operandi. They are required, on the other hand, to undertake project financing, long-term risky ventures, and address the social aspirations for economic development. They hardly have the aptitude, environment, or personnel to do what we expect them to do. And this important structural issue is seldom addressed in the literature. Rather, one often comes across explanation, even justification, for the overwhelming use of deferred contracts in Islamic banking: risk aversion is commonly mentioned, and of late profit rates, and dividend policies are also being exclusively used as efficiency criteria for Islamic banks. In fact, the two are listed among the reasons for Islamic banks concentrating on short or medium term finance. But for this, the main blame lies in our opinion on the organizational design these banks were initially conceived to adopt.

Opening Islamic windows in western styled commercial banks represents an apparent mismatch between the provision of capabilities to them, and what they are expected to achieve. Mainstream commercial banks cannot be barred from entering the field for valid reasons but we had suggested on an earlier occasion that they may better be asked to establish exclusive branches with pre-stated objectives (Ḥasan 2005). It is indeed gratifying to note that Bank Negara Malaysia is now on that course. Though the country's banking law is yet to be suitably amended.[19] The

[18] For details on the point see Hasan (2005a).

[19] The Banking Law of the country was amended in 1992 for allowing mainstream commercial banks to open Islamic windows or counters. Indonesia does not allow this facility.

Central Bank is now granting permission for Islamic financing only if commercial banks open separate branches or subsidiaries for the purpose. The process is already well on course.

Islamic banking in the true sense of the term can rarely meet vital Sharīʿah objectives of raising a strong and prosperous Muslim *Ummah* (community) unless there is a complete break from tradition with reference to goals, sources, and uses of funds, and operation methods. Planning authorities of a country, better its central bank, must prepare a blue print for the purpose, including a regulatory mechanism. Once the development is redirected along appropriate lines, one can hope that profit and loss sharing (PLS) schemes and deferred contracts will appropriately supplement one another in a balanced growth and efficient performance of the Islamic system.

Finally, Islamic finance though important is only a street under construction in a much bigger Islamic road map. Its ultimate shape, carrying capacity, and usefulness would depend on what happens to the bigger picture. Crucial for success in the matter are social conditioning and political will; everything else would then follow suit.

5. Concluding Remarks

This paper has examined some of the important writings in the area on measuring the efficiency of Islamic banks with a twofold objective. First, we aimed at highlighting the current criteria and measures being used for the purpose. A related goal was to examine if the applications were in order. Second, and on a more important side, we wanted to judge the efficacy of the current efficiency measures in the context of the social objectives and priorities of an Islamic order and the role banks are expected to play for their achievement. There is disillusionment, but there are some rays of hope as well.

Econometric models have the advantage of providing frontier estimation against which to compare the performance of actual financial units, the banks. However, two broad problems confront us here. First, which of the methods - DEA or SFA – or their variant one must use as the superiority of one over the other depends on a variety of factors. There is, therefore, a trend of applying the two techniques simultaneously to the same problem for verification of results Mortimer (2002), presents the results of 41 such studies in his Table 1 (pp.9-13), but he doubts the reliability of comparison criteria (p.8). Second, both the methods have the potential to deliver biased estimates of inefficiency due to specification errors of one sort or another. Biases in the opposite direction raise the possibility of substantial divergence between the DEA and SFA estimations of inefficiency. Noisy data makes the results in either case all the more unreliable.

It is gratifying to note that Islamic economists have been quick to realize the importance of performance assessment in the fast expanding sector of interest free

finance and showed readiness to introduce in Islamic economics the recent techniques available for the purpose; it is a valuable addition to the literature. However, their efforts are wanting on two fronts. First, even if one need not dispute the efficacy of looking at the cost-profit equation for efficiency appraisal of the Islamic banks, the application of the methods itself has left much to be desired. The use of financial ratios that we have not discussed in this paper is a relatively older and easier technique of analysis. But one must recognize the pitfalls along the way: averages, ratios and percentages without providing the bases for their calculation or without assigning weights where needed, especially if the data were highly heterogeneous, may take us, as indicated earlier (n.1), to misleading conclusions

The parametric models are to be handled with care. The writings on the subject in Islamic banking generally lack conceptual clarity and background information was not always adequate. There are serious explanatory gaps, and a mixing up of the parametric and non-parametric methods in the same study remained inexplicable. In sum, the blemishes resulted in half-baked models and, at times, lead to conflicting results. The conclusions arrived at were mostly confirmatory, seldom unexpected or revealing.

Let it be understood that econometric models are not readily understood by the common man, the managers of Islamic banks, Sharīʿah advisors, or policy makers -- the groups that are interested in understanding Islamic banking. Who then are our addressees? Sometimes one digs a whole mountain of data only to find a known rat! Most often these models do not follow the theory: they attempt to lead or mislead it. Finally, their conclusions are valid only over the range of the data used; they are often time-specific. Remix the data i.e. Change definitions, variables, or the timeframe and the results are most likely to change. They provide average values of coefficients, but the mean as we know need not coincide even with a single observation sometimes. These models are to be used but with discretion.

To reiterate, the lament is that the mainstream criteria, methods, and procedures were applied to the neglect of the objectives of establishing the Islamic banks and their social responsibilities. These banks are to be structurally enabled to fulfil their societal obligations Shortfalls from econometric cost or profit efficiency frontiers do not mitigate the bliss of social transformation ushered in by the Grameen bank in Bangladesh, for example. To me, the writings such as of Ausaf Ahmad (2003) are more fruitful and efficacious than all the models whose complexities I have discussed above.

Greater transparency in transactions, encouragement for participatory financing, opening up of more specialized banks and customer services, increasing indulgence in long run finance, promotion of cooperative organizations are some of the suggestions to revamp, and reorganize Islamic finance. Things are moving in that direction even as the pace is slow.

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12

An Evaluation of Special Finance Houses: A Case Study on Turkey

Savas Alpay[*]

Turkey presents an interesting combination of interest-based and interest-free systems since 1985. As interest-based system is the only system in almost all countries around the world, it is difficult to investigate comparative performances of both systems. Countries like Turkey present an experimental environment where both alternatives coexist, and where people make their choices on how to utilize their savings. Thus, the Turkish experience will be very useful in identifying the advantages and disadvantages of the interest-free system in order to make its survival and expansion more likely.

Introduction

The Turkish banking system has three main players: Commercial Banks (private and state-owned), Investment Banks, and Special Finance Houses. Special finance houses (SFH), the name given to financial institutions based on interest-free principles, started to operate in Turkey in 1983 after a government decree allowing their operations. In 1984, Al-Baraka Turk and Faisal Finance House were established. Kuveyt-Turk Finance House was the third institution operating in this sector. These three SFHs were established with large foreign capital, and the first SFH with 100% domestic capital, Anadolu Finance House was established in 1991. In 2000, the Faisal Finance House has been purchased by a large Turkish company, Ulker, and has been renamed as Family Finance House. Today, there are 5 special finance houses operating on the interest-free principles, which is widely known as profit-loss sharing in the general public. The general motivation for the foundation of such institutions is to attract the funds from people, who do not want to deal with interest-based financial institutions for religious reasons. Today, it is clearly observed that these institutions are attracting funds not only from those people but also from others, and their overall performance as compared to other financial institutions is conspicuous.

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Under the 1983 government decree, the status of the SFHs was different from that of the conventional banks, and this caused some competitive disadvantages for them. With the entry of fully-domestic-owned special finance houses into the market, the complaints regarding the weaknesses in the legal structure, became more pronounced. As a result, in 1999, special finance houses became subject to the new Banking Act. After a revision in this act in 2001, the competitive position of the SFHs has been improved in terms of the legal infrastructure. In 2001, the Association of Special Finance Houses has been established, and the legal status of these institutions has been strengthened with the passage of the enabling legislation from the Parliament.

In Turkey, the overall volume of the banking sector is very low, and is less than what it should be as compared to similar countries in the developed world. There are different reasons for this. Firstly, the propensity to save of the Turkish people is not high and this results in a very low savings pool. Moreover, the share of the funds directed to financial sector from this savings pool is also low. It is estimated that the share of deposits is around 14 % in the total savings. This share is less than those of the foreign exchange holdings, gold and real estate. There are different reasons why the share of deposits and so the size of the banking sector is low in Turkey. After 1990s, successive big budget deficits accumulated a very high public debt. Financing of this debt through government bonds resulted in very high real interest rates, which exceeded 50 % in some years. Such high real interest rates on government bonds naturally attracted the funds in the national savings pool, and thus caused a significant decline in deposits at the banking sector. Recently the real interest rates have been decreased to around 10 %, and so, the government bonds' alternative role against deposits is changing.

Another important reason for the low volume of the banking sector, is the chronic inflation problem since 1970s. Turkey experienced a very long inflationary period, and inflation rate was stubbornly above 40 % for a very long period of time (sometimes more than 100 % inflation rate was observed with an average of 77 % for the 1990s). Turkish people reacted to these inflationary periods by moving away from the domestic currency and holding their savings mostly in foreign currency or gold. Recently, after a successful and stable economic policy, this trend is also changing surprisingly very rapidly. At the moment, the inflation rate is below 10 % for the first time in the past 40 years. The confidence to domestic currency is being recovered, and there is a rapid transfer back from foreign exchange holdings to Turkish Lira.[1] These positive changes are also expected to result in an increase in the volume and the size of the banking sector, both for conventional banks and the special finance houses.

[1] A successful domestic currency transformation has been realized in 2005 and new Turkish Lira is introduced into the market. In 2005 both the new and the old currency will be in circulation, and starting in 2006, only the new currency will be allowed in circulation.

In this paper, we will analyze the performance of the special finance houses in Turkey in the last 20 years, both in the times of economic crisis and normal times. This will increase our understanding of the problems faced by these institutions, their performance as compared to other financial institutions, and their contribution to the financial and real sectors of the economy. The interest-free and interest-based financial systems are, to some extent, alternative systems to each other. In the long run, the one with better performance will be the dominant system. At this time, the size of interest-free system in the overall financial sector is very little. This is not surprising as it has been introduced in a systematic manner in the usual financial environment only very recently. Countries like Turkey present an experimental environment where both alternatives coexist, and where people make their choices on where to hold their savings. Thus, the Turkish experience will be very useful in identifying the advantages and disadvantages of the interest-free system in order to make its survival and expansion more likely.

2. Operations of Special Finance Houses

The operations of special finance houses are based on interest-free system. Transactions based on interest in the conventional banks are usually performed by profit-loss sharing principle. One can group different operations of the SFHs into corporate services and retail services. We briefly summarize each category in turn.

2.1 Corporate Services

1) *Leasing*: Fixed assets, which are subject to depreciation, can be leased to investors on the condition that the ownership of the leased belongs to the lessor according to Turkish financial leasing law. Minimum period for financial leasing is 48 months except for computers and some other specified consumer goods, which may be leased for the period of two years. At the end of the leasing period, the leased equipment is transferred to the lessee at a price stipulated in the agreement. Leasing is more commonly used in the SFHs as compared to conventional banks.

2) *Financial Support for Production*: Manufacturers continuously need raw materials, semi-products, final products, machinery and other equipments to maintain production. Special finance houses provide support to its corporate customers, and purchase goods in advance, and resale it to the customers on installment basis. After delivery of the requested goods, customers become indebted to the SFHs according to a previously agreed price, profit rate and payment term.

3) *Profit and Loss Sharing Funds*: This is a special type of funding provided for which need to be financed to realize their short term projects. This kind of transactions starts with signing a contract between the SFHs and the customer and this contract is based critically on the feasibility of the project, and it mentions the agreed rates of profit and loss between the parties. At the end of the project,

generated profit is distributed between the parties with the rate stipulated in the agreement, and the project is concluded.

Other most commonly used operations are mainly related to the international trade. The SFHs provide services such as letters of guarantee and counter-guarantees, avalization, foreign remittance (outgoing and incoming money transfers), letter of credits, export and import services.

2.2 Retail Services

In this group, different types of consumer financing options are offered to individual customers. In essence, with this service, special finance houses purchase goods in advance and, after adding a certain profit margin, sell them to their customers on payment by installment. These transactions are performed according to principles of interest-free banking and no cash credit is given.

In general, the SFHs are financing final consumer goods such as real estate, automobile, long-lasting consumption goods, computer, office equipment, house equipment, second-hand cars and commercial vehicles, etc., within the principles of interest-free banking and with favourable rates. Usually, customers are presented with a payment calendar of 36 months in every product except real estate financing, which can go up to 60-month installments. The payment currency can be chosen as Turkish Lira, US Dollars or Euro for the transaction periods up to 36 months. For longer term financing, only foreign currencies are used.

In real estate financing, customers are usually required to make a % 25-advance payment, and the SFHs finance only 75 % of real estate's value. In real estate financing, initially the sellers transfer the real estate to the SFHs, and after adding a certain profit, it is sold to customer. Special finance houses keep the real estate under mortgage until the total debt is cleared by the customer. All expenses and taxes generated by this operation are borne by the customer.

3. Performance of Special Finance Houses During the Economic Crisis

In different parts of the world, financial institutions operating on the interest-free principles have shown their strength and reliability. Instead of using conventional interest-based system due to religious preferences or other reasons, these institutions operate on essentially the profit-loss sharing system. They have been on the market for a reasonable period of time enough for testing their stability and long-run survival. The past experience reveals that such financial institutions exhibit a success story; in fact, a story which demonstrates a better performance as compared to conventional banks despite their inferior legal status in some cases. Furthermore, the performance of these institutions in the economic crisis periods is much better than that of the conventional banks as seen in various real life experiences. During the 1997 East Asia crisis, many banks went bankrupt in the

region, whereas majority of the institutions working on the interest-free principles managed to survive the crisis. Similarly, in 2000 and 2001 economic crises in Turkey, the operations of more than 20 banks were terminated; due to state warranty on the deposits at conventional banks, these banks were transferred to Savings Deposits Insurance Fund, with a considerable increase in the amount of public debt. In the same period, special finance houses managed to survive even though they experienced a considerable amount of withdrawals (sometimes as high as 50 %).[2] It should be noted that the legal environment was such that all deposits in the conventional banks were under state warranty whereas the deposits at the special finance houses were not under any warranty.[3] So even under a legal environment disfavouring special finance houses, they showed superior performance. Now, we can explore the reasons for the superior performance of the SFHs.

As the SFHs operate with the interest-free instruments, they avoid the interest risk during the economic crisis. As a principle, most of the funds of the SFHs are used to finance the real sector of the economy. The loans, for example, are not given directly to the firms, but are paid to the suppliers from which the firms are buying machines, raw materials etc. Thus, the use of the loans in speculative, short term, risky investments instead of their intended areas is automatically not permitted. Indeed, most of the default loans of the conventional banks have been resulted from the ones which were used outside the areas stated in the application process, and in the speculative and short term investments. Banks do not control (and do not want to control) where their loans will be used. On the contrary, the process of distribution of funds as loans to individual firms in the SFHs guarantees that the loans are directed to their actual investment projects.

A second important source of failure especially in the developing countries is the exchange rate risk. Conventional banks used to borrow from abroad in foreign currency, and then converted them into domestic currency, which were then utilized in purchasing government bonds. This was a very famous way of operation in the late 1990s. Such a practise costed a lot to banks during the economic crisis of 2000 and 2001 in Turkey. A very high devaluation experienced during the crisis played a big role in the bankruptcy of many banks, which ultimately resulted in big increases in the government debt. Essentially by failing to control such risky

[2] The reason for those withdrawals cannot be attributed only to the economic crisis; it was partially due to the mismanagement of one of the domestically owned special finance house. This institution used the deposits in financing the other companies of the same group and thus, control principles of the profit-loss share system have not been incorporated into the channelling of the funds to the right direction. Instead, almost all deposits were given as loans to and by the same people.

[3] This warranty scheme has been changed starting in July 2004. Now, the state warranty to deposits in conventional banks is limited, and deposits at special finance houses are insured by a fund collected under a recent organization established by the name of Association of Special Finance Houses.

transactions in the first place, the government had a big responsibility in huge increases in public debt after the bank failures. On the other hand, the SFHs were also immune to exchange rate risk. The operating principles of the SFHs do not permit the conversion of foreign exchange deposits into domestic currency loans. Foreign exchange holdings can only be used as foreign exchange in whatever operation the SFHs choose to use. Thus, during the crisis the SFHs were not affected from high devaluation of the domestic currency as their assets and liabilities in foreign exchange matched each other.

A further superiority of the SFHs stems from the harmony in the maturity of the assets and liabilities. In general short term deposits have been used in the short term loans. Therefore, the liquidity risk was also not a big concern for the SFHs. Long term loan demands have been accommodated through the leasing option. Such an approach is in harmony with the credit techniques, and it not only proves useful for the SFHs but also for the firms which can pay their installments with the cash flows from their financed operations. Thus, special finance houses in Turkey operated in a framework in which they avoided interest, liquidity and exchange rate risks, which made them more resistant to economic crisis as compared to conventional banks; the SFHs were only subject to standard market and credit risks.

The superior performance of the SFHs during the economic crisis in Turkey indicates that their existence should be supported and strengthened. Nevertheless, the present legal infrastructure puts them in an uncompetitive position as compared to conventional banks. As mentioned above, the deposits at the SFHs are not under state warranty whereas the deposits at the banks were fully insured by the state until very recently. Because of this, the share of deposits at the SFHs has only reached to 2.6 % in 20 years. This performance could be much better if they were also taken under state warranty. There is not a convincing reason for their exclusion from the state warranty. After very recent legal changes, now this ungrounded discrimination has been partially resolved with the enactment of laws which limit the state warranty for the deposits at the conventional banks, and which require deposit warranty at the SFHs through the Association of Special Finance Houses. However, this does not change the discriminative situation very much. Firstly, the limitation on the state warranty for deposits at conventional banks only puts upper limit for an individual's deposit at a specific bank; by opening up accounts at different banks one can still accommodate a 'full' state warranty on the personal savings. The limitation should have been based on individuals and not on the banks. Secondly, the Association of Special Finance Houses is financed by the individual SFHs. Thus, legally required contributions for the warranty fund from each SFH generate an additional burden for them, and essentially force them to finance the loss of their competitors had they gone bankrupt. Naturally, such a warranty scheme brings confidence to their operations, but still in the eyes of the public, the state warranty is much stronger. Therefore, the warranty problem continues to persist in a different dimension.

Another disadvantage for special finance houses lies in the non-existence of short-term assets and thus, short term investment for them is very limited. Conventional banks may purchase government bonds and thus, can use their short term funds in a profitable way. The SFHs choose not to invest in government bonds as their operations are based on interest-free system. Thus, it will be very important to introduce *ṣukūk* bonds[4] not only for the SFHs but also for the government as they will constitute an alternative to the costly government bonds. This may also attract new funds from especially the Gulf region. Since 2004, works on legal infrastructure are being undertaken by the Treasury Department but they are not finalized yet.

4. Comparative Performance of Special Finance Houses against Conventional Banks

Previous studies on the empirical investigation of the financial institutions operating on the interest-free principles are very limited. The existing ones are mostly descriptive, and focus on the simple financial ratios. A few studies have undertaken a comparative analysis and explored the performance of the conventional banks and banks based on interest-free system. Among these, one can mention Samad (1999), Iqbal (2001) and El-Gamal and Inanoglu (2004) and (2005). Iqbal (2001) analyzed a sample of 12 interest-free banks and 12 conventional banks from 10 different countries for the period 1990-1998. His findings suggest that interest-free banks are not necessarily inefficient in their operations. El-Gamal and Inanoglu (2005) present almost the most rigorous econometric study in this literature. Furthermore, their empirical study is based on the Turkish financial sector. We will briefly summarize the methodology and the findings of their papers here due to their pertinence to our subject.

El-Gamal and Inanoglu (2005) make use of a fully parametric stochastic frontier analysis in order to utilize the likelihood-based EC-estimator[5] of El-Gamal and Grether (1995) for modelling unknown heterogeneity in bank types and ownership structures especially important in Turkish banking sector. The separation of heterogeneity effects from efficiency has been shown to be important by many studies on U.S. and European banking (for example, Elysiani and Rezvanian (2002) and Altunbas et al. (2001)). El-Gamal and Inanoglu (2005) examine the heterogeneity in the banking industry, and then study the relative efficiencies in the sector.

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[4] Recent introductions of so-called Islamic bonds in the form of *ijāra ṣukūk* and *salam ṣukūk* in Malaysia and Bahrain suggest that banks based-on interest-free system in other countries may soon have access to bond-like securities that would allow them to have the asset-composition similar to conventional banks, in particular with respect to short term investment options.
[5] EC stands for estimation–classification.

The data set is a panel data set that includes most of the institutions operating in the Turkish banking sector. Their data includes all banks that were in operation throughout the 1990s. Of the 49 conventional banks in the sample 13 were foreign banks (or branches of foreign banks), 23 were domestically owned, 4 were state-owned, and 9 were failed private banks that were transferred to Savings Deposits Insurance Fund (SDIF). This sample comprised of more than 93% of total assets of the conventional banking system. On the other hand, their data set includes 4 special finance houses (SFHs), which accounted for more than 90% of the total assets of all special finance houses in Turkey during the sample period.

Firstly, El-Gamal and Inanoglu (2005) undertake a stochastic frontier analysis of Turkish banking sector for the period 1990-2000. This analysis comprises estimation of a best-practice frontier, and comparison of the individual banks or SFHs with that frontier. They assume that each firm in the sample wants to maximize output (proxied by loans) for any given level of inputs, ignoring the multiproduct structure of the banks. This assumption is also necessitated by the fact that the SFHs in their sample issue virtually no securities during their sample period. Additionally, as SFHs did not distinguish between short and long term loans, they were urged to use aggregated loans as the single output of the banks in the sample. Using the duality, instead of analyzing the profit maximization process they focus on the cost minimization for any given level of output, and represent the production technology of firms by a dual cost function, which is associated with the minimum expenditure needed to produce a given output with given input prices. In such an approach, bank (or SFH) inefficiency is measured by the difference between each bank's (SFH's) realized costs of production, and the theoretical minimum at the estimated frontier. The cost frontier is obtained by estimating a total cost function, which is assumed to be the sum of interest expense, employee and fixed assets expenses. The estimated cost function also allows for differences in quality and risk factors. By making use of the El-Gamal and Grether (1995) estimation-classification procedure and a translog cost function specification, they obtained an endogenous (data-driven) classification of Turkish banks into two groups (heterogeneity part).[6] After these estimations, domestic banks including the SFHs are grouped together, and small and foreign banks (with two exceptions) are grouped together for further analysis. For each group, inefficiency scores are computed separately. In the first group, the SFHs claimed the top ranks among 40 institutions. Faisal Finance House (now operating as Family Finance House) ranked 1st, Al-Baraka ranked 2nd, Kuveyt-Turk ranked 6th and Anadolu Finance House ranked 8th. When averages of inefficiency scores for different types of banks are taken, the SFHs ranked first as compared all other

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[6] They find no evidence of heterogeneity between special finance houses and conventional banks. Homogeneity tests were rejected along the small vs. large and foreign vs. domestic dimensions. However, as foreign banks were mostly small, these two results are combined into small-and-foreign vs. domestic.

types, including State Banks, Private Banks, Banks transferred to Savings Deposits Insurance Fund (SDIF), and all conventional banks as shown in figure 1.

El-Gamal and Inanoglu (2004) present a comparative analysis of some familiar financial ratios for conventional banks and the special finance houses for the period 1990-2000. Such an exposition is also useful in understanding the efficiency differences found in El-Gamal and Inanoglu (2005). The financial ratios used in their analysis include capital adequacy ratio (the ratio of equity capital to total assets), asset quality (the ratio of total loans to total assets), loan quality (the ratio of nonperforming loans to total loans), management-efficiency (the ratio of employee expenses to total assets), earnings performance (the ratio of net income to total assets) and liquidity ratio (the ratio of liquid assets to total assets).

With respect to capital adequacy ratio, SFHs have been less capitalized as compared to both domestic and foreign conventional banks during the 1990s; however, the capital adequacy ratios of the SFHs have been on the rise since 1995, and in 2000 it has been higher than those of the conventional banks. As regards to loans-to-assets ratio, which is an indicator of asset quality, the performance of the SFHs is notably different from the conventional banks both domestic and foreign-owned. Over the 1990s, the average loans-to-assets ratio of the SFHs was as high as 70%, whereas the averages were 40% and 30% for domestic and foreign conventional banks, respectively. This difference is highly associated with the willingness to invest of conventional banks in high-interest-paying government bonds, and the avoidance of investing in such bonds by the SFHs as an operating principle. The reflection of such behavioural differences on the post-crisis outcomes should also be noted. A very related ratio is the loan quality ratio, which indicates the extent of default credits. There is a rising trend in the ratio of nonperforming loans to total loans (NPL/TL) for the SFHs especially after 1994 mini crisis with a maximum of 12% in 2000. In this respect, the performance of domestic conventional banks seems similar to that of the SFHs.

With respect to management-efficiency, measured by the ratio of employee expenses to total assets, a converging trend is observed between conventional banks and the SFHs; this ratio declines for conventional banks, and increases for SFHs during 1990s. Nevertheless, this comparison may not be done on healthy grounds as the period under investigation coincides with the early stages of opening-up of the SFHs; in fact, two new SFHs have opened up during the period under consideration. Finally, the earnings performance of the domestic conventional banks fluctuates around 2% and becomes negative after 1999. Foreign conventional banks and SFHs managed to sustain profitability during the entire period, with foreign banks being the most profitable in the sector.

El-Gamal and Inanoglu (2004) investigate the performance of the SFHs between 1990 and 2000. We will now update their analysis on financial ratios for the period 1999-2004. This period is especially important as two big economic crises hit Turkey in 2000 and 2001. This extension is very useful for both the

individual and the comparative performance of the SFHs during the economic crisis. In the appendix, table 2 presents the new values of the financial ratios mentioned above for 1999-2004, and figures 2 to 5 present the graphical representation of the same values.

It is clearly observed that the capital adequacy ratio of both the conventional banks and the SFHs are rising in the entire period, and reaching to around 14% for the banks and 12% for the SFHs (figure 2). These increases are mainly due to the provisions of the new Turkish Banking Act, which made the regulations in this sector stronger, and urged increases in the equity capital. Furthermore banks experiencing problems in this dimension are transferred to the State Deposit Insurance Fund (SDIF), and the SDIF improved their conditions through mergers and significant capital injections by the state. The rising trend in the capital adequacy ratio of the SFHs continued during, before and after the crisis. In regards to asset quality, the performance of the SFHs continues to be better than that of the conventional banks. After a decline in the ratio of total loans-to-total assets in 2001, this ratio increased steadily until 2004 and reached to more than 80% for the SFHs and around 40% for the conventional banks (figure 3). Both special finance houses and conventional banks have higher asset quality for the period 2000-2004 as compared to 1990-2000.

With respect to loan quality, the SFHs and the conventional banks show similar trends. In 2001, due to a large increase in the amount of non-performing loans during the crisis, there is a big deterioration in the loan quality for both special finance houses and the banks (the ratio of non-performing loans to total loans reached to more than 20% in 2001); however, after 2001, a continuous improvement is being observed in this dimension and in 2004, the share of non-performing loans in total loans falls below 5% for both institutions (figure 4). Finally, we compare the earnings performance. As shown in figure 5, conventional banks' profits were negative before and during the crisis. This can be associated with the mismanagement of the 20 banks, transferred to the State Deposit Insurance Fund during the same period. After the enactment of the new Banking Law and structural transformation in this sector, banks have recovered and their profitability has increased. In 2004, the ratio of net earnings to total assets was 2%, slightly above that of the SFHs. Special finance houses managed to generate positive profits during the entire period with the exception of 2001.

5. Conclusions

As of the end of 2004, the total amount of deposits at the conventional banks is 191 billion new Turkish lira. Only 52 percent of all these deposits is transferred to the real sector as credits. In the same year, the total amount of deposits at the special finance houses is 6 billion new Turkish lira, and 82 percent of these deposits is given as credits to the real sector. Although the share of special finance houses in overall deposits is 3 percent, their share in overall credits transferred into

the real sector is 5.7 percent. This kind of differences in the share of deposits and the share of credits between special finance houses and conventional banks is visible during almost entire existence of the SFHs in Turkey. This little piece of information clearly indicates that special finance houses are doing a better job with respect to what one expects from financial institutions in general; that is to say, they are performing better than banks in terms of financing the real sector of the economy, which is especially very critical for developing countries.

From another perspective, it is a common fact that most of the conventional banks are transferring a significant portion of their deposits into government bonds. In Turkey, as in many other developing countries, public debt is very high, and thus, most of the savings are directed towards government bonds, which offer real returns sometimes as high as 40 percent. The presence of the 'risk-free' and high returns on government bonds jeopardizes the amount of credits that could be directed towards the real sector, and this affects the real sector adversely, which in turn lowers the rate of economic growth, and starts a vicious cycle. The special finance houses, as a principle, do not invest in government bonds; their operations are directed towards the real sector, and thus, they make very important contributions to the economic growth of the country.

Another interesting experience is related to the comparative performance of the financial institutions in the times of economic crisis. Turkey experienced two consecutive economic crises in November 2000 and February 2001. A lot of private banks had to be transferred to Savings Deposits Insurance Fund. Because of full state warranty on deposits in private banks, these transfers increased the public debt by around 40 billion US dollars. As there was no state warranty on the deposits at the special finance houses, no additional burden on the public debt has arisen from SFHs. Thus, the performance of special finance houses was much better than those of the conventional banks during the times of economic crisis, at least because of the debt burden resulted from the mismanagement of banks. Currently, the government has abolished unlimited state warranty on deposits at the private banks, and limited it to a reasonable number; at the same time, new legislations require the special finance houses to insure their deposits through the Association of Special Finance Houses, which was established in 2001. The introduction of "Deposit Insurance Fund for SFHs," guarantees the deposits at the SFHs in a manner similar to deposits at conventional banks; however, this fund was to be directly managed by Association of Special Finance Houses, whereas conventional deposit insurance fund is managed by the state. These provisions allowed SFHs to give more confidence to their depositors, and thus, competitive disadvantage of the SFHs with respect to conventional banks was resolved to some extent[7].

[7] After a very recent change in the banking law, both the special finance houses and the conventional banks are taken under the same limited state warranty.

Although there were big withdrawals from the financial sector in 2001 during the economic crisis, starting from 2002, special finance houses were able to increase their equity capital, deposits, assets and credits considerably. Between 2002 and 2004, the average rate of increase in each of these values was more than 50 percent (see table 1 in the appendix). Net earnings of the SFHs also demonstrated notable increases in the same period. The mentioned increases in these important indicators were significantly more than those of the conventional banks. Therefore one can make an evidence-based claim that post-crisis performance of special finance houses is superior as compared to conventional banks in Turkey.

These observations are strengthened by a recent rigorous econometric study by El-Gamal and Inanoglu (2005). This paper analyzed the cost and labour efficiencies of foreign and domestic conventional banks and special finance houses during the 1990s. They show that special finance houses are no less efficient than their conventional counterparts; in fact, they found that the SFHs are more cost-efficient (measured in terms of credit extension) when controlling for size of operations. Their results were obtained based on a Turkish banking panel dataset, thus controlling for macroeconomic and other factors affecting the performance of all banks. The labour efficiency results for SFHs suggest that they are also more efficient in terms of their hiring practices; this study also shows that the SFHs are similar to foreign banks and different from domestic banks in this respect. This result is not surprising as both SFHs and foreign banks shared the characteristic of having small numbers of branches and employees relative to domestic banks. In conclusion, they state that to the extent the SFHs "draw customers away from the conventional sector, the current results suggest that their presence does not reduce overall banking efficiency. To the extent that they may also bring into the financial system individuals who had chosen not to deal with conventional banks, they may in fact serve a positive role, by increasing financial intermediation. Thus, the current policy allowing for the continued growth of this sector appears to be sound."

One other important contribution of the SFHs is that they help increase the size and the volume of the Turkish banking sector, which is a significant obstacle in front of economic growth. Turkish people keep a considerable part of their savings either in gold or in foreign currency due to periods of high inflation for a long time.[8] The unwillingness of some part of population to put their money into banks due to their avoidance of interest-based transactions also increases the desire to hold money in gold or foreign currency forms and outside the banking sector. Special finance houses are helping to overturn this tendency, and the amount of money being injected into the financial sector is increasing. The difficulty in

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[8] Foreign currency holdings are not always put in the banks, and a considerable portion of these savings in foreign currency is held outside the banking sector.

increasing the size of the financial sector is one of the critical issues in most of the developing countries, and it seems that the special finance houses are contributing towards the solution of this problem. This contribution will be especially higher in Muslim countries, as interest-based transactions are not desirable for a good number of their citizens.

A recent study by Uyan (2004), summarizing the present position of the SFHs and presenting future projections, indicates that there is high growth potential for the SFHs in Turkey. It is estimated that in 2005, the assets of the SFHs will be 6.2 billion US dollars with a market share of 3 percent in the overall assets of the banking sector. The projections indicate that this value will reach to 26 billion US dollars in 2014, with a market share of 10 percent. The average rate of increase in total assets of the SFHs is estimated to be 17 percent annually. As the share of the SFHs increases in the banking sector, our analysis indicates that this will affect the Turkish economy positively.

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Appendix

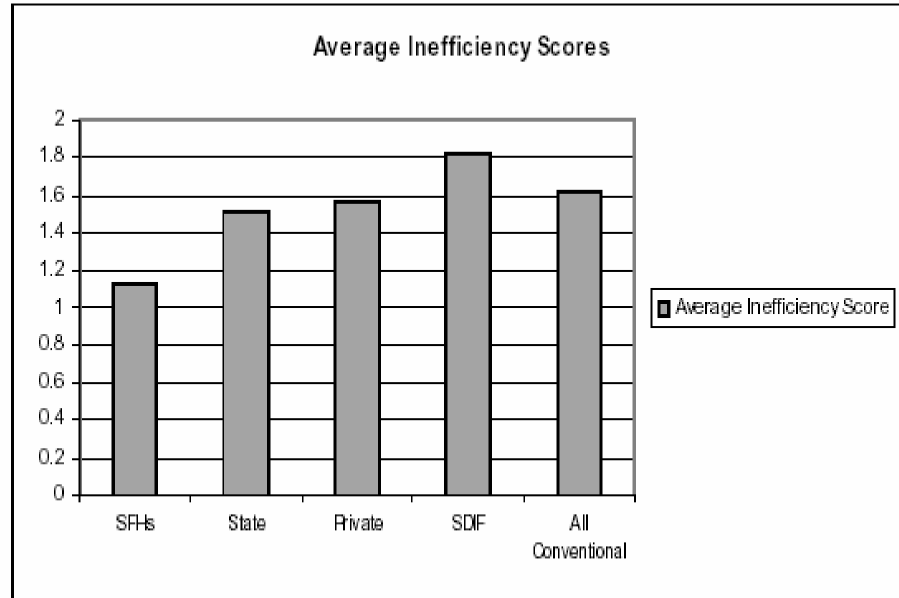
Table 1: Growth of selected variables (assets and liabilities)

		Percent Changes (%)					
		1999	2000	2001	2002	2003	2004
Total Credits	Banks	52	60	19	29	35	50
	SFHs	103	37	-38	96	49	55
Default Loans (On follow-up)	Banks	57	65	347	-43	-74	-29
	SFHs	127	136	368	9	-49	-10
Total Assets	Banks	96	44	67	23	17	23
	SFHs	96	35	4	68	33	39
Total Deposits	Banks	99	36	87	25	13	23
	SFHs	107	31	3	67	28	46
Total Equity Capital	Banks	29	70	154	40	38	30
	SFHs	79	58	26	97	68	35
Total Earnings	Banks	-140	-930	-234	127	95	13
	SFHs	18	-19	-308	170	326	54

Table 2: Selected financial ratios

		1999	2000	2001	2002	2003	2004
Capital Adequacy	Banks	0.059	0.069	0.106	0.121	0.142	0.150
	SFHs	0.061	0.071	0.086	0.101	0.128	0.124
Asset Quality	Banks	0.276	0.306	0.219	0.230	0.265	0.324
	SFHs	0.887	0.926	0.559	0.655	0.763	0.817
Loan Quality	Banks	0.044	0.046	0.172	0.076	0.015	0.007
	SFHs	0.016	0.028	0.209	0.116	0.040	0.015
Earnings Performance	Banks	-0.004	-0.030	-0.061	0.014	0.022	0.021
	SFHs	0.009	0.005	-0.010	0.004	0.014	0.013

Figure 1: Efficiency Scores for different types of financial institutions.



Source: El-Gamal and Inanoglu (2004).

Figure 2: Capital Adequacy Ratio (Equity Capital / Total Assets) 1999-2004.

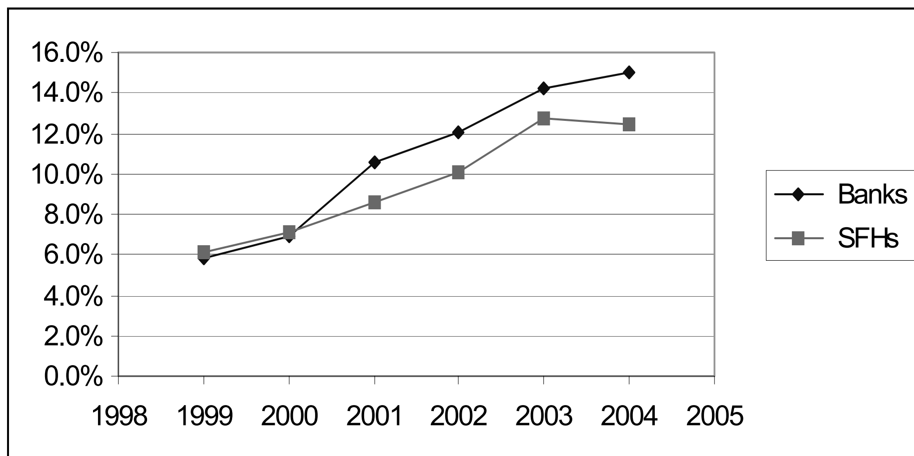


Figure 3: Asset Quality Ratio (Total Loans / Total Assets) 1999-2004.

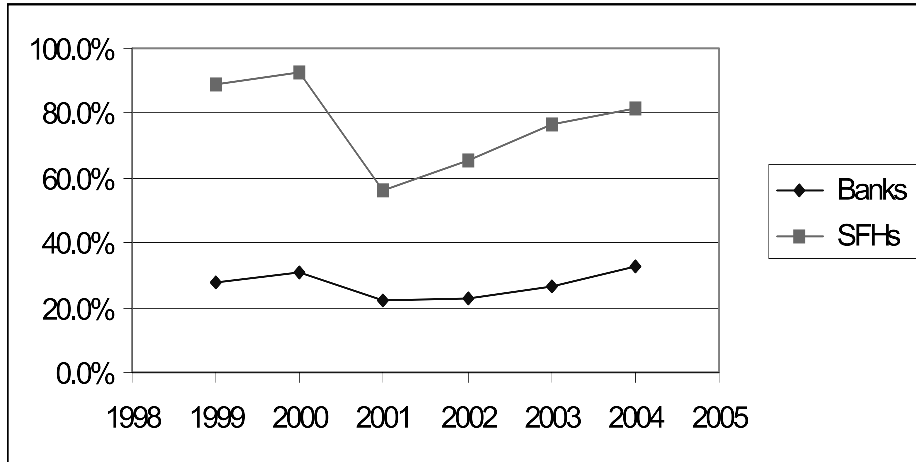


Figure 4: Loan Quality Ratio (Nonperforming Loans / Total Loans) 1999-2004.

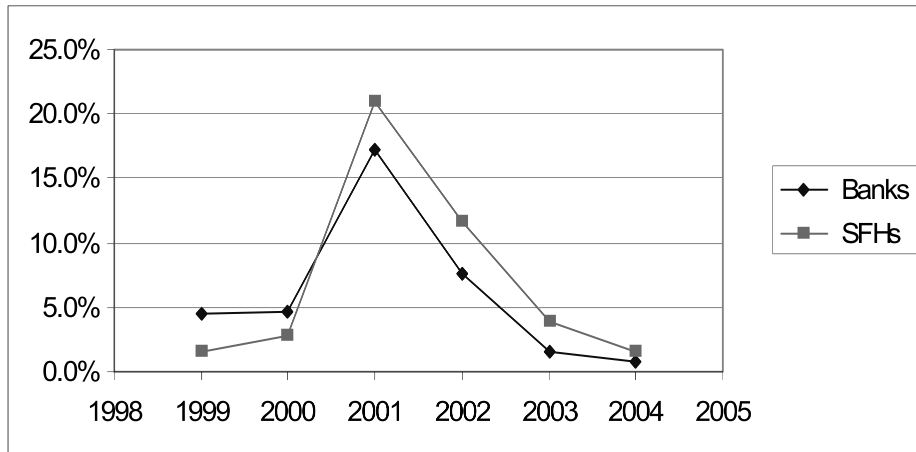
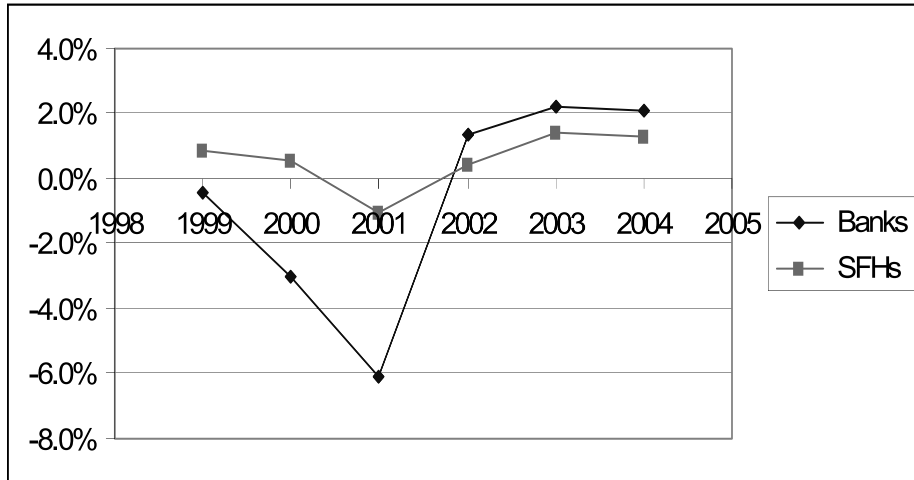


Figure 5: Earnings Performance (Net Income / Total Assets) 1999-2004.



13

Islamic Investment: Evidence From Dow Jones and FTSE Indices

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Despite the increasing attention to Islamic investment, the empirical studies on Islamic indices and/or funds are scarce. Due to increased monitoring costs, availability of a smaller investment universe, and restricted potential for diversification, it has been argued that unscreened benchmarks should outperform Islamic (ethical) investment. This paper examines the impact of the Sharīʿah screening on the performance of FTSE Global Islamic index and Dow Jones Islamic Market Index (DJIMI) using a number of performance measurement techniques. We particularly examine whether returns earned by investors who purchases shares in the FTSE Global Islamic and DJIMI indices are significantly different from their indices counterparts, both in the short-run and long-run. In order to capture the impact of the changes in the economic conditions on the indices performance, we divide the sample period into bull and bear market periods. Our findings provide strong evidence to reject the assumption that Sharīʿah investing offer inferior investment performance compared to unscreened portfolios.

Introduction

Until the 1970s, a great proportion of the Muslim community was not involved in any stock market investments due to Islamic prohibition of certain business activities. In the 1990s, a major breakthrough took place in religious rulings related to equity investment, and since then Islamic equity funds have started to operate. It has recently been estimated that the Islamic financial markets have $230 billion to invest, an amount that is growing annually by 15% (Hakim and Rashidian, 2004).

Islamic equity funds experienced strong growth during the second half of the 1990s. In 1996, there were 29 Islamic funds, valued at US$800 million. During that

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period, the performance of the Islamic funds was mixed whereby investors lacked a suitable benchmark to assess performance. By March 2002, the number of Islamic funds rose to 105 with total assets of US$3.3 billion, down from US$5 billion in 2000 (Siddiqi, 2002). As a result of the increasing demand for Islamic equity investment, the International Investor (of Kuwait) in collaboration with FTSE Group, The Independent Global Index Company (based in London), launched the first Islamic equity index series, FTSE Global Islamic Index Series (GIIS) at the end of 1998. Subsequently, in February 1999 the first Dow Jones Islamic market index (DJIMI) was launched to track the performance of companies whose activities are consistent with Islamic principles from 34 countries.

Due to increased monitoring costs, availability of a smaller investment universe, and restricted potential for diversification, it has been argued that unscreened benchmarks should outperform Islamic investment. Despite the increasing attention to Islamic investment, the empirical studies on Islamic indices and/or funds are scarce.

This paper examines the impact of the ethical screening on the performance of FTSE Global Islamic index and Dow Jones Islamic Market Index (DJIMI) using a number of performance measurement techniques. We examine whether returns earned by investors who purchases shares in the FTSE Global Islamic and DJIM indices are significantly different from their indices counterparts, both in the short-run and long-run. In this paper, we provide a comprehensive study on the accurate performance of each Islamic index by capturing the effects of different economic conditions on returns.

The rest of the paper is organized as follows: Section 2 provides an overview of the current major Islamic indices and a summary of the empirical studies on Islamic indices performance. Section 3 explains the main hypothesis of the study and its theoretical background, while Section 4 identifies the variables used in the study and specifies the different sample periods. Section 5 gives full description of the methodology utilized in the study. Results are discussed in Section 6, while Section 7 concludes.

2. Islamic Indices: an Overview

At the end of December 1998 and due to the growing interest in Islamic finance, FTSE, in collaboration with the International investor, launched FTSE Global Islamic Index Series (GIIS). GIIS are equity benchmark indices designed to track the performance of leading publicly trading companies whose activities are consistent with Islamic Sharīʿah principles. The GIIS are a subset of FTSE All-World Index group,[1] which includes stocks from 29 countries.[2] FTSE has 15

[1] The FTSE All-World Index covers 48 different countries and over 2,700 stocks. The index is divided into Developed, Advanced Emerging and Emerging segments.

Islamic indices, classification is based on industry (10 indices) and region (Global, Americas, Europe, Pacific Basin, South Africa).

The GIIS are calculated at the end of each day when the FTSE All-World Index is calculated where the base currency for the GIIS is the US dollar. Companies are included in the appropriate GIIS index, if they are current constituents of one of the FTSE All-World index markets and also meet the Islamic criteria. Islamic Sharīʿah principles exclude stocks whose core activities are related to any of the following: banking or any other interest related activity, alcohol, tobacco, gambling, arms manufacturing, life insurance, pork production, packaging and processing any activity related to pork, and companies with gross interest bearing debt to total assets exceeds 33%. GIIS have a management committee which is responsible for the calculation of the GIIS, reviewing the GIIS and approving changes to the constituents. The GIIS are reviewed semi-annually in the first week of March and September. If a stock drops out of the FTSE All-World Index markets, it is removed from the relevant GIIS index. Further, if a stock of the GIIS fails to meet the eligibility criteria, the management committee removes it from the relevant GIIS index. Changes arising from the semi-annual review are implemented after the close of the index calculation on the third Friday in March and September.

In February 1999, Dow Jones launched its first Islamic market index. The Dow Jones Islamic Market Index (DJIMI) is a subset of Dow Jones Global Indexes (DJGI) group, which includes stocks from 34 countries and covers 10 economic sectors, 18 market sectors, 51 industry groups and 89 subgroups defined by the Dow Jones Global Classification Standard. The DJIMI excludes from the index universe any industry group that represents an incompatible line of business with Islamic principles. Those activities include tobacco, alcoholic beverages, pork, gambling, arms, pornography, hotel and leisure industry, and conventional financial services (banking, insurance, etc).

Once companies with unacceptable primary business activities have been eliminated from the universe, the remaining stocks are tested according to three filters designed to limit the Dow Jones Islamic universe to the most desirable firms. Debt and assets are considered, as to which extent that assets are financed by debt. Thus, the debt/capital ratio should not exceed 33% in order for a firm to be included in the DJIMI. Companies are also excluded if the sum of cash and interest bearing securities exceeds 33% of market capitalization. Firms also cannot be included in the DJIMI if accounts receivables is greater than 45% of total assets. Companies that pass these criteria are included in the DJIMI investable universe.

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[2] Countries eligible for inclusion in the FTSE Global Islamic Index series are: Australia, Austria, Belgium/Luxembourg, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Indonesia, Ireland, Italy, Japan, Mexico, Netherlands, New Zealand, Norway, Philippines, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, UK and USA.

DJIMI is created and maintained according to a consistent methodology. It is monitored by a supervisory board of Islamic scholars that advise Dow Jones on matters pertaining to the compliance of the indices' eligible components. The composition of the DJIMI is reviewed quarterly with changes implemented on the third Friday in March, June, September and December. Market data from the end of January, April, July and October are used as the basis for the revision process. The review process is carried out by repeating the universe creation and component selection processes as described above. In addition to the quarterly and annual composition reviews, the DJIMI is reviewed on an ongoing basis. A change in the index is necessary if an extraordinary event such as bankruptcy, merger, and take-rover affect the index component. Furthermore, when there is a new issue and it is added to the Dow Jones Global Indices, it is also evaluated according to the DJIMI criteria to determine whether it will be included in the DJIMI.

It has been argued that excluding significant chunks of business from Islamic portfolio funds runs the risk of losing out in terms of overall performance since liquor companies in general have been able to withstand the recent global recession very well and were among the world best performers. On the other hand, in the recent global recession and on several occasions before the collapse of high-profile companies such as WorldCom and Enron, DJIMI was able to detect signs of corporate troubles and remove those stocks from the Islamic indices. Almost a year before WorldCom's collapse, the DJIMI removed WorldCom from its indices. WorldCom was taken out because its debt to market capitalization ratio exceeded the limit of 33 percent that DJIMI requires in order to include a company in the Islamic indices.[3] As soon as WorldCom was removed from DJIMI, the Islamic fund managers sold off WorldCom shares, when share price was trading at $14. Six months later, the share has lost its entire value.

Despite the growing interest in Islamic finance, there are few empirical studies that examine the performance of Islamic equity investing in the literature. Hassan (2002) examines the issues of market efficiency and the time-varying risk return relationship for the DJIMI over the 1996-2000. Several statistical tests, such as serial correlation; variance ratio; and Dickey-Fuller tests, were employed. The results document that DJIMI returns are normally distributed and the DJIMI has remarkable market efficiency. Utilizing a GARCH econometric framework, Hassan also tests the volatility of the DJIMI returns. His results show that there is still operational inefficiency at DJIMI that needs to be corrected to make the risk behaviour of DJIMI stable overtime.

Using cointegration and causality analysis, Hakim and Rashidian (2004) examine the relationship between DJIMI, Wilshire 5000 index, and the risk-free

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[3] The decision to take off WorldCom from DJIMI was an automatic decision since the debt had gone beyond the limit and therefore were no longer in accordance with the Islamic principles.

rate- proxied by the three month treasury bill over the time period 1999-2002. They find that the DJIMI is not correlated with neither Wilshire 5000 index nor the three month treasury bill. The results also show that the changes in the DJIMI are not caused by the Wilshire 5000 or the three month treasury bill. They conclude that the filtering criteria adopted to eliminate non-compliant firms leads to an Islamic index with a unique risk-return characteristics that are not affected by the broad equity market.

Hussein (2004) examines the hypothesis that the performance of the FTSE Global Islamic index is significantly different from those of the FTSE All-World Index during the sample period 1996-2003. A comparison of the raw and risk-adjusted performance show that the Islamic index performs as well as the FTSE All-World index over the entire period. There is evidence that the Islamic index yields statistically significant positive abnormal returns in the bull market period, though it underperforms the FTSE All-World index in the bear market period. In general, the results show that the application of ethical screens does not have an adverse impact on the FTSE Global Islamic index performance.

3. The Hypothesis

Opponents of ethical investing unscreened benchmarks may outperform ethical investment since using ethical investing criteria may cause additional screening and monitoring costs, availability of a smaller investment universe, and restricted potential for diversification (Temper, 1991). In particular, ethical screening tends to eliminate large firms from the investment universe and as a result remaining firms tend to be smaller and have more volatile returns.

Advocates of ethical investing argue that a company that adopts and implements an effective corporate responsibility policy is better positioned to avoid any environmental and social crises that could lead to reputation damage, higher production costs, lost production, higher security costs, and increased insurance premiums. Good corporate responsibility practise can offer companies range of opportunities to help them secure a competitive advantage.

Here, we examine the hypothesis that whether returns earned by investors who purchases shares in the FTSE Global Islamic and DJIM indices are significantly different from their indices counterparts, both in the short-run and long-run.

4. Data

We use the Dow Jones Islamic Market Index (DJIMI) and adopt the Dow Jones World Index as a corresponding index. Since the Dow Jones company was able to track-back the Islamic index, thus our sample period is extended to cover from January 1996 to December 2004. On the other hand, we use the FTSE All-World index as the counterpart index of the FTSE Global Islamic Index. The available sample period of the FTSE Islamic indices are two years longer that the Dow Jones

Islamic indices since the FTSE company can provide historical monthly data on the Islamic indices from December 1993.

In order to capture the impact of the changes in the economic conditions on the indices performance, we divide the sample period into bull and bear market periods. The sample period is classified into three sub-periods: bull period (1) from Dec 1993 – Dec 2000, bear period from Dec 2000- Sept 2002, bull period (2) from Sept 2002 to Dec 2004.

To capture the risk factor, we use the world portfolio as a reference portfolio (market benchmark) for both the Islamic index and its index counterparts. Therefore, we follow other studies and use the monthly data of the World Index All International, established by Morgan Stanley database, as an appropriate proxy for the market portfolio. Furthermore, we use the one-month US treasury bill return as a proxy for risk-free rate.

5. Methodology

This section highlights the methodology that we employ to achieve the objectives of this study. We utilize the parametric t statistic and the non-parametric signed-rank test to examine whether the Islamic indices achieve abnormal returns for investors based on monthly returns. The long-run performance is calculated using more than one technique.

To test the behaviour of the Islamic indexes and compare them with the corresponding indices (FTSE All-World index, and Dow Jones World index), we calculate the return on a monthly basis by taking the logarithmic difference of the price index, so that:

$$R_{i,t} = [\log(P_{i,t}) - \log(P_{i,t-1})] \qquad (1)$$

where $R_{i,t}$ is the raw return for index i for the time t, $P_{i,t}$ refers to the price of index i at time t, and $P_{i,t-1}$ is the price of index i at time t-1.

Since the Islamic indexes and their index counterparts are not from the same category of risk, and since the raw returns are not adjusted for risk, we utilize the Capital Asset Pricing Model (CAPM) in order to estimate the risk-adjusted returns:

$$\left\{(R_{i,t} - R_{f,t}) = \alpha_{i,t} + \beta_{i,t}(R_{m,t} - R_{f,t}) + \varepsilon_{i,t}\right\} \qquad (2)$$

where $R_{f,t}$ is the risk-free rate measured by a short-term one-month treasury bill return, $R_{m,t}$ is the monthly return on the market portfolio (Morgan Stanley World Index All International) in period t, $\alpha_{i,t}$ is an intercept and known as Jensen

(1968) measure of performance or Jensen's alpha, and $\beta_{i,t}$ is the risk of index i in period t relative to benchmark, m. $\varepsilon_{i,t}$ is an error term. Note that ($R_{i,t} - R_{f,t}$) is the excess return on the Islamic index i in period t and ($R_{m,t} - R_{f,t}$) is the excess return on the benchmark index m in period t. If beta is greater than one, this indicates that index i has higher risk than the benchmark index m. Further, if alpha is positive and statistically significant, it indicates that the index i outperforms the market index m.

Based on Jensen measure and given $\beta_{i,t}$ from equation (2), the risk-adjusted returns can be calculated as follows:[4]

$$\overline{R}_{i,t} = \left\{R_{i,t} - R_{f,t} - \beta_{i,t}[R_{m,t} - R_{f,t}]\right\} \tag{3}$$

where $\overline{R}_{i,t}$ is the risk-adjusted monthly return of index i.

We test the null hypothesis that the monthly excess returns (market-adjusted return) over different periods are equal to zero where the market-adjusted return is calculated as follows:

$$MAR_{i,t} = R_{i,t} - R_{crp,t}, \tag{4}$$

where $MAR_{i,t}$ is the abnormal return or market-adjusted return for index i for the month t, and $R_{crp,t}$ is the raw return on corresponding reference portfolio for the month t, Under the null hypothesis, these test statistics follow a Student's t-distribution if the sample is normally distributed. Given the fact that some returns might not be normally distributed, an alternative (non-parametric) technique is also implemented. We adopt the non-parametric Wilcoxon signed-rank test, which examines the null hypothesis that the median abnormal return is equal to zero. Although the non-parametric test statistic is less sensitive to the presence of outliers, it is, however, less powerful than the t-test if the data all come from a single normal distribution. Hence, we use both test statistics for the robustness of the results.[5] Further, we use Skewness and Kurtosis tests to examine whether the monthly return series are normally distributed.

We, then, examine the long-run performance of the concerned indices. The literature shows that there is no consensus on the appropriate methodology of

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[4] Jensen measure is the most commonly used and widely accepted measure of risk-adjusted returns in the literature.

[5] The findings from the parametric test should be treated with caution if their corresponding returns are not normally distributed.

calculating long-run returns (see, among others, Barber and Lyon, 1997; Kothari and Warner, 1997; Brav and Gompers, 1997; and Lyon, Barber and Tsai, 1999). So, we use two alternative methods to calculate long-run returns: buy-and-hold returns (BHRs) and cumulative returns (CRs). We compute CRs and BHRs utilizing both the raw returns and the Jensen return model, which take the risk factor into consideration.

$$CR_{i,s,e} = \sum_{t=s}^{e} R_{i,t}, \tag{5}$$

where $CR_{i,s,e}$ is the cumulative return for index i from the event month s to the event month e, where s is the starting month of the calculated period of an index i and e is the end of the calculated period.

We also calculate BHR as follows:

$$BHR_{i,T} = \left[\prod_{t=1}^{T} (1 + R_{i,t}) - 1 \right] \tag{6}$$

where $BHR_{i,t}$ is the buy-and-hold return for index i, is in period T, and $t = 1$ indicates the first month of the calculated period of an index i.

As we previously did, we take into account the risk factor. Hence, we already calculated the returns of each index based on the Jensen measure, we apply the same two forms, CRs and BHRs, to the risk-adjusted returns.

6. The Results

Table (1) presents the average monthly raw returns of the DJ indices. It shows that the DJ Islamic index outperforms its counterpart in the entire period (1996-2004) and bull period (1). It is worth noting that the median monthly return of the DJ World index is higher than the DJ Islamic returns over the entire period. This indicates that the Islamic index has greater volatility compared with the DJ world index. On the other hand, the DJ Islamic index fails to maintain its superior performance over the bear market period and in the recent bull period where the DJ World index provides investors with higher average monthly returns.

Table (2) presents the average monthly returns of the FTSE indices. The findings from the FTSE indices tend to be similar to those of Table (1). Table (2) reports that the FTSE Islamic index has a better performance over the FTSE All-World index in the entire and bull (1) periods. In the contrary, the FTSE Islamic index under perform its counterpart in the bear market. Further, both indices provide an average monthly return of 0.013 in the bull (2) period.

In order to provide more meaningful estimates of the indices performance, the risk factor should be controlled, thus we proceed and estimate the risk-adjusted returns using CAPM model (as shown in equations 2 and 3). The results of the OLS estimations of equation (2) are shown in Table (3). It is interesting to note that the betas of the two Islamic indices are greater than unity and higher than those of the two counterpart indices (DJ World index and FTSE All-World index). These results imply that the two Islamic indices are riskier than the benchmark (Morgan Stanley World Index All International index) and the counterpart indices. In fact, the DJ Islamic index has a higher risk than the FTSE Islamic index since the risk coefficients are 1.07 and 1.01, respectively. Table (2) also reports that Jensen's alpha is positive for all four indices but statistically insignificant for all cases. This means that the Islamic indices do not provide any marginal return over the benchmark return. Further, the R2 statistic, which shows the proportion of variation in the return of the index that is explained by variations in the market (benchmark) return, is quite high (above 81 percent) for the DJ World Index and FTSE indices, suggesting that the three indices move in line with the market. In contrast, the R2 statistic is quite low (0.37) in case of the DJ Islamic index. This would imply that the deviations of the DJ Islamic index from the MSCI index are considerable and MSCI may not be the suitable benchmark index for the DJ Islamic index.

Table 1: Raw Returns of Dow Jones Indices

	Mean	Median	Min.	Max.	Std.Dev.	Skew.	Kurt.
Entire Period							
DJ Islamic	0.009	0.007	-0.169	0.221	0.077	0.468	0.448
DJ World	0.005	0.011	-0.129	0.135	0.046	-0.259	0.644
Bull Period (1)							
DJ Islamic	0.026	0.018	-0.169	0.221	0.096	0.179	-0.529
DJ World	0.013	0.017	-0.129	0.127	0.043	-0.500	1.653
Bear Period							
DJ Islamic	-0.024	-0.026	-0.128	0.092	0.057	0.269	-0.727
DJ World	-0.018	-0.020	-0.103	0.093	0.050	0.067	-0.650
Bull Period (2)							
DJ Islamic	0.012	0.014	-0.101	0.084	0.039	-0.728	1.432
DJ World	0.014	0.019	-0.089	0.135	0.041	0.215	2.751

Notes: Min. Max. St. Dev., Skew. and. Kurt refer to minimum, maximum, standard deviation, skewness and kurtosis, respectively.

Table 2: Raw Returns of the FTSE Indices

	Mean	Median	Min.	Max.	Std.Dev.	Skew.	Kurt.
Entire Period							
FTSE Islamic	0.007	0.010	-0.137	0.154	0.047	-0.388	0.775
FTSE All-World	0.006	0.008	-0.112	0.091	0.042	-0.412	0.042
Bull Period (1)							
FTSE Islamic	0.017	0.017	-0.124	0.154	0.042	-0.137	1.975
FTSE All-World	0.012	0.011	-0.110	0.091	0.038	-0.424	0.463
Bear Period							
FTSE Islamic	-0.022	-0.020	-0.137	0.064	0.053	-0.156	-0.501
FTSE All-World	-0.017	-0.020	-0.112	0.075	0.049	0.068	-0.614
Bull Period (2)							
FTSE Islamic	0.013	0.017	-0.100	0.103	0.047	-0.596	0.541
FTSE All-World	0.013	0.018	-0.112	0.086	0.041	-0.854	1.877

Notes: Min. Max. St. Dev., Skew. and. Kurt refer to minimum, maximum, standard deviation, skewness and kurtosis, respectively.

Table 3: OLS Estimation

Index	Alpha	Beta	R^2
DJ Islamic	0.003	1.07	0.37
	(0.56)	(7.87)***	
DJ World	0.0002	0.99	0.90
	(0.13)	(30.30)***	
FTSE Islamic	0.001	1.01	0.81
	(0.70)	(22.90)***	
FTSE All-World	0.00	0.99	0.99
	(0.14)	(100.81)***	

Notes: Three asterisks indicate significance at the 1 percent level.

Based on the calculation of Equation (3), the risk-adjusted returns are reported in Tables (4) and (5). The results from the Dow Jones indices are similar to those obtained from the FTSE indices. The results indicate that the Islamic indices offer investors higher monthly returns compared to their counterparts in the entire and bull (1) market periods. The Islamic indices fail to sustain their superior performance during the bear and bull (2) market periods whereby both DJ World Index and FTSE All-World Index achieve higher mean monthly returns compared with the Islamic counterpart indices. Overall, the risk-adjusted findings of Tables (3) and (4) are fairly similar to those of the raw returns in Tables (1) and (2).

Notes: Min, Max, St. Dev., Skew. and Kurt. Refer to minimum, maximum, standard deviation, skewness and kurtosis, respectively.

Table 4: Risk Adjusted Returns of Dow Jones Indices

	Mean	Median	Min.	Max.	Std.Dev.	Skew.	Kurt.
Entire Period							
DJ Islamic	0.004	0.002	-0.132	0.164	0.061	0.369	1.757
DJ World	0.000	-0.001	-0.053	0.049	0.015	-0.142	2.661
Bull Period (1)							
DJ Islamic	0.012	0.014	-0.132	0.164	0.088	-0.005	-0.660
DJ World	-0.001	0.000	-0.046	0.038	0.014	-0.397	2.998
Bear Period							
DJ Islamic	-0.004	-0.005	-0.041	0.027	-0.017	-0.140	-0.318
DJ World	0.000	-0.003	-0.038	0.027	0.015	0.128	0.669
Bull Period (2)							
DJ Islamic	-0.002	-0.003	-0.031	0.019	0.009	-0.680	2.537
DJ World	0.001	0.003	-0.53	0.049	0.018	-0.357	2.902

Notes: Min. Max. St. Dev., Skew. and. Kurt refer to minimum, maximum, standard deviation, skewness and kurtosis, respectively.

Table (5): Risk Adjusted Returns of the FTSE Indices

	Mean	Median	Min.	Max.	Std.Dev.	Skew.	Kurt.
Entire Period							
FTSE Islamic	0.002	0.002	-0.108	0.112	0.021	0.066	14.559
FTSE All-World	0.000	0.000	-0.031	0.024	0.005	-1.398	20.694
Bull Period (1)							
FTSE Islamic	0.004	0.005	-0.081	0.093	0.017	0.212	17.004
FTSE All-World	-0.001	0.000	-0.031	0.024	0.006	-1.034	13.825
Bear Period							
FTSE Islamic	-0.002	0.000	-0.048	0.042	0.018	-0.312	1.526
FTSE All-World	0.001	0.001	-0.007	0.010	0.003	0.300	4.041
Bull Period (2)							
FTSE Islamic	-0.001	-0.002	-0.108	0.112	0.031	0.241	11.463
FTSE All-World	0.000	0.000	-0.003	0.003	0.001	-0.411	-0.227

Notes: Min. Max. St. Dev., Skew. and. Kurt refer to minimum, maximum, standard deviation, skewness and kurtosis, respectively.

Now we proceed and test whether the excess monthly returns (abnormal returns) of the Islamic index are equal to zero. We employ the parametric t- test and the non-parametric Wilcoxon signed-rank test. Based on market adjusted and Jensen models, the results in Table (6) indicate that the yields of the Islamic indices

do not differ significantly from those of the other two counterpart indices in the entire period. The null hypothesis cannot be rejected in seven cases out of eight.

With respect to the bull (1) market period, there is a clear evidence that there is a statistically significant difference between the Islamic index and the FTSE All-World index at the 5 percent level. With respect to the DJ indices in the bull (1) period, the parametric tests do not reject the hypothesis that observed difference in average performance between the two DJ indices is insignificant, while the non-parametric test provide mixed evidence.

With respect to the bear market period and based on raw returns, both tests (parametric and non-parametric) show that (negative) abnormal returns of the two (DJ and FTSE) Islamic indices are significant at the five and ten percent levels, respectively. The results are entirely different when findings are based on risk-adjusted returns whereby the null hypothesis on insignificant abnormal returns cannot be rejected.

With respect to the second bull market period, the results indicate no significant difference the Islamic indices returns and those of two counterpart indices since the null hypothesis cannot be rejected in all eight cases.

Table 6: Mean Abnormal Monthly Return for the Islamic Index

	Dow Jones		FTSE	
	Market-adjusted	Jensen	Market-adjusted	Jensen
Entire Period				
mean abnormal return	0.004	0.004	0.001	0.002
t-statistics	(059)	(0.67)	(0.73)	(0.97)
median abnormal return	0.001	0.001	0.001	0.002
z-statistics	(0.52)	(0.88)	(1.45)	(1.85)*
Bull Period (1)				
mean abnormal return	0.013	0.013	0.005	0.005
t-statistics	(1.03)	(1.04)	(2.18)**	(2.28)**
median abnormal return	0.011	0.014	0.004	0.006
z-statistics	(1.88)*	(1.93)*	(3.26)***	(3.49)***
Bear Period				
mean abnormal return	-0.007	-0.004	-0.005	-0.003
t-statistics	(-2.04)**	(-1.45)	(-1.61)*	-(0.92)
median abnormal return	-0.005	-0.005	-0.003	-0.001
-z-statistics	(-2.03)**	(-1.56)	(-1.71)*	(-0.99)
Bull Period (2)				
mean abnormal return	-0.002	-0.003	0.000	-0.001
t-statistics	(-0.76)	(-0.94)	(-016)	(-0.29)
median abnormal return	-0.004	-0.001	-0.001	-0.001
z-statistics	(-0.99)	(-1.17)	(-0.63)	(-1.09)

Notes: One, two and three asterisks indicate significance at the 10, 5 and 1 percent levels.

Further, we examine the long run performance of the four indices. The cumulative return (CR) and buy-and-hold return (BHR) methods are employed. The results, given in Table (7), are quite consistent with our earlier findings of the short run (monthly) performance. Based on raw returns and risk-adjusted returns, Table (7) indicates that the Islamic indices outperform their counterpart indices in the entire and first bull market periods. On the other hand, the two counterpart indices provide superior long tern returns compared with the Islamic indices in the bear and second bull market periods.

Table 7: Long-run Performance

	Raw Returns				Risk-Adjusted Returns			
	DJ Indices		FTSE Indices		DJ Indices		FTSE Indices	
	Islamic	World	Islamic	World	Islamic	World	Islamic	World
Panel A: Cumulative Returns								
Entire Period	0.95	0.57	0.096	0.78	0.45	0.02	0.24	-0.01
Bull Period(1)	1.30	0.68	1.23	0.89	0.01	-0.04	0.32	-0.04
Bear Period	-0.75	-0.55	-0.68	-0.53	-0.13	0.01	-0.06	0.03
Bull Period(2)	0.33	0.40	0.37	0.38	-0.05	0.03	-0.01	0.01
Panel B: Buy and Hold Returns								
Entire Period	0.09	0.58	1.26	0.95	0.39	0.01	0.32	-0.01
Bull Period(1)	1.91	0.84	2.20	1.30	0.98	-0.08	0.80	-0.09
Bear Period	-0.57	-0.46	-0.55	-0.47	-0.02	0.02	-0.05	0.00
Bull Period(2)	0.52	0.59	0.56	0.60	-0.10	0.01	-0.03	0.02

7. Conclusions

The main objective of this study is to examine whether returns earned by investors who purchases shares in the Dow Jones Islamic Index and FTSE Global Islamic index are significantly different from those of the Dow Jones World Index and FTSE All-World Index, both in the short-run and long-run. In order to control for changes in market conditions, the performance of the four indices is measured over several periods: entire period from Dec 1993 – Dec 2004, bull period (1) from Dec 1993 – Dec 2000, bear period from Dec 2000- Sept 2002, bull period (2) from Sept 2002 to Dec 2004.

Our findings indicate that the application of Sharīʿah screens does not have an adverse impact on the Islamic indices performance. In the short run, a comparison of the raw and risk-adjusted performance show that the Islamic indices perform as well as their counterparts over the entire period and the second bull market period. There is clear evidence that the Islamic indices yield statistically significant positive abnormal returns in the first bull market period, though the Islamic indices under-perform the Dow Jones World Index and FTSE All-World index in the bear market period. In the long run, there is a clear evidence that the Islamic indices have a superior performance compared with their counterparts in the entire and first bull market periods. On the other hand, the Islamic indices fail to sustain their better performance over the bear and second bull market periods since the counterpart indices achieve higher returns.

In general, our findings reject the assumption that Sharīʿah investing offer inferior investment performance compared to unscreened portfolios.

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Comments

on "Evaluation of Islamic Banking Performance: Criteria, Models, and Priorities" by Zubair Hasan

Asad Zaman*

Introduction

This is an excellent overview of the literature on evaluation of performance of Islamic Banks. It begins with a much needed review of technical details of two popular methods for evaluating the performance of banks – the so called DEA and SFA are clearly explained, and the assumptions behind these measures are spelled out. After laying out the required technical apparatus currently used to evaluate banking efficiency in conventional economic literature, they turn to review a number of studies of Islamic Banks which use these performance criteria.

Hasan presents an excellent technical critique of many papers in this field. Instead of going over well trodden ground, I would like to focus on a few elements which are general weaknesses in the literature, in the hope that more attention would be paid to these issues in future studies. These are based on the findings of Hasan and his statements regarding the papers in question. Not all of the criticisms below apply to all papers reviewed by Hasan, but the points made below do generally apply to the majority of the studies reviewed.

1. As Hasan points out, Majid et. al. use a data set on Malaysian bank performance from 1993 to 2000, without making any reference to the East Asian crisis. A large number of interesting issues are thereby swept under the rug. Of great interest would be the post crisis performance of Islamic Banks in comparison with conventional banks, especially since Islamic Economic theorists have often asserted that Islamic banks would have superior stability in crisis environments.
2. In reference to the previous point, it is likely that the data set contains outliers, due to the East Asian crisis. Outliers have a major impact on standard OLS type analyses. Econometricians frequently ignore outliers, or else use inappropriate tools to deal with them. See Chapter 5 of Zaman (1996) for an extended discussion.

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3. There is insufficient historical background, context, and attention to details of the Malaysian context – for example, no allowance is made of the existence of Islamic windows in conventional banks. This is typical problem (not confined to Islamic economics) – the tools of econometrics overpower the thought process. Data combined with high powered number crunching software packages are used to produce undigested results. It would be much better to do a historical analysis and look at basic insights from conventional viewpoints. Elementary graphical and exploratory data analysis often produces useful insights which could be backed up by more sophisticated analyses.
4. There is no sensitivity analysis to alternative assumptions. Sophisticated data analysis depends on making a complex set of assumptions, and it is essential to assess how much of the analysis depends on these assumptions. As Hasan has discussed, the efficiency analyses depend on assumptions about perfect competition, cost minimization, profit maximization, as well as complex technical assumptions about distributions and functional forms of the production function. It is entirely unclear how much of the result depends on these assumptions. There is also no assessment of the extent to which the data set conforms to these assumptions. As Hendry (1996) has often pointed out, major econometric errors result from untested assumptions built into conventional analysis.
5. An essential requirement of science is the replicability of results. Enough information should be provided in the paper so that anyone can replicate the results obtained by the authors. Poor methodology prevents this for two reasons. Quite often, the data sets used are not described or not easily available. Editors of journals should take note, and require authors to make available all relevant data sets whenever possible. Authors should also ensure inclusion of small data sets as part of the paper, and attempt to make larger data sets available to other researchers via internet. An essential requirement for progress in any field is cumulative work. Subsequent researchers must build on previous work. This is only possible if the early researchers provide enough information to allow replication. In absence of this, every researcher starts afresh, and as a result there is no cumulative progress. As the parable goes, if 10 people dig 10 feet holes in separate spots, no one will reach the water, but if all dig at the same spot, then they will easily reach the water.
6. Another difficult with replicating results is that descriptions of what was done by the authors is so vague that it is not at all clear exactly what econometric technique was used. The variables used are not described in sufficient precision to allow reconstruction from the data set. The econometric techniques and computer packages and procedures used are not defined with sufficient accuracy to permit replication. As stated earlier,

without replicability, cumulative research is not possible, and this is a strong handicap, especially in a new field like Islamic Economics.

7. Purely technical efficiency measures identical to those used by conventional economists are not suitable for Islamic Banks, since they have different objectives. Profits are relevant, but Islamic Banks were introduced to bring about a social transformation and achieve several humanitarian and developmental objectives envisaged in the Sharīʿah. Low marks on technical efficiency would not be of great concern (provided that viability was maintained) if there was progress on these larger fronts. Almost no attention is paid to this in the studies under review.

8. To evaluate the issues discussed in the previous point, it seems likely that qualitative work will be a better place to start. Hasan cites Ausaf (2003) as a good qualitative example which assesses these larger issues. Once there is some clarity on the directions, it may be possible to work out some more quantitative methods of assessment, which would be more relevant for the Islamic dimension of banking.

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Comments

on "An Evaluation of Special Finance Houses: A Case Study on Turkey" by Savaş Alpay

Murat Cizakca*

Overall Impression

This is a highly informative and welcome paper on the latest developments in the Turkish Islamic bank sector. While I learned considerably from the paper, it suffers a basic weakness: it does not provide sufficient evidence for the many arguments of the author. If the author can do the further research necessary and provide the evidence, the paper would benefit considerably. Moreover, certain sections with long quotations can be deleted.

2. Assessment

In the abstract, the author states that studying Turkey's experience in Islamic banking would be important for countries considering to make a transition towards an interest free system. This is because such a transition will not be abrupt but gradual. Therefore studying the co-existence of the interest based and interest free systems in Turkey is important. While there is no denying the importance of studying the Turkish co-existence, Turkey does not provide the sole example. There are other Islamic countries, where a co-existence of interest based and interest free financial systems is a fact of life. If Turkey has any particular importance, the author should explain it.

In the 'Introduction' to the paper (see paragraph starting with: "In Turkey, the overall…") the author argues that "in Turkey, the overall volume of the banking sector is very low, and is less than what it should be as compared to similar countries in the developed world". A table providing the pertinent international data supporting his argument would be appropriate here.

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Note: Some of the editorial comments made here may appear superfluous because they are already incorporated in the revised version of Mr. Savas Alpay's paper.

In the same paragraph he also says that the MPS (marginal propensity to save) of the Turks is not high. Once again, a more precise figure should be provided and if possible be compared with the saving propensities of other nations. Moreover, he says that much of these savings are in the form of foreign exchange holdings. Since these holdings are also deposited in the banks, one wonders if they are part of the 14%, i.e., the share of the deposits in total savings.

The same paragraph states: “There are different reasons…”. Here the author is referring to the crowding-out effect. It would be very useful if he could quantify his argument. What exactly is the size of this crowding out-effect and how does it stand when it is compared with other countries?

In section 2 (with paragraph starting with “The operations of …”) the author states that the “operations of the special finance houses are based on interest-free system”. Everyone in the field knows that this is only half true. It is well known that the *murābaḥah* investments, which dominate the investment portfolio of Islamic banks, come uncomfortably close to the ordinary interest. The author should therefore use a more careful language. He should also provide the *murābaḥah*-total investment ratio of each major Islamic bank.

In section 2.1 entitled “Corporate Services”, while describing the financial instruments utilized by the Turkish Islamic Banks, the author should make clear how they relate to the better known Islamic financial instruments such as the *murābaḥah* or the *mushārakah* etc.

In the last paragraph of the same section 2.1 (starting with: “Other most commonly…”) the author has used some technical terms. Not all the readers may be familiar with such financial jargon. The author should therefore explain in a footnote what “avalization” means.

Paragraph starting with: “In different parts of the world…” in section 3:

Here the author talks about the many conventional banks that went bankrupt in East Asia during the 1997 crisis and in Turkey during the 2000-2001 crisis. The names of these banks should be provided in a footnote. If this is not possible, at least the number of banks that went bankrupt in East Asia should be provided.

Paragraph starting with: “A second …” in section 3:

Here the author argues that the Turkish Islamic banks are less prone to the exchange rate risks. He should substantiate his argument by providing data on the relative foreign exchange holdings of the Islamic and conventional banks.

Paragraph starting with: “The superior…” in section 3:

Here he refers to the upper limit of warranty for an individual’s deposit at a specific bank. What exactly is this upper limit? He then argues that since an individual can divide his savings among different banks so as to remain within the limit and enjoy full warranty, the limitation should have been based on individuals

and not on the banks. If the government of Turkey agreed with the author and applied his suggestion, wouldn't the new policy lead to a flight of capital from the banking system?

Furthermore the author argues that "the warranty fund from each Islamic bank generates an additional burden for them, and essentially forces them to finance the loss of their competitors had they gone bankrupt." On the face of it it is difficult to agree with the author, because the state has created two warranty systems, one for the Islamic banks and a separate one for the conventional ones. The latter also pay a certain proportion of their deposits to the Turkish Central Bank. If the author wishes to argue that the warranty burden imposed upon the Islamic banks is too heavy, then he should substantiate his argument by providing data on the relative burden of the warranties imposed upon the two systems. Actually his argument would gain further strength if he were to focus instead on the very nature of the deposits. A conventional bank promises to pay to the depositors their principal plus the rate of interest, hence the need for Central Bank warranty. By contrast, an Islamic bank signs essentially a *muḍārabah* contract with each depositor and is therefore not obliged to pay back the principal in case of crisis. Under these circumstances, actually Islamic banks should not need to contribute to any warranty scheme at all. Only if viewed from this angle, the author's argument that "the warranty fund from each SFH generate an additional burden for them, and essentially force them to finance the loss of their competitors had they gone bankrupt" makes sense.

Paragraph starting with, "Another disadvantage…" and the footnote 4:

The *ijārah ṣukūk* and *salam ṣukūk* should be briefly explained in this footnote. Are these instruments really interest free? Being Turkish, one would have expected that the author explain and suggest the so-called *Gelir Ortaklığı Senetleri* (GOS) applied by the Turkish government under Turgut Ozal. These GOS bonds were the modernized versions of a much older instrument. Indeed, the Ottoman state had successfully utilized ever since 1774 government bonds without interest called the *esham*. The author would benefit if he read the following sources on *esham*: Mehmet Genc, "Esham", *Islam Ansiklopedisi* (Ankara: Diyanet Vakfı); Murat Cizakca, *A Comparative Evolution of Business Partnerships* (Leiden: Brill, 1996) and Pinar Akkoyunlu, "Osmanli Maliyesindeki Esham Senedinin Gunumuzdeki Uzantisi: Gelir Ortakligi Senetleri", *Sosyal Bilimler Dergisi,* Mayıs 1994, c. I, no. 2, 76-85.

Section 4: Comparative Performance:

The author has summarized in detail the recent work by El-Gamal and Inanoglu. This is not appropriate for if we are interested in these works we can read them directly and do not need the author. What would be much more interesting is what the author thinks about these works. Therefore I have skipped much of this section from my comments.

Paragraph starting with: “It is clearly observed…” towards the end of section 4:

The author needs to explain, at least in a footnote, the great discrepancy in the loans-to-total assets ratios. Not every reader may realize that he is actually referring to the crowding-out effect.

Paragraph starting with: “From another perspective…”

Some excellent points are made here.

Comments

on "An Evaluation of Special Finance Houses: A Case Study on Turkey" by Savaş Alpay

Sofyan S. Harahap

The objective of Alpay's paper is to discuss the history, position, characteristics, functions and performance of the Special Finance Houses (SFH) in Turkey which were interest free financial institutions operating in a dual banking system.

The analysis shows that SFH were successful in increasing the size of the banking sector by motivating savings and bringing them for investment in the real sector. The SFH were cost efficient, generated good earnings and they were also better positioned for exchange rate risk as compared to the conventional commercial banks. They even survived the sever financial crisis of Turkey. However, SFH faced external and internal problems such as insufficient legal infrastructure, smaller capitalization and high liquidity risk due to non-availability of short-term liquidity facility. These problems came to prominence during the crisis.

The analysis in the paper can be improved by giving more background information on the Turkish economy, its financial sector and the position of SFH in it. Equally important would be the information on the role of Muslim investors in developing Islamic financial institutions in Turkey, public perception about interest, ulema's stand on the issue and government's commitment for Islamic banking industry.

The paper has given us an understanding of the role of SFHs in Turkey. The role played by SFH showed that Islamic banks can positively contribute to economic growth and the wellbeing of *Ummah*. Some financial indicators also demonstrated that Islamic banks performed better than the commercial banks. This is consistent with our general expectations and belief that Islam and its principles stand for humanity's good in this world and in the hereafter.

The case of Islamic banks in Turkey appears to have many similarities with the role and performance of Islamic banks in Malaysia, Indonesia and many other countries. Future research may focus on comparative analysis of the development and performance of Islamic banks across different countries.

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Comments

on "Islamic Investment: Evidence from Dow Jones and FTSE Indices" by Khaled A. Hussein

Javed Ghulam Hussain [*]

General Comments

The paper provides an empirical evidence for Islamic indices; FTSE Global Islamic Index (GIIS) and Dow Jones Islamic Index (DJIMI) and evaluates the impact of Sharīʿah screening on the performance of the respective indices over 1993 to 2004. The paper makes contribution towards empirical literature in Islamic finance, a niche that has potential for significant growth and is likely to promote benefits of Islamic finance or modes of finance based on this concept. The author used well-tested methodological tools in the western economics to define the variables and apply techniques to infer the results. The paper draws upon important emerging and existing literature to provide academic underpinning and justify the study. Some policy issues are considered but results reported do not consider implications and there are no explicit recommendations for policy makers or users. Results reported are derived using robust econometric techniques but there is limited discussion or justification for the definitions and construction of the indices; given the fact the indices are extracted from the FTSE and Dow Jones, a prior reasoning could be applied to argue that the results will mimic one another.

2. Specific Comments

I have a number of comments, which I hope the author will find useful in polishing the final version of his paper.

1. The introduction is competent and motivates the paper well; right length, appropriate exposition to the issues under consideration, provides some facts about the introduction of Islamic indices. However, it provides no rationale for why an index extracted from the main FTSE or Dow Jones should exhibit different outcomes, though it is acceptable practice to provide most of the discussion in the body of the paper but the introduction ought to refer to land

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marks to motivate the paper and state the purpose of the paper. For example, I will be inclined to justify the derivation of Islamic Indices, contribution they make and why their results should be different from the existing empirical results reported for western economies. The penultimate paragraph is same as the abstract; it can be expanded to provide a rationale of the paper; given the length of this section, further exposition would be useful.

2. In section 2, which deals with "an overview", it is helpful to read definitions and development of Islamic indices, but there is not much of critique or rationale provided of these indices. It is important to question/justify the composition of such indices and how they contribute towards advancement of Islamic finance in general and the user in particular. The likely criticism of Islamic indices is that, extracted data from western financial sources are likely to mimic and closely exhibit the western indices. The interesting findings of higher volatility of Islamic indices are intriguing and could benefit from further exploration; smaller companies by definition are more responsive to changing economic conditions but the definition includes all those companies which have less than 33 per cent debt in their capital structure, one would expect the volatility level to be mitigated by lower financial exposure; therefore, it would be useful to consider the major causes of volatility and implications for an investor. The second observation the author makes is that the criteria used to select companies to be included in the Islamic indices helps to minimize bankruptcy risk as evidenced by WorldCom and Enron; it can be argued that portfolio managers do use such filters and it is not a unique practice in Islamic finance. Therefore, to motivate debate and theories the risk minimization principal implicit within the selection criteria needs further exploration if we are to infer global benefit of the practice. The conclusion of empirical studies cited is that "ethical screens does not have an adverse impact on GIIS", a point that will benefit from further analysis; this should be used to rework the concluding paragraph of section 2.
3. The opening sentence of section 3 is not that easy to comprehend and author my wish to reconsider the hypothesis to make the statements more explicit, conclusive and address the corporate responsibility aspect in a more meaningful way. However, the last sentence does reflect the hypothesis quite well.
4. It is useful to extend the data series up to 1993, to give a large set of data to undertake statistical studies; it would be useful to use quarterly data and reported statistics. The author attempts to use innovation to capture the impact of changes in the economic conditions on the indices performance but this is not backed by theoretical exposition, in particular why indices performance should vary during the 'bull' or 'bear' market. There is no explanation as to why Morgan Stanley database is an appropriate proxy for the market portfolio and why the same proxy measure is applicable for different regions; at least consideration of the point will lend credibility to the paper.

5. The methodology is easy to follow; it is consistent with studies that have attempted to test market efficiency or test stock market predictability. The model derived to apply to Islamic indices closely matches the establish literature. It is appropriate to be used as it is used for a subset of the FTSE and Dow Jones Index. However, the methodology section would be robust if author could have cited research where the same methodological techniques were employed, for example Fama 1990 etc.; especially, when the study employs the set of companies extracted from the indices which are compliant with the definitions of Islamic finance.
6. Results reported are clear and consistent with the model employed. However, the author provides no analysis that may explain why the Dow Jones Islamic index outperforms its counterpart for the period (1996-2004) and 'bull' period (1993 – 2000). Author may wish to extrapolate and consider possible reasons for this pattern and draw inferences for investors and institutions. In particular, it would be useful to consider what makes companies in Islamic indices more risky and what lessons investors and institutions may learn to engender lower financial risk for all agents engaged in economic activity. In general, I would encourage the author to reconsider the results from the regressions in the paper. Ideally, the results obtained ought to tell a story, extend the logical inferences drawn from this study and consider variables which could be germane to the paper. Furthermore, the author questions the suitability of MSCI index but no discussion ensues to reason suitability of this index.
7. Surely, tables 1, 2, 3, 4 and 5 can be presented in smaller fonts that will improve presentations. Results reported in tables 3, 4 and 5 offer interesting findings; surely these need to be explained and reasoned to tell the story.
8. The conclusions are plausible, in that the key stated objectives were met. However, the hypothesis is too narrowly framed and heavily relies on basic statistical tests; secondly, there are a number of important issues which are not addressed. Firstly, the data used to test the hypothesis, FTSE and Dow Jones indices subsets could have covariance that could impact on the results, if not then at least an explanation ought to be furnished. Very important here is the source of data derived for Islamic indices and their usefulness for investors and institutions. I believe that this issue should be addressed in the literature review and implications stated in the concluding section
9. It is regrettable that no attempt is made to examine the limitation of the pure econometric studies, in particular, how data can shadow the real story; how relevant is the data and what are the limitation of this data to infer conclusion for Islamic companies operating in Islamic countries in compliance with Sharīʿah law.
10. Let us think of a number of questions in sequence.

    Question 1: How reliable is a measure that is extracted from main indices using Islamic finance definitions? I suppose, this question can be answered for this

study by stating that the study has set clear parameter and has not considered the definition used to extract companies to be included in Islamic indices.

Question2: Can we quantitatively measure the performance of screened portfolio using Sharīʿah criteria with those of unscreened portfolios? The framework used to test the hypothesis is sufficient. The answer to this is yes as well; the study achieved its stated objectives. Combining question 1 and 2 and theorizing the model lends itself to credible empirical study that could serve as a foundation for further studies. It may be too late for the author to fully incorporate the above points but at least the author should be considering some discussion in the conclusion, in order to broaden the research question and provoke some intense empirical research.

Part-V

Miscellaneous Topics

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14

An Inquiry into Alternative Models of Islamic Banking

Muhammad Iqbal Anjum*

Since the time of publication of M. N. Siddiqi's book entitled Banking Without Interest containing the first-ever comprehensive, consistent, and feasible model of Islamic banking, several theoretical models of Islamic banking have been conceived, instituted, and globally promoted. After the initial academic attempts of conceiving and instituting Islamic banks accomplishing interest-free commercial banking based on a pure financial intermediation model, diverse discourses on nature, scope and operational framework of an appropriate model of Islamic banks have culminated into models of Islamic banks such as Business Bank, Mutual Saving and Investment Association, Islamic Saving Bank, Islamic Investment Bank, Islamic Narrow Bank, and Islamic Universal Bank. Some models, being the latest additions and being generally unknown, deserve to be comprehensively understood, compared and contrasted with the earlier models of Islamic banks. In this background, this research paper synthesizes the published seminal literature on the subject.

Introduction

The novelty of Islamic banking, introduced as an Islamic counterpart to the arena of traditional capitalistic banking in the first half of the 20th century, has culminated into a banking revolution especially in the contemporary Islamic world, in the form of an institutional transition from the Islamized version of the imported interest-based capitalistic model of the commercial banking into an interest-free Islamized model of the universal[1] banking which is premised in the principles of corporate governance and has universal appeal on account of having its uniquely

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[1] The scope of the Islamic universal baking is broader than that of the conventional universal banking, which signifies multipurpose banking only, because the Islamic universal banking refers to the interest-free Islamic multipurpose banking in a geographically universal framework.

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efficient, equitable, and progressive institutional and operational mechanisms. These spectacular developments have been successful to such a great extent in drawing attention of the western economists that they (e.g., Garcia et. Al., 2004) have initiated a trend of documenting comparisons and contrasts between the capitalist model of universal banking and the model of Islamic banking.

This paper illustrates the panorama of evolution of the theoretical systemic[2] models of Islamic banking in their chronological order. It portrays the nature of conceptual and institutional transition as well as the distinguishing universal, humane, progressive, developmental, and viable systemic aspects of the movement of Islamic banking. Especially, on the basis of a comprehensive review of the alternative models of the Islamic banking, it highlights the fact that the system of Islamic banking inherently transcends the sphere of mere Islamic financial intermediation and it inevitably encompasses a universally comprehensive, progressive and equitable systemic design, infrastructure, and framework of Islamic central banking.

2. The Rationale for Instituting the Universal Banking System

After the introduction of the Western institution of interest-based bank in the Islamic regions initially colonized and later decolonized by the Western capitalist countries, the Islamic societies and their intellectuals responded to the challenge of Islamically reforming the interest-based bank in their era of modern ignorance by replicating the strategy of Islamically reforming the potentially useful institution of bank, along the lines of the Islamic reforms introduced in the pre-Islamic ancient era of *jahiliyah*, as well as integrating it within the equitable and progressive macroeconomic framework of the Islamic economic subsystem which is instituted for realizing the Islamic humanitarian goals of human development and empowerment through the accomplishment of equitable growth of output/income/wealth as well as its equitable distribution, full-employment of human and physical resources, economic stability (e.g., price stability etc.) on the universal level in the light of the Islamic guidelines available in the Holy Qur'ān and the Sunnah of the Holy Prophet Muhammad (Peace Be Upon Him).

Thus the rationale of establishing the Islamic banks and the overall Islamic monetary/financial system is political as well as economic in scope. The economic rationale for the establishment of the Islamic banks and the Islamic monetary/financial system arises in the context of insulating at least the set of

[2] Systemic models of the Islamic banking comprehensively portray the overall institutional structure (i.e., institutional structure of the Islamic banking including simultaneously the systemically interacting institutions of Islamic government, Islamic central bank as well as its member Islamic banks and other financial institutions) and the operational mechanism in a progressive milieu of the dynamic Islamic economic system.

contemporary Islamic countries from their individual financial systems' vulnerability in form of financial contagions and financial crises (e.g., In July 1997, Indonesia experienced monetary crises). Moreover, Indonesian Vice President Dr. Hamza Haz has also pointed to a broader politico-economic scope and rationale of the Islamic banking (Haz, 2004), in the context of the imperative of accomplishing massive Islamic financial intermediation in an Islamic institutional framework which transcends national boundaries of Indonesia, as following:

> "Indonesia's 2002 population is around 212 million people, 178 million of which are Muslims. It is a huge potential for the development of Sharīʿah economy. It is reported in 2002 that there are around 40 million small entrepreneurs, 54 thousand medium enterprises, and 2000 large enterprises. I believe most of them are potential captive market of the Sharīʿah system.... I put my hope on the Sharīʿah economic system to boost the creation of a "clean" institutional system in Indonesia. The welfare quality of most Indonesians is poor. This is indicated by high number of poor people, excessive social-economic disparity, and high number of the unemployment. I believe that the Sharīʿah economic system will be able to reduce the burden. I wish that the Islamic Development Bank in particular could take part in supporting the effort of poverty alleviation. ...We must be able to create an idealism to manage such challenges and potencies."

Islamic economists and statesmen[3] have been highlighting the rationale and scope of instituting a comprehensive Islamic system[4] of banks and other financial institutions in the original Islamic universal systemic framework, which is broader than the Western limited nationalistic scope of the monetary and banking system, while acknowledging the economic imperative of instituting Islamic financial intermediation in an environment of ever-growing complexity of the urbanizing human society wherein the surplus funds of the savers could not be directly

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[3] Former Malaysian Prime Minister has been championing the idea of instituting Islamic Dinar as the unified currency of the Islamic countries. In this context, he has also urged the Muslims to stop trade in US $ during his trip to Dhaka in the context of receiving an honorary Doctorate of Laws in the convocation of Dhaka University, Bangladesh held on December 19, 2004. Of course, Muslims can stop trading in the US $ if they have access to a stable Islamic currency, as a viable alternative to U.S. $, which is required to be made available to them by the Islamic statesmen through their appropriate policy responses in the form of giving up their ever-vulnerable nationalistic monetary policy regimes for instituting a single vehicle currency-based Islamic world-level monetary system. Therefore, an indirect implication of his aforementioned views envisages the culmination of the Islamic central banking system into a unified Islamic monetary regime initially at least for the contemporary Islamic countries from the point of view of empowering and developing all constituents of the Muslim *Ummah* and the whole global human society.

[4] i.e., a network of the world-level Islamic Central Bank, the Islamic banks and other Islamic financial intermediaries as the constituents of a progressive universal Islamic monetary regime.

transferred to the deficit units on a massive scale due to the persistence of serious problems of asymmetric information manifest in the forms of adverse selection, moral hazard, and transactions costs.

However, mere awareness, consciousness, and recognition of the imperative of developing politico-economic and banking linkages transcending national jurisdictions are not sufficient for realizing the Islamic goals of development and empowerment of humanity. Even Huntington, who acknowledges (Huntington, 1996) that the concept of sovereign nation states is incompatible with the belief in the sovereignty of Allah and the primacy of *Ummah*, envisages a movement from consciousness to Islamic cohesion and considers the consciousness without cohesion as a source of weakness of Islam (i.e., Muslims). Consequently, no Muslim country, among the contemporary 57 fragile Muslim nation states, has the sufficient power, Islamic legitimacy, and global acceptability which is a prerequisite for assuming the leadership of *Ummah* in the 20th century.

It is due to the aforementioned weaknesses of the Islamic countries that all Islamic countries have been entrapped into their own inefficient interest-based systems of narrowest nationalistic capitalistic central banking, accomplished by the policy regimes and the top bureaucracy recommended by Western powers, that supply national currencies which have been too weak to become generally acceptable as the Islamic vehicle currency. Consequently, neither Muslim public has an option other than the option of trading in the U.S. $ which is relatively stable vehicle currency nor, due to the aforementioned fact, it is possible for the Islamic countries' central banks to have an autonomous[5] monetary policy.

Due to the absence of any Islamic vehicle currency in the entire set of the official currencies of Islamic countries, even common urban people in Islamic

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[5] This fact is illustrated by Patrick Gormely, who authored Chapter 27 International Monetary System in Thomas' book *Money, Banking, and Financial Markets* as following (Thomas ,1997):

"Because the three dominant currencies-the dollar, mark and yen- float against one another, the currency of any fourth country acting to maintain a fixed exchange rate with one of the three also floats relative to the other two. For example, the Saudi Arabian Monetary Agency (SAMA) fixes the riyal-dollar exchange rate. This means that the riyal is fixed not only relative to the dollar but also to all other currencies that are fixed relative to the dollar; it floats relative to the yen, the mark, and all currencies that float relative to the dollar. Saudi Arabia fixes the riyal-dollar exchange rate and allows its citizens free international movement of capital. Consequently, it has no autonomous monetary policy; it adapts its monetary policy to that of the United States."

In addition to the above fact, it is important to note that Saudi Arabia sells oil in the U.S. dollars and Riyal is closely associated with the U.S. $.Thus, it has become the short-term monetary objective of SAMA to reduce the association between riyal and dollar, by connecting Riyal to Special Drawing Right (SDR), due to its undesirable consequences. Saudi Arabia and all other Islamic countries can avoid the aforementioned problems by instituting the Islamic vehicle currency issued by their common central banking system.

countries like Pakistan are demanding the house rents to be paid in the form of U.S. Dollars and the enormously growing surplus funds of the surplus units of the Islamic countries of the Middle East have been fast transformed into Eurodollars/dollars deposited as well as invested abroad merely because the U.S. Dollar has assumed the vehicle currency status on the global level. As a result, the Islamic world's numerous possessors of wealth (i.e., countries, organizations, firms, and individuals) in the form of U.S. Dollars/Euro-Dollars have always been highly vulnerable because the real worth of their aforementioned wealth is extremely volatile primarily due to the frequent "pre-emptive" U.S. Monetary policy changes which are overwhelmingly conditioned by an ever-growing expansionist strategic agenda of the governments of the U.S. The political economy of the pre-emptive financial strikes of the U.S. as well as the use of money a weapon of war is stated (Krugman et. Al., 1994) by Krugman and Obstfeld:

> "(in 1979, Iranian assets in U.S. Banks and their European branches were frozen by President Carter in response to the taking of hostages at the American embassy in Tehran. A similar fact befell Iraq's U.S. Assets after that country invaded neighbouring Kuwait in 1990)".
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> "… And the United States was bombarding Iraq with bogus dinars difficult to tell apart from the real thing."

Such negative outcomes of the capitalistic political economy of central banking system have plunged the credibility of the U.S. Dollar as a vehicle currency in the profound ocean of doubts. Al-Habashi anticipated the aforementioned scenarios as following (Al-Habashi, 1999):

> "The dominance of the U.S. Dollars simply means that we have to succumb to their demands. Our wealth that we have taken so long to accumulate could be lost within months as has been repeatedly proven in the economic turmoil of East Asian economies. Could we formulate an economic system that is resilient to vagaries of the external economic forces? Could we actually develop a financial system or even an Islamic financial institution that would withstand these external forces?"

Of course, the affirmative answers to Al-Habashi's questions are possible and inevitable in the institutional framework of an autonomous progressive pan-Islamic politico-economic and monetary regime which can be instituted by ensuring the effective integration of the 57 Islamic states in the light of the Islamic juristic principle of dominance of *maṣlaḥah* Aammah (manifest in the form of restoration, defence, and promotion of intertwined forms of politico-economic and strategic security) of Muslim *Ummah* over the *maṣlaḥah* of individual/individual Muslim state in the light of *maqāṣid*-al-Sharīʿah.

Keeping in view the prospective usefulness of the Islamic interest-free system of banking/financial intermediation and the inequitable[6]-cum-inefficient outcomes of the legally highly compartmentalized and restricted financial role of numerous types of the capitalistic interest-based banks/financial intermediaries (e.g., commercial banks' role of largely providing short-term financing is bound to have a limited developmental impact in the economy), the Islamic economists have been highlighting the rationale of developing an Islamically reformed banking and financial system for realizing the humanitarian Islamic goal of human empowerment/development.

In short, the rationale of the Islamic banking lies not only in the context of promotion of interest-free Islamic financial intermediation but also in the broader context of instituting progressive universal monetary regime of autonomous Islamic central banking.

3. Evolution of the Theoretical Models of Islamic Banking

Since the year[7] of publication of Siddiqi's book entitled Ghair Sudi Bankari (Banking Without Interest), containing the first-ever comprehensive and feasible model of Islamic banking, several theoretical models of the Islamic banking have been conceived throughout the whole world. In this background, the following inquiry into ten alternative models of Islamic banking focuses primarily on the task of identifying their nature, salient structural-cum-operational features, and vital systemic as well as functional interrelationships within the human development/empowerment-oriented institutional and policy frameworks of the overall Islamic economy.

Siddiqi, in his pioneering treatise (Siddiqi,1969) entitled Banking Without Interest contributed before the advent of the era of actual establishment of Islamic banks, renders an understandable outline and exhibition of the model of an interest-free Islamic commercial-cum-central banking operating easily on the basis of principle of sharing of profit and loss. His model is premised in the fact of total prohibition of all forms of interest, including the banking interest as well as commercial interest, in Islam. He envisages the possibility of the establishment of an Islamic bank by an individual, a group of individual partners, and an Islamic state. However, in the light of the empirical fact that generally the requisite

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[6] Siddiqi contends (Siddiqi, 1981), "The institution of fixed interest payment ensures a continuous flow of resources from the debtors, who are many, to the creditors, who are few. In many cases the loan does not result in creation of additional wealth out of which interest could be paid to the lender. This is true of consumption loans and most of the loans to the government. This is also true of some loans to business in so far as the business enterprise concerned incurs losses or ends up with a profit smaller than the rate of interest. In all these cases the institution of interest is responsible for a net transfer of the existing resources from the debtors to the creditors."

[7] i.e., 1969 A.D.

considerably massive amount of capital is contributed by the several persons and that the amount of capital provided by each partner may be equal or different, he conceives the establishment of an Islamic bank on the basis of al-*shirkatul al-inʿan* which refers to the agreement of partnership between either two or among more than two persons to work[8] jointly in an enterprise with their fixed capital contributions,[9] with their agreed upon proportionate share in the profit,[10] and with their share in the losses strictly in proportion to their respective capital contributions in the partnership-based funds mobilized for the promotion of business of the Islamic bank. He recommends that the number of shareholders of the interest-free Islam bank must be kept to the minimum number beyond the number two.

From the point of view of operation, promotion and expansion of business of the bank, it is binding on every partner to authorize the bank to hire the staff (e.g., administrative/executive/clerical staff), hire or purchase other requisites (e.g., buildings, vehicles, and fuel), to acquire additional capital either on the basis of interest-free credit or on the basis of *muḍārabah* and to offer interest-free loans as well as monetary investments to the needy individuals and institutions. In the light of the practical experiences showing that it is rarely possible to recover sufficient amounts of money from the shareholders for meeting the liabilities of the bank regarding their depositors and that the central bank supervises as well as controls banks for safeguarding the interests of depositors, Siddiqi acknowledges that the expansion of the business of banks requires the establishment of banks on the basis of principle of limited liability of the shareholders of banks. In his model, major decisions regarding the operations of the bank are conditioned by the mutual understanding of all partners of the bank. In the case of a very large number of partners, the power of making decisions is delegated to a Council of Representatives and the day-to-day decisions regarding the routine business of the

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[8] While in principle each partner has the undeniable right to participate in the actual running of the business, it is not essential that every partner should participate in the management of business of bank.

[9] e.g., any number of shares having a fixed value of Rs. 100,000 can be purchased by each shareholder who would become owner of the bank in proportion to the extent of his assets' contribution to the total investment in the bank. However, the minimum as well as the maximum limits of the subscribed capital may also be prescribed.

[10] In the case of distribution of bank's profits in proportion to the number of shares possessed by a partner, the total profit may be divided by the total investment in the bank for determining the profit in percentage form payable to possessor of each share. In this context, Siddiqi proposes that the distribution of profit should be based on the number of paid-up shares and, in this background, every shareholder must inescapably share any amount of the actual loss of the bank in proportion to the size of his investment in bank's shares. However in case of some partners' participation in the accomplishment of managerial responsibilities, implementation of a formula of disproportionate distribution of profit is quite justified in the framework of partnership.

bank are entrusted to the managers who are appointed and discharged either by partners or by the Council of Representatives.

The business of the bank includes services rendered in exchange for fee/commission/fixed charges, investment of capital according to principles of the partnership (i.e., *mushārakah*) as well as *muḍārabah*, and the free services. The interest-free charged services[11] are an important source of the bank's profit because the income from these services may be greater than their costs for the bank. However, the bank's prime source of income is its service of making the capital available to the economic agents who are interested in accomplishing business according to the principles of either *muḍārabah*[12] or *shirkatul al-inʿan.*[13] In case of completion of the business, the bank may get refunded its increased or decreased capital according to the profit or loss. In the context of the accomplishment of additional investment by the existing investors in the ongoing business, it is an imperative to clear their accounts, determine their profits or losses, adjust their invested amounts for their respective profits or losses, add together their adjusted sums and their additional investment, and institute a fresh agreement. The bank may withdraw its capital with the willingness of its partner in case of its investment for a definite term as well as for an indefinite term.

Siddiqi opposes the investment of a bank's capital in a business in which the capital procured on the basis of long-term loans is being invested. However, the bank may approve the capital procured on the basis of *muḍārabah* for

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[11] Set of the charged services includes facilities of safe deposits, transfer of money through traveller's cheques/bank drafts/letters of credit as well as miscellaneous monetary receipts, obtaining as well as directing the final delivery of commercial goods or other articles, purchase and sale of immovable property on behalf of clients in compliance with Sharīʿah, expert advisory services (i.e., services of business/legal consultancy) for businessmen regarding the purchase of machinery, raw materials etc, expert advisory services for account holders, purchase and holding of commercial shares for clients, investment of capital as well as the corresponding receipt of profit on the behalf of clients, and any other Islamically acceptable innovative service resulting from the needs of clients, ingenuity, and progressiveness in the attitudes as well as the methods of the bank.

[12] In case of *muḍārabah*-based investment, the bank is entitled to receive a fixed ratio of the profit, which is mutually agreed upon with *muḍārib* at the time of negotiation of the terms of the contract and which may be varying with the enterprise and with the region, earned from the capital provided to the entrepreneur. However, the bank can fix the different ratio of profit with different entities which are individually categorized as *muḍārib*. If *muḍārabah* results into the loss then the bank bears the entire burden of full loss in accordance with its full share in the joint capital. It is important to note that the short-term loans, which may not be counted with the original capital investment, are required to be repaid before accounting for the overall profit and loss.

[13] In case of *shirkatul al-inʿan*-based investment, a bank is entitled to receive a fixed ratio of the profit, that is mutually agreed upon between the contracting parties at the time of negotiation of terms of the contract.

accomplishing investment as well as the capital procured on the basis of *mushārakah* for accomplishing investment.

The Islamic banks may also invest a part of their capital in a certain company's common stock shares, whose profits depend on its degree of success (i.e., the level of profit), which are likely to yield annual profits. They may sell the purchased shares in times of necessity especially for maintaining an adequate level of liquidity.

While pointing to the facts that not only the bills of exchange are becoming rare but also they are being replaced by short-term loans, Siddiqi suggests that businessmen may pay the seller the cost of his goods by taking short-term *muḍārabah* funds from the bank which can accept a smaller share of profit than share of profit accepted by it for the loan of a duration of three months or more than three months. A loss on the sale of their products will be borne by the Islamic bank.

In addition to the initial capital supplied by the founding shareholders of the bank, the Islamic bank acquires additional capital by inducing the general public to deposit its savings with the bank in the *muḍārabah* account and in a 'loan account'. The bank should keep a small proportion (e.g., 3% or 5%) of the *muḍārabah* deposits as reserves for ensuring the normal return of money to the depositors without a need for the bank to depend on the release of bank capital from its *muḍārabah* business. The entire remaining amount, after keeping aside the reserves, will be invested and the resulting profits will be spread over the total amount deposited in *muḍārabah* account for determining the percentage of profit.

Holders of the loan account, who are not at all charged by the bank, are privileged to draw cheques as well as transfer their money to other account holders. Similarly, the bank is privileged to have full control on the money as long as it remains in the loan account and it can freely invest it profitably.

Bank is required to reciprocate the receipt of loans without interest by issuing loans to business parties[14] without receiving either any remuneration for this service or interest and this facility[15] of the bank should motivate the people, having a sense of public good, to deposit their savings in the loan account instead of hoarding their savings. Short-term loans[16] may be advanced against the production of a security by the borrower.

The bank loans for consumers may be either in the form of overdraft permitted for a fixed period against a security for the overdraft or in the form of the facility

[14] The borrowers will guarantee the repayment of loan with in the scheduled duration.

[15] The extent of interest-free loans advanced by the bank is determined as a proportion of the capital deposited in the bank's loan account.

[16] The stipulated maximum term for such loans must be shorter than the term for which the bank supplies the capital on the basis of *muḍārabah*.

that the prospective borrower, who buys the durable goods on instalments, should give a certificate[17] to the seller about the good sold to him and the seller will encash the certificate from the bank on the basis of his responsibility to secure the payment of instalments until the loan account is cleared. The ratio between loan account and the loans to be advanced is to be determined and enforced by the central bank. Bank's expenses of maintaining and safeguarding the loan accounts will be adequately financed either from the expected profits resulting from the profitable investment of sums of the loan accounts or from the fees.

In anticipation that all the account holders do not withdraw deposits simultaneously, the Islamic commercial bank is assumed to keep a fraction (i.e., 10%) of the demand deposits as well as *muḍārabah* deposits reserved as cash without losing its ability to make payments on the demand for withdrawal. In this background, Siddiqi acknowledges the role[18] of banks in creation of the bank money (i.e., credit) as well as in the reduction of bank money.

Siddiqi also envisages the establishment of the central bank, as a non-profit Government bank, by the Islamic state with the Government capital for issuing currency notes, for supervising financial as well as monetary affairs with the foreign countries, and for all monetary matters arising from transactions with the foreign countries. The cost of the management of the central bank may be financed from the profits resulting from the sale of Government *muḍārabah* Shares as well as Government Partnership Shares. Alternatively, for financing the cost of the management of the central banking, either the central banking may be regarded as an essential public service and it may be financed by the Public Exchequer or an annual fee may be levied on banks exactly in proportion to their annual income.

Siddiqi proposes that the Government as well as all other banks should be the account holders of the central bank such that they can draw loans or finances in the case of the need. The central bank will monitor as well as improve the macroeconomic indicators, direct capital to the deserving industries and areas of economic development, balance the supply of credit and cash with its demand, and protect the value of national currency from the harmful national and international factors. It will be constitutionally empowered to inform, encourage, guide, advise, and force the commercial banks to formulate their policies according to the national interest and congenial principles which ensure mutual cooperation and confidence among the central bank, the commercial banks, and the public. In this context, Siddiqi also recommends that the banks can temporarily[19] borrow from the central bank sums amounting to certain percentage (i.e., 25%), called 'borrowing

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[17] The certificate includes details about the sold good, its total cost, procedure of repayment, and name as well as address of the seller and buyer.
[18] Its numerical illustration has also been rendered (Siddiqi, 1969) by Siddiqi.
[19] i.e., for one week or two weeks or three weeks.

ratio[20]', of the loans advanced by them by presenting the certificates of the loans to the central bank only and only if there arises unexpected demand on the banks for cash. In case of a permanent increase in the demand for cash, the central bank will advance additional loans to the whole banking system by purchasing shares. For influencing the trends of investments and for controlling expansion of credit facilities in particular directions, the central bank can vary the borrowing ratio[21] for advancing loans against the bills of trade. The central bank can also trade the commercial shares.

In an interest-free banking system, the central bank can control the banking business and the supply of money by varying the reserve ratio as well as the borrowing ratio, by accomplishing preferential use of the borrowing ratio, by trading commercial shares, and by changing the lending ratio.

Siddiqi has envisaged the exploitation of a critical progressive linkage between the interest-free banking system and the human development and human empowerment-oriented public finance within framework of the Islamic welfare state especially in the contemporary underdeveloped Islamic countries wherein the requisite massive financial resources can not be realized merely from taxation, income from the state properties as well as state production, and profits from state industries/the state-sponsored trade. In the background of his own proposal of only exceptionally using the inherently inflationary facility of creation of new money for the deficit financing in only the extremely difficult situations of natural calamity or war, he points out that it becomes an imperative for the Islamic state to procure some part of the people's savings on the basis of *muḍārabah* and partnership (i.e., by issuing Government *muḍārabah* Shares[22] and Government Partnership Shares[23]) as well as on the basis of interest-free Government Loans by issuing Government Loan Certificates[24] for financing its development schemes through the vehicle of the interest-free banking system.

[20] Borrowing ratio is defined as the proportion between loans obtainable from the central bank and the loans advanced by the commercial banks.

[21] e.g., the borrowing ratio may be 30% in case of loans advanced to agriculture and this ratio may be 20% in case of the cotton business.

[22] Such shares of the value of Rs. 1,000 or Rs. 10,000, or Rs. 100,000 may be issued along with a maturity date of six months, one year, two years, five years etc. Holders of *muḍārabah* shares will have no role at all either in the policy making or in the running of the business. However, the finance raised from the shares issued in the name of a specific enterprise must be invested only in that particular enterprise.

[23] For starting an enterprise with a capital of 10 million rupees, the state can issue 100 shares such that each share has a value of Rs. 100, 000. The state itself purchases 60 shares and the banks as well as individual can buy the remaining 40 shares.

[24] The values of the loan certificates can range from Rs. 100 to Rs. 1 million and their period may be a fortnight, a month, three months and up to 3 years.

In the interest-free banking system, the commercial banks will be keeping numerous Government Loan Certificates of various terms in their custody in order to maintain their liquidity as well as Government Partnership Shares as secondary reserves which will serve as a source of income for the bank and as a means of liquidity. In case of expecting a reasonable rate of profit from Government *muḍārabah* Shares, the interest-free banks may invest some of their business capital in them. In the case of the date of expiry of the term of Government *muḍārabah* Shares being near the date of the repayment of loan, Government *muḍārabah* Shares can be presented as a surety by the individual or the institution interested in taking loans. From the point of view small savers, Government *muḍārabah* Shares will be a suitable alternative to the *muḍārabah* accounts of the banks. While the above shares and certificates will be used by the Government for the implementation of monetary policy and by the Central Bank as a means for conveying its decisions to commercial banks, the existence of numerous Islamic shares and certificates will serve as a means of convenience and orderliness in the national monetary system.

Report of the Council of Islamic Ideology (CII) recommends the approach of simultaneously remodelling the commercial banking system according to the Islamic imperatives and Islamizing the society as well as the laws governing sale of goods, hire, lease, loans, trust, partnership, and defalcation etc (CII, 1980). For remodelling the banking system on the interest-free basis, CII recommends the transformation of the operating procedures of commercial banks envisaged to be instituted on the basis of a two-tier *muḍārabah* without requiring any change in the institutional structure of the commercial banks as well as the operating procedures of specialized finance institutions[25] based on the Islamic concepts of *muḍārabah* and *mushārakah*. For example, CII not only proposes the replacement of the interest-based saving deposits and time deposits by a system of variable returns based on the Islamic principle of sharing profit as well as loss but also illustrates the use of the daily product method[26] for computing the capital contributions of the parties as well as determining shares in either profit or loss in cases of saving and time deposits. For the purpose of commercial banking, CII has allowed the commercial banks to charge a commission for providing the services of opening of letters of credit (L/Cs).

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[25] e.g., Pakistan Industrial Credit and Investment Corporation, Industrial Development Bank of Pakistan, National Development Finance Corporation, Agricultural Development Bank of Pakistan, Small Business Finance Corporation, Equity Participation Fund, Federal Bank for Cooperatives and other Cooperative Credit Institutions, and Insurance Companies.

[26] The study of the following reference material is recommended for developing an understanding of the relevant hypothetical examples of the aforementioned use of the daily product method:
Council of Islamic Ideology, "Elimination of Interest from the Economy", In: Ahmad et. al., 1983, pp.167-173.

For the fixed investment financing, CII has allowed the commercial banks to provide financing on profit/loss sharing basis to those parties[27] which maintain the accounts audited by Chartered Accountants, to provide financing on the basis of arrangements of 'hire-purchase'/*bayʿ mu'ajjal*/leasing to those parties which maintain accounts without getting them audited by the Chartered Accountants, and to provide financing on the basis of arrangements of 'normal rate of return'/'hire-purchase'/'*bayʿ mu'ajjal*'(i.e., mark-up)/time multiple counter loans to the small parties[28] which are unable to maintain accounts. However, CII considers it incorrect to use the counter multiple loans by the way of a permanent alternative to the interest-based system.

Despite developing an understanding about the permissibility of *bayʿ mu'ajjal* under Sharīʿah and about its applicability only to the unavoidable cases, CII has not only warned against the indiscriminate use of *bayʿ mu'ajjal* in anticipation that it may open a back door for dealing on the basis of interest but also advised the least possible use of the Islamically allowed modes of financing other than profit/loss-sharing and *al-qarḍ al-Ḥasan*.

Moreover, CII encourages the commercial banks to formulate, finance and execute their own new projects either individually or in collaboration with the non-bank financial intermediaries by using the method of "investment-auctioning". In the contracts of the fixed investment financing, CII requires the incorporation of the provision for the banks' role of monitoring the actual performance of the project financed by them.

CII requires the commercial banks to replace the financial assistance provided by the banks to the projects during their gestation periods under the interest-based arrangements of 'bridge-financing' by 'the firm commitment'-underwriting under which the underwriters actually take a part of the equity at an agreed upon price which may be less than the face value of the shares. Moreover, CII requires them to replace the debenture financing by issuing the new corporate security called "Participation Term Certificate" which entitles its holder to claim a share in the profits of the issuing concern. CII permits the commercial banks to provide services regarding the bills of exchange in exchange for an advance payment of commission which varies in accordance with the amount of the bill of exchange and, in this context, any variation in commission according to the period of payment is prohibited by the CII.

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[27] CII allows the commercial banks to finance their working capital needs either individually and jointly by them or in collaboration with the specialized financial institutions by providing the facilities of cash credit, overdraft, and demand loan under the arrangement of profit/loss-sharing based on the daily products which take into the account the amount of capital and their period of employment such that profit is shared according to any agreed profit sharing ratio and the loss is shared in proportion to the contributed capital.

[28] Banks finance their working capital needs on the bases of either 'normal rate of return' or *bayʿ mu'ajjal*.

Commercial banks can provide financing to retail as well as wholesale businesses under the already mentioned[29] Islamically reformed arrangements of cash credit, overdraft, demand loans, discounting of bills and opening of letters of credit either in exchange for commission or on the basis of profit-loss sharing. CII permits only the provision of interest-free personal loans to the meritorious students by the commercial banks as well as the provision of interest-free personal loans to the deserving individuals of the calamity-stricken areas.

CII's model of Islamic banking system envisages the continuation of the Islamic central bank's inherent goal as well as the functional responsibility of regulating the monetary and credit system of the Islamic state[30] in the best national interest from the point of view of securing monetary stability and full employment of national resources by using currency notes, regulating money and credit, acting as a banker[31]-cum-advisor not only of the government but also of the other banks, and performing its duties as the ultimate reservoir of liquidity for the financial and banking system.

While discarding certain monetary instruments, CII's model of the Islamic banking system retains some monetary instruments (i.e., State Bank's financial assistance[32] to the commercial banks and other financial institutions as well as the open market operations[33]) with substantial legal-cum-procedural reforms as well as retains most of the conventional monetary policy instruments (e.g., minimum cash requirements[34], liquidity ratio requirements[35] as the statutory obligation of every

[29] i.e., arrangements mentioned for financing the working capital needs of the industry.

[30] i.e., the Islamic Republic of Pakistan.

[31] Banks, the federal government, and the provincial governments can maintain their interest-free accounts instituted at the State Bank. While the provision of finance by the State Bank to banks and other financial institutions is to be instituted according to the principle of profit-loss sharing based on the daily products of their respective amounts, the task of provision of the finance by the State Bank to the federal government and provincial governments will be accomplished on the interest-free basis for enabling them to tide over their temporary fiscal deficits.

[32] e.g., The State Bank can provide a charge-free refinance facility to the commercial banks against their interest-free loans advanced to the government for its social-welfare-oriented commodity operations and prescribe for commercial banks to levy only a service charge on the interest-free loans provided by them.

[33] The State Bank can issue its own variable dividend securities as well as use them for open market operations. The holders of profit-loss sharing securities will share either profit or loss with the State Bank on the basis of the daily products of the sums contributed by the aforementioned parties.

[34] In relation to the amount of default on the part of banks, the State Bank can impose a fine per day.

[35] The related financial requirements may be in the form of banks' holdings of Sharīʿah-consistent financial instruments which are approved by the government for the purpose of meeting the liquidity requirements. The State Bank can also impose a fine per day in relation to the amount of default on the part of banks.

scheduled bank, overall ceilings[36] on the lending and investment operations of the banks, monetary targets[37] for providing finance to priority sectors, selective credit controls[38], issuance of directions[39], moral suasion, variations in own profit-sharing ratio in case of the finance provided by the central bank to banks and other financial institutions as well as variations in the maximum/minimum profit sharing ratio with minor legal-cum-procedural reforms. It also envisages the government of the Islamic state to design its fiscal policy in a way which sufficiently reinforces the Islamic monetary policy in achieving stability in the value of money. For eliminating interest from the international transactions, it proposes the acceleration of the efforts of both the governments of the Islamic countries and the Islamic Development Bank for promoting their cooperation in the contexts of instituting Islamic Countries' Trading Block (ICTB) as well as the interest-free intra-ICBT trade/aid.

Al-Jarhi presents (Al-Jarhi, 1981) a development-oriented productivity-based monetary and financial structure for an interest-free Islamic economy wherein the mutually supportive interactions of a model of Islamic banking, the Islamic treasury,[40] and Islamic financial markets culminate into the Islamic financial

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[36] This monetary tool limits the overall credit expansion accomplished by the commercial banks within the estimated safe levels of monetary and credit expansion. In case of a bank's excess of the provided credit over the credit ceiling of the bank, an amount equal to the aforementioned excess is required to be deposited on interest-free basis for a period ending at the time when the bank readjusts its credit according to its credit ceiling. Moreover, a fine in relation to the amount of excess of the bank's credit over its credit ceiling is proposed to be imposed on the bank on account of the bank's act of violating the credit ceiling.

[37] This monetary tool enables the State Bank to realize the Islamic socioeconomic goals of the monetary policy by setting banks' targets of providing small interest-free loans not only for financing the business, industry, and the low-cost housing production but also for financing the fixed investment in the agriculture on the basis of the condition that a bank's violations of the aforementioned monetary targets will be punished by the State Bank through the imposition of a fine per day on the concerned bank in relation to the amount of default on the part of the bank.

[38] e.g., In case of bank financing on the basis of profit-loss sharing, the State Bank can prescribe certain minimum ratios of the own contribution of the parties which are obtaining finances from the bank. Similarly in the case of bank loans advanced against the security of goods and in the case of opening of the letters of credit for importing goods, minimum margin requirements can be prescribed by the State Bank.

[39] e.g., The State Bank can prescribe the maximum and minimum profit-sharing ratio on the investments which are accomplished by banks and on time deposits as well as saving deposits held by the banks.

[40] Islamic Treasury consists of the distributive branch having the responsibility of collection as well as distribution of *Zakāh*, allocative branch having the responsibility of managing the socially-owned mineral resources as well as providing public goods, and the division of market order having the responsibilities of handling monopolies, ensuring orderly markets, and correcting for externalities.

market equilibrium and economic development. Al-Jarhi's Islamic narrow banking model (i.e., core banking model[41]), which is modelled in the tradition of 100% reserve plan, consists of the Islamically reformed central bank, commercial banks, specialized banks, and financial intermediaries. He envisages the management of money supply in the form of not only providing a maximum amount of transaction services to the community according to the transaction needs of society but also ensuring the development of different regions and sectors of the economy as well as the stability of price level. In this model of the Islamic banking, the Islamic central bank has the official authority to create fiat money in the absence of government interest-bearing securities while anchoring the growth of money supply to the growth rate of economy.

[41] Conventionally, an equity-based as well as 100% reserves-based system of banking, which is known as "narrow banking" or "core banking", consists of a "narrow bank window" and a "broad bank window" such that both distinct windows offer different products. The first product, called money or deposits, has a 100% backing on domestic or foreign ad well as public or private AAA highly liquid securities. The second product includes a subset of alternatives in the form of profit-loss sharing accounts as well as other specific investment funds having similarity with mutual funds. On the liability side of the narrow bank's broad bank window, there are interest-free Profit-Loss-Sharing (PLS) accounts or interest-free mutual fund accounts such that the aforementioned liabilities would periodically share a percentage of the corresponding profits or losses of the asset side of the bank.

Figure 1

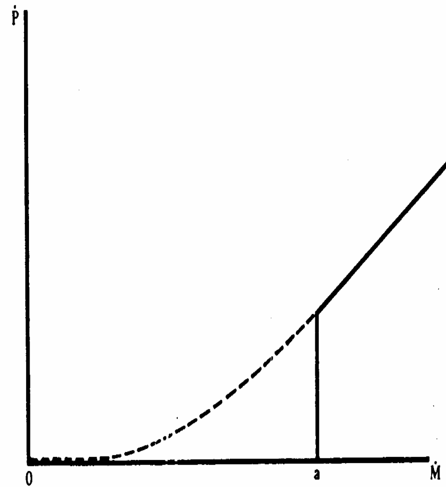
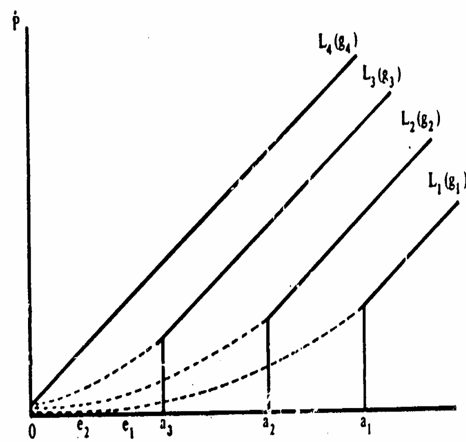


Figure 2



The relationship, assumed by al-Jarhi, between the growth of money supply "$\dot{M}$" and the rate of inflation "$\dot{P}$" is shown in Figure I in the form of a monetary expansion line associated with the realization of a certain growth rate "g" and in Figure II.[42] The horizontal segment of monetary expansion line, which coincides with the horizontal axis, implies that rates of monetary expansion are too low to produce any inflation for the given rate of real growth of economy as well as state of expectations. After the end of a regime of non-inflationary monetary expansion, higher rates of monetary expansion are going to produce positive rates of inflation in a pattern of progression wherein initially $\dot{P}$ increases less than proportionately as a result of increase in $\dot{M}$ and finally increases in $\dot{M}$ result into equiproportional changes in $\dot{P}$. Al-Jarhi asserts that the price stability-oriented Islamic economy should either choose $\dot{M} = 0e_1$ with g_1 and $\dot{M} = 0e_2$ with g_2 or $\dot{M} = 0$. The role and structure of the Islamic treasury, having sufficient flexibility in the context of expanding its development-oriented facilities and activities through taxation and *zakāh*, rule out any justification for monetary expansion-based financing of the government deficits and reinforce the Islamic agenda of macroeconomic stability.

Al-Jarhi proposes the realization of the changes in money supply through central bank's investment accounts instituted in its member banks. He requires the member banks to invest central bank's deposits (CDs) in real sectors according to their investment policies. It is important to note that CDs are used by the Islamic central bank as a tool of the Islamic monetary policy and the Islamic central bank allocates the CDs among its member banks on the basis of the traditional criteria of profitability, liquidity, and risk. Thus, the Islamic central bank promotes investment efficiency in the economy because only the efficient Islamic banks will receive CDs. The profits earned by the Islamic central bank on CDs can be used for covering the costs of the operations of the Islamic central bank. Moreover, the Islamic central bank has the authority to create Central Deposit Certificates (CDCs) as a means of financial intermediation whose proceeds are obligated to be invested in CDs all over the banking system. In this background, the rate of return "ρ" on CDCs denotes an average rate of profit on investment for the whole economy.

While radically departing from the structural and operational pattern of the traditional Anglo-Saxon model of commercial banking, Al-Jarhi characterizes a member Islamic bank as Banque d'Affaires (i.e., business bank) which undertakes direct investment as a part of its investment activities,[43] provides regular banking

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[42] In Figure II, the depicted monetary expansion lines $L_1(g_1)$, $L_2(g_2)$, $L_3(g_3)$ and $L_4(g_4)$ correspond to different growth rates g_1, g_2, g_3 and g_4 (i.e., $g_1>g_2>g_3>g_4$). In the case of realizing higher and higher rates of growth, there are realized larger and larger segments of the monetary expansion lines along which prices react less proportionately to monetary expansions.

[43] The set of investment activities of the *Banque d'Affaires* includes direct investment, which refers to the bank's investment in the form of holding shares in the enterprises as

services (e.g., services of demand deposits which are insured against the insolvency of the Islamic bank, selling foreign exchange as well as issuing letters of credit for a fee on the basis of Islamic bank's correspondence relationships with the foreign banks etc.) and gets involved in lending activities. Business bank's direct investment in enterprises implies that the Islamic bank uses its expertise, provides technical assistance to them and, thereby improves degrees of their productivity, profitability, and business success because the Islamic bank has the geographic proximity to the financed projects as well as the first hand information about them and the relative familiarity with their managers.

The member Islamic banks can issue Specific Investment Certificates (SICs), General Investment Certificates (GICs), Profit-Sharing Certificates (PSCs), and Leasing Certificates (LCs) which pay out the dividends which are not specified in advance. For the lending activities of the Islamic banks, the Islamic central bank can frame a regulation which requires every Islamic bank to provide a small percentage of its resources as interest-free loans to the deserving economic agents on the basis of certain social criteria. By instituting and selling the interest-free Central Lending Certificates (CLCs) to the rich economic agents of the Islamic economy, the Islamic central bank can provide the proceeds of CLCs to the Islamic banks for augmenting their lending facilities. In this setting, there arise Islamic financial market instruments such as corporate stocks, SICs, GICs, PSCs, LCs, CDCs, and CLCs having a variety of maturities keeping in view the diverse preferences of savers and a country can promote investment and economic growth in certain regions or sectors of the economy through the central bank's role of changing the money supply by adding and withdrawing the CDs and by selling and buying CDCs. Thus, Islamic monetary policy and development policy have become closely intertwined.

Ansari portrays the institutional structure and working mechanism of Islamic banking (Ansari,1983) within the overall dynamic institutional framework of a progressive Islamic system having the family as its basic social unit which has intrinsic progressive linkages with an inherently integrated set of the Islamic institutions including community, community government working under the sacred community leadership symbolized by Imam,[44] regional government, Islamic state, planning organization, mosque, inheritance, *zakāh*/*ʿushr*/*ṣadaqāt*, taxation, domestic/foreign trade, education and vocational training, Mutual Saving and

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well as participating in the their administration, investment in the short-term profit-sharing ventures, and investment in leasing activities.

[44] Imam is the community leader, who leads prayers, having a role which transcends the roles of mosque as well as government, and includes his role in productive investment activities.

Investment Association (MS&I), and Central Monetary Authority (CMA). Families are classified as contractual,[45] non-contractual,[46] and deficit families.[47]

Ansari's system of Islamic banking envisages the establishment of MS&Is and CMA. MS&I is instituted/managed, by the community, to act as a financial intermediary for productive investment in the community as specified and prioritized by the community government. A board of trustees appointed by the community leader has the authority of accomplishing the management of MS&I on the lines of community management of the investable funds in the community, instead of managing the MS&I on the lines of private management which works primarily for private gain, because a community is expected to simultaneously defend/promote the community interests as well as earn profits. Unlike the case of inefficiencies resulting from operation of public enterprises on the basis of "no profit" and "no loss", the community management of MS&I rules out its operational inefficiencies because MS&I works for profit.

MS&I, for earning profit, invests in the *mushārakah*/*muḍārabah*-based projects of enterprising families/community government/regional government. Profits resulting from the investment-financing activities of MS&I are shared with its depositors according to the agreed profit-sharing ratio. MS&I's share of the profit, owned by the community, is used for financing the community projects which generate the benefits for all. Community management enables MS&Is to realize the benefits of credit creation exclusively for the community gain and the CMA to regulate[48] the MS&Is with greater ease. MS&I solicits, evaluates, and finances investment proposals coming from the enterprising families. It also provides the investment counselling to contractual families. MS&I joins both contractual families to form a partnership or a joint stock company and deficit families for forming *muḍārabah* for creating opportunities for their self-employment. Thus, MS&Is ensure wider ownership of resources and socio-economic justice. MS&Is jointly finance the intercommunity projects under the supervision of regional governments. They change the relative profitability of investment opportunities,

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[45] Contractual families are the families which vend their labor in exchange for a contractual reward. They have their propensity to save ranging from zero to a medium value. A marginal contractual family's current expenditures equals its current income. Therefore, the surplus funds (i.e., savings) are generated by all non-marginal families whose positive propensity to save ranges from zero to a medium value.

[46] Self-employed families (e.g., owner-cultivator peasants, practicing physicians, owners of plants and factories, taxi owner-operators), called non-contractual families, produce and trade goods and services. Profit are the primary source of the income of the non-contractual families which have their propensity to save ranging from a low value to a high value.

[47] Deficit families (e.g., under-employed, unemployed, widows, orphans, disabled, and aged persons) have their current incomes below their current expenditures. They do not generate any surplus and Islam secures a fair share for them.

[48] For example, in case of community management of MS&Is, it becomes easier for the CMA to sell the State Certificates to MS&Is without any provision of sharing profits.

which are specified/prioritized by a local authority, by varying the profit-sharing ratios.

CMA, established for formulating and implementing the monetary policy through a board of directors appointed by the Islamic state, effectively regulates the MS&Is by instituting its regional branches wherein its regional directors formulate and implement regional monetary policies in cooperation with regional and community leaders. By varying the deposit-legal reserve ratio, CMA regulates the volume of credit-creation and accomplishes selective credit control. By varying reserve ratios of the MS&Is of various regions, it equitably allocates the credit to the various regions. It allocates the credit to the desired projects and programs by varying the reserve ratios for different types of industries. It varies statutory reserves of MS&Is, kept on *muḍārabah* basis, between the regions and within a certain region keeping in view the marked differences in the demand for funds in regions and communities based on their metropolitan, urban, and rural characteristics. It lends funds to the Islamic state without any provision of profit sharing by buying State Certificates[49] (SCs) and selling them, for nullifying their inflationary impact, to the MS&Is. It buys SCs from the financially stressed regions and communities.

Chapra explores the possible institutional and operational mechanism for accomplishing an efficient and equitable management of the created money (Chapra, 1996). He proposes an Islamic strategy of monetary management to be accomplished through an equity-based financial intermediation which renders the demand for money efficient and equitable and, at the same time, brings the rationalized money demand[50] into an equilibrium with the non-inflationary money supply. He argues that the most practical approach of bringing aggregate money supply into equilibrium with the Islamically stabilized money demand is to

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[49] SCs are allowed to be used by MS&Is as collateral for getting temporary loans from CMA.

[50] In this contexts, he has introduced the following Islamic money demand function:

$$M_d = f(Y_S, S, \pi)$$

In the aforementioned Islamic money demand function, Y_S symbolizes the Islamic goods and services related to need fulfillment as well as productive investment, S signifies all those moral and social values as well as institutions (e.g., *Zakāh*) which effectively rationalize the allocation as well as distribution of resources and, thereby, enable the Islamic economy to accomplish its agenda of minimizing the money demand for conspicuous consumption, unproductive investment, precautionary motives and speculative motives, and π refers to the rate of either profit or loss. Chapra expects the Islamic money demand function to be more stable than the Keynesian money demand function especially due to the following factors:

- The contractual stability of the profit sharing ratio, between the entrepreneur and the financier for the duration of contract, and the corresponding stability of expectations regarding the rates of profits
- The stability partially resulting from the absence of interest rates.

estimate the money demand and establish a target range for a non-inflationary money supply (i.e., sum of currency in circulation and commercial bank deposits) which can satisfy the money demand sufficiently.

Chapra justifies the treatment of created high-powered money as *Fay'*, because the created high-powered money gives rise to seigniorage and command over resources without effort, and recommends the Islamic goal-oriented allocation of credit, especially for providing the requisite finance to small businesses, on the basis of a loan guarantee scheme, underwritten jointly by the government and the Islamic commercial banks, which can relieve the Islamic commercial banks of the need to demand the collateral from the needy owners of the small businesses.[51] He requires the created money to be primarily used for financing the projects which improve the socio-economic conditions of the poor and reduce the economic inequalities. In this context, the Islamic central bank can provide a part of the created money to the government in the form of interest-free loan and a part of the created money to the Islamic commercial banks as well as to the Islamic specialized credit institutions in the form of *muḍārabah* advances which are required to be used for the provision of self-employment opportunities to the poor.

Chapra envisages the existence of an independent Islamic central bank which has the authority and the ability of resisting the dictates and demands of the government for providing loans which are incompatible with the imperatives of price stability. Keeping in view the generally recognized close relationship between growth in derivative deposits and the growth in the high powered money in the Islamic commercial banking based on the fractional reserve system, the Islamic central bank is inevitably made responsible for closely regulating the process of growth in the high-powered money. List of the recommended monetary policy instruments includes the statutory reserve requirement only for demand deposits, credit ceilings, government deposits,[52] common pool[53] of deposits instituted for commercial banks at the central bank for solving banks' liquidity problems, moral suasion, use of equity-based instruments of the public sector companies for open market operations, and changes in the profit-and-loss-sharing ratio.

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[51] The general credentials of the small businesses are required to be registered with the authorities of the loan guarantee scheme which are also required to certify the credentials of the small businesses.

[52] The instrument of government deposits empowers the Islamic Central Bank to shift the demand deposits of the government to or from the Islamic commercial banks for directly influencing their reserves.

[53] This instrument solves the liquidity problem of the Islamic commercial banks by requiring them to contribute a specific proportion of their deposits to the common pool instituted at the Islamic Central Bank on the basis of cooperative arrangements among them. Any member bank can solve its liquidity problem by getting loan from the facility of common pool on the condition that the net use of this facility by the bank over a given period is zero.

International Institute of Islamic Economics (IIIE)'s model of modern Islamic banking system (IIIE, 1999), developed with reference to the commercial banking as an integral part of the framework of a modern Islamic economy, is the latest comprehensive treatise. It views the Islamic bank as an economic agent which accomplishes financial intermediation by simultaneously playing the role functions of partner, seller, buyer, lessor, and provider of interest-free loan in the framework of permissible forms of transactions in Sharīʿah which give rise to two distinguishing features of Islamic banking:

1. All financial flows either correspond to real flows or have a check on them due to the partnership-based structure of financing.
2. Despite the possibility of existence of debt in an Islamic banking framework, there is no scope for credit or untied cash in the Islamic banking framework.

In this background, the foundations of the modern Islamic banking operations are defined in terms of trade (i.e., *bayʿ mu'ajjal* and *bayʿ salam*)-based arrangements, leasing(i.e., operating lease)-based arrangements, partnership(i.e., *mushārakah* and *muḍārabah*)-based arrangements, and interest-free lending arrangements based on the collateral (i.e., *rehn*) and guarantees. In this model, Islamic banks are not expected to opt for pure lending. This model asserts that the options of *amānah* (i.e., safe-keeping), *wadīʿah* (i.e., safe-keeping combined with the option of benefiting from the asset kept for safe-keeping), loan with service charge, charity and *infāq* (i.e., spending for the sake of Allah), *bayʿ* Eeenah (i.e., buy-back arrangements), *ijārah* Wa *iqtinā'* (i.e., hire-purchase), and time-multiple counter loans[54] are not relevant to the Islamic banking operations.

On the side of deposits, IIIE's model of the Islamic banking, proposes to institute the current account on the basis of a contract of interest-free loan and, in the context of this current account, a recourse to *amānah* and *wadīʿah* is declared to be uncalled for. In addition, it proposes to institute more than one line of *muḍārabah* deposits as well as perpetual *muḍārabah* deposits and more than one line of *mushārakah* deposits as well as perpetual *mushārakah* deposits for addressing diverse goals and concerns of the depositors with the provision for existence of differentials in profit–sharing ratios, which must be announced in advance, for different lines of *muḍārabah* deposits as well as *mushārakah* deposits. On the side of application of funds, it envisages the use of either only one of the three Islamic modes of financing (i.e., partnership, trading, and leasing modes) or a combination of these Islamic modes of financing for accomplishing financing of consumer goods' purchases, financing of micro enterprises, agricultural financing, project financing, home financing, financing of machinery and equipment needs, financing of working capital, and financing of private investors' equity purchases

[54] Time multiple counter loans are not recommended because the ensuing credit expansion is expected to fuel inflation.

on the basis of the criterion that partnership modes are used in case of prospects of explicit income flows from the application of funds and, otherwise, trading and leasing modes are used in case of non-explicit income flows from the use of funds.

IIIE's model of the Islamic banking requires the government's prerogative of financing deficits through printing of new money to be exercised, subject to the constraint of maintaining balance between printing money and keeping inflation within 'acceptable limits', only when the public expenditure is justified on the basis of government's discharge of state obligations[55] but neither tax revenue nor any alternative means of financing is available. While highlighting the nature of government transactions related to the financing of the Islamically rationalized[56] budgetary deficits, IIIE's model of the Islamic banking proposes the activation of the institution of Waqf as well as the introduction of divisible as well as tradable trade-related instruments,[57] leasing-based instruments including Asset *ijārah* Securities[58] and Transferable *ijārah* Warrants,[59] and the partnership-based instruments[60] in the Islamic economy.

In the context of elimination of interest from international transactions, it is argued that not only banks can continue to act as an intermediary in matters of collecting and transferring funds and issue a letter of credit according to Sharīʿah requirements in exchange for a fee but also they can satisfy the needs of their clientele by entering into the export and import processes as traders. From the point of view of reducing *ribā* pressures in the arena of settlement of international payments, IIIE's model of Islamic banking system proposes the adoption of IMF[61] model at the level of importers and exporters. For accomplishing central banking, it rejects the idea of 100% reserve requirement for demand deposits as well as the idea of prescribing upper and lower limits for the determination of profit-sharing ratio as a result of negotiations between banks and their clients. It envisages the

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[55] e.g., fulfilment of guaranteed minimum needs of the poor, defense procurement, debt servicing.

[56] In this context, a detailed discourse on the subject of the Islamic reforms and related issues is documented (*IIIE*, 1999).

[57] e.g., *Bayʿ Mu'ajjal*-Based Tradable Securities, *Istiṣnāʿ*-Cum-Staggered Payment Arrangement, *Salam* Securities.

[58] e.g., Simple Asset *Ijārah* Securities, Asset *Ijārah* Securities involving a financial intermediary, and Asset *Ijārah* Securities, issued by the government itself, for a third party acquiring an asset and leasing the same to the government

[59] e.g., Transferable *Ijārah* Warrants with a finance-lease-transfer arrangement, Transferable *Ijārah* Warrants with a build-lease-transfer arrangement.

[60] e.g., General *Mushārakah* Certificates, Decreasing-Participation/Redeemable *Mushārakah* Certificates, Special *Mushārakah* Certificates against Existing Pubic Sector Undertakings.

[61] IMF signifies the International Monetary Fund.

introduction as well as operation of control[62] measures as well as regulatory[63] measures for accomplishing central banking and monetary management.

Al-Jarhi and Iqbal's point of view about the special intrinsic nature of the Islamic banking gets crystallized into an Islamic universal banking model[64](Al-Jarhi et. al. 2001) wherein an Islamic universal bank,[65] portrayed as a multipurpose bank, culminates into a cross-breed of commercial banks, investment banks, merchant banks, investment trusts, insurance institutions and investment management institutions. An Islamic universal bank offers a wide-range of services to its clients on the basis of instituting a long-term bank-client relationship. In sharp contrast to conventional commercial banking model, the Islamic universal

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[62] Control measures include the minimum reserve requirements as well as liquidity ratio requirement imposed only on the current accounts, the reserve requirements applied on the paid-up capital of banks, and the imposition of a minimum share of the capital required to be committed by the banks for ensuring that banks discharge their prospective payment obligations corresponding to the facility of flexible *muḍārabah* deposits as well as flexible *mushārakah* deposits instituted by the banks. Moreover, the central bank can prescribe the minimum ratios of contributions of banks and clients in the contracts of partnership. The central bank has also available a control measure in the form of a system of fines for ensuring the compliance of its orders by all the banks.

[63] In the context of the regulatory measures, the central bank has the ability to increase or decrease the volume of liquidity in the system through purchase/sale of the bills of exchange/Sharīʿah-consistent tradable instruments held by the banks/new government securities and certificates while complying with the restrictions of Sharīʿah. It is important to note that on the regulatory side, the central bank can provide temporary equity support to the deserving banks. However, the central bank does not issue the debt securities against itself. IIIE's model of the Islamic banking system envisages the establishment of a high powered Sharīʿah Board for ensuring Sharīʿah compliance by all participants of the banking system.

[64] The idea of Islamic universal banking model originated in the background of the conventional universal banking which is permitted to be practiced in several countries of European Union.

[65] An Islamic universal bank, instituted as a joint stock company, has the main business of mobilizing funds by taking deposits from savers and supplying these funds to businessmen and entrepreneurs and the scope of its activities includes all the currently known banking activities with the exception of interest-based borrowing and lending. On the liability side of the Islamic universal bank, funds are deposited on the basis of interest-free demand deposits, *muḍārabah* deposits, and *wakālah* deposits (i.e. clients deposit funds in the *wakālah* account on the basis of *wakālah* contract with the Islamic universal bank which serves as the investment manager and charges a predetermined fee in exchange for its managerial services). On the assets side of the Islamic universal bank, finance is provided on the basis of interest-free modes of financing [i.e., *muḍārabah* (passive partnership), *mushārakah* (active partnership), diminishing partnership, *murābaḥah* (sales contract at a profit markup), *ijārah* (leasing), a lease ending in the purchase of the leased asset, *al-istiṣnāʿ* (contract of manufacture) and *al-istiṣnāʿ al-tamwili* (financing by way of *al-istiṣnāʿ*), and *salam*].

banking model offers a wide scope of banking operations especially in the context of authority of the universal banks to follow up and monitor more closely the activities and performances of the enterprises and companies which are financed by them. Islamic universal banks, being partners and stake-holders in the capital of the aforementioned enterprises and companies, have greater capacity of employing various techniques and procedures of monitoring and, therefore, are less amenable to moral hazards. In this setting, Islamic universal banks face less risk than commercial banks in downswings and upswings. The permission of other non-bank activities beyond investment banking is likely to generate further diversification benefits especially when the correlation of returns on diverse activities is sufficiently low. Thus, the Islamic universal banks have an edge in profitability over the conventional commercial banks.

The Islamic model of universal banking envisages the application of legal reserve requirement by the Islamic central bank only to demand deposits while governing other deposits by liquidity ratios and other monitoring indicators. In this model, bank's reserves held at the Islamic central bank will necessarily be placed in the profit-sharing certificates for generating lawful income for the banks as well as using the banks' reserves/profits for enabling the central bank to act as the lender of last resort. For ensuring sound financial conditions of the Islamic banks, the Islamic central bank will enforce financial controls,[66] operational controls,[67] and Sharīʿah compliance by instituting a Council of *ʿulamāʾ* at the national level for Sharīʿah-audit and for issuing *fatāwā* (i.e., Sharīʿah-based opinions).

Khan's model of Islamic banking system (Khan, 2002), while dispelling the point of view that Profit and Loss Sharing (PLS)-based system is the sole Islamic alternative to the interest-based system, illustrates the scope of many Islamically admissible trade–related transactions which conform to the nature of Islamic finance and satisfy the fundamental requirement of Sharīʿah that there exist certain assets which are able to either yield return in trading (i.e., *bayʿ*) and/or in use (i.e., *ijārah*), or create assets which give rise to the flow of income (i.e., profit) which is distributed among the suppliers of capital. This model asserts that the goal of the Islamic monetary policy is to stimulate growth and to ensure price stability. It proposes monetary policy instruments of open market operations in interest-free securities (i.e. PLS securities), reserve requirements, bank sharing ratio, bank/depositor/investor PLS ratios, selective credit controls, and moral suasion. It illustrates that the Islamic central bank's ability to regulate the banking system and

[66] e.g., capital adequacy ratio, liquidity ratio, profit-sharing ratios among different capital providers, limits to exposure to various types of risks, soundness of the feasibility studies, soundness of contracts, and rules governing banking and financial operations linked to items lying outside the balance sheet.
[67] e.g., the application of consolidated and acceptable Islamic accounting standards, a review of project financing operation, and an evaluation of the performance of banks.

to control money supply is not compromised after elimination of interest from the economy.

Hassan/Farhat/Al-Zu'bi's discourse (Hassan et. Al., 2003) about corporate governance of the Islamic banks and Iqbal/Mirakhor's discourse (Iqbal et. Al., 2004) on corporate governance structure provide theoretical insights into a latest model of Islamic corporate governance-based banking which envisages Islamic bank as an un-levered interest-free financial intermediary working under Sharīʿah according to which Allah (Subhanu Hu Wa Taa'ala) is the absolute owner of wealth and the wealth (e.g., the Islamic Bank and assets of this bank etc.) is entrusted by Him to the mankind as a trust under terms of trusteeship for serving Him. This concept culminates into a unique Islamic corporate culture[68] consisting of numerous stakeholders[69] and the corresponding Islamic corporate governance existing in the Islamic economy and, hence, in the model of Islamic banking.

This model of Islamic banking is based on two principles namely the principle of profit-loss sharing practised through the application of instruments of *muḍārabah* financing as well as *mushārakah* financing, which are perceived as equity investments, and the rarely allowed principle of mark-up which is used for commercial financing in the form of *murābaḥah* financing and *ijārah* financing. The Islamic bank (trustee) operates an interest-free current account, the saving account on a safe-keeping basis, and *mushārakah*-based investment account. In this setting, there arises a basis of the Islamic banking formed by equity participation in real transactions and PLS contract-based risk sharing. The financing on the basis of PLS may create agency problems on the asset and liability sides of the Islamic bank which may be solved within the operational framework of the Islamic corporate governance-based banking model consisting of internal regulatory systems,[70] internal control systems,[71] and external regulatory system.[72]

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[68] The Islamic corporate culture establishes appropriate behavioral standards for all stakeholders, motivates them, governs their internal relations within the organization (e.g., employer-employees relationships) as well as external relations (e.g., dealings with bank's customers), and conditions their internal as well as external environment on the basis of application of the principle of promoting mutual benefits as well as avoiding and eliminating harm for all stakeholders. Thus, all facets of the Islamic bank reflect the Islamic universal values.

[69] In this context, there coexist 7 categories of mutually functionally integrated key stakeholders (i.e., shareholders, management, *mushārakah*-financing parties, partners in *muḍārabah*-based investments, current account holders, employees, and Islamic community).

[70] Constituents of the internal regulatory systems are board of directors, non-executive directors, audit committee, internal audit, Sharīʿah supervisory board, and judicial advisor.

[71] Constituents of the internal control systems are financial controls, operational controls, audit reviews, compliance with reporting standards, and Sharīʿah compliance.

Big individual equity holders, who form the board of directors of the Islamic bank, and the equity shareholders are insiders of the Islamic bank and *muḍārabah*/*mushārakah* account holders (i.e., investment depositors) are outsiders such that the investment deposits are contributing 71% of the total capital and equity is contributing 14% of the total capital. Therefore, managers optimally invest all investment deposits from the point of view of outsiders and use dividends to signal their bank profitability to depositors for maintaining the level and inflow of investment deposits. The imperative of signalling the profitability and its stability to the depositors restricts mangers' investment activities to short-term and medium-term-investment projects only because of the highly risky and unstable nature of returns in the long-term investment projects. In short, the Islamic corporate governance-based banking model addresses the concerns of all stakeholders (i.e., insiders and outsiders).

Anjum presents a design of a progressive pan-Islamic monetary model[73] (Anjum, 2004) by outlining its systemic goals, rationale, politico-economic framework, the nature/scope/benefits/costs of the proposed Islamic monetary unit (Islamic) Universal *"Ψ"*, and the Islamic monetary management framework consisting of Islamic monetary agency, member banks, demand for money function, the Islamic money supply rule of eliminating monetary hardships through *shūrātic* (i.e., Islamic consultative framework) process, money supply function and the Islamic monetary transmission mechanism. He envisages the Islamic monetary regime aiming at the development of all humans of all regions in the light of five fundamental progressive objectives (*maqāṣid*) of the Islamic system namely security and advancement of life, religion, intellect, offspring and wealth. He lists the Islamic monetary regime's goals (i.e., the progressive needs[74]-fulfilment for human development from the point of view of improving living standards, equitable economic growth/distribution, full-employment, and price stability as the goals[75] of the Islamic monetary system) which are to be prioritized through Muslim

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[72] Constituents of the external regulatory systems are shareholders, external auditor, stock exchange, company law, central bank/financial regulator, and the Islamic accounting standard board.

[73] In 2005, Choudhury has republished Anjum's paper including his progressive pan-Islamic monetary model (Choudhury, 2005).

[74] The Islamic approach of satisfying the human needs, keeping in view the available resources, follows the prioritized pattern of basic necessities of life, necessaries of efficiency, and legitimate comforts/ beautifications of human life.

[75] Goals of price stability, full-employment-oriented growth, and provision of an optimal level of transactions services in the framework of a growing economy are inevitably ranked highest among the goals of the Islamic monetary regime. These highest-ranking goals are necessarily to be achieved through a non-inflationary monetary expansion corresponding to the segments of monetary expansion lines coinciding with horizontal axis in al-Jarhi's Figure I and Figure II (Al-Jarhi, 1983).

Ummah/grassroots-level *shūrātic* process[76] and realized through the practise of the Islamic progressive principles of politico-economic autonomy for self-reliance, justice, benevolence, and elimination of monetary as well as economic hardships.

Anjum observes that the most relevant politico-economic framework conducive for establishing a progressive pan-Islamic monetary regime is embodied in the Islamic universal institution of *Khilāfatul-Khulafa* (i.e., government of all governments) envisioned by Shah Wali Ullah in his theory of stages of socio-economic development. In the final stage of socio-economic development, human society and the institution of government assume international character and, as a result, there appears a need for instituting *Khilāfatul-Khulafa* [77] in the context of safeguarding[78] the socioeconomic interests of different states and establishing peace and justice among them. He argues that the existing vacuum[79] in the area of a vehicle currency justifies the contemporary 57 Islamic countries' proposed common policy action of simultaneously abolishing their weak individual currencies and jointly instituting as well as promoting an official Islamic vehicle currency[80] (i.e., *Ψ*) for ensuring the preservation, development, autonomous control and utilization of their own colossal wealth through the promotion of their progressive pan-Islamic global monetary regime instituted for guaranteeing the politico-economic empowerment of all humans on the global level. The aforementioned common policy action of all the Islamic countries is expected to

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[76] Choudhury interprets the term s*hūrātic* process as the institutionalized process of extensive discursions in Islam (Chaudhury, 1997).

[77] Keeping in view the prevalent universal consensus on the sanctified status of *al-Hararamain al-Shareefain* among all Muslims of the entire globe, all the contemporary Islamic countries may get completely integrated under the Islamic Caliphate as well as the *Khilāfat-ul-Khulafa* headed by an Arabian *Khaadimul Haramain al- Shareefain* in order to meaningfully revive the unparalleled power of Muslim *Ummah*.

[78] Keeping in view the latest invasion of Iraq by the U.S.A. and the U.K. without any legal approval of the United Nations as well as the future possibilities of preemptive strikes of the West against other Islamic states, the simultaneous establishment of *Khilāfat-ul-Khulafa* as well as development of a pan-Islamic progressive monetary regime seems to be the only viable mechanism for the politico-economic autonomy, security and development of the contemporary Islamic world.

[79] Unfortunately, this vacuum is due to the failure of the governments of the individual Islamic countries in providing the urgently needed alternative vehicle currency.

[80] Enormous numerical strength of the global community of over 1 billion Muslims, who will stop trading in the U.S. dollar as well as give up their individual holdings of the US dollar as a vehicle currency in order to hold their own Islamic vehicle currency "*Ψ*", is expected to reinforce the strength as well as the confidence commanded by *Ψ* not only within the boundaries of *Khilāfat-ul-Khulafa* but also in all other parts of the globe due to Muslims' overwhelming trade and financial linkages with the humanity living all over the globe. Consequently, *Ψ* has the potential to assume the character of a truly universal currency.

reduce the practically avoidable huge costs of economic inefficiency[81](e.g., transaction costs/calculation costs etc.) in the monetary and real sectors of the economies of the Islamic countries. Thus, the pan-Islamic monetary integration is destined to significantly increase the human welfare by reducing risk/uncertainty/vulnerability, by generating monetary efficiency gains, and by eliminating the costs of conversions of one Islamic country's currency into another Islamic country's currency borne by traders and investors.

The Islamic progressive monetary regime will have a distinguishing feature of accomplishing optimal monetary management in the dynamic framework of a growing Islamic economy wherein the real money supply is increased in order to ensure the efficient provision of maximum possible amount of transaction services to all economic agents such that the real money supply gets equilibrated with the estimated demand for money along with the successful realization of the already mentioned Islamic macroeconomic goals.[82]

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[81] Such costs of economic inefficiency are experienced in the form of losses of time, effort, and real resources corresponding to the mutual exchange of 57 currencies of individual OIC-member countries.

[82] i.e., price stability, growth, full-employment, equitable distribution, and human development.

Islamic Monetary Authorities Network (IMAN[83]), proposed to constituted by *Khilāfat-ul-Khulafa*, will accomplish progressive monetary management in the framework of a pan-Islamic universal economy. The list of constituents of the optimal Islamic monetary management regime includes IMAN including Islamic treasury[84], Islamic Consensus-Based Banks (ICBBs[85]), Islamic money demand function[86], and the Islamic money supply function[87] which is equilibrated with the

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[83] IMAN is proposed to be an autonomous central monetary authority which has the ability to regulate the activities of member Islamic banks and financial institutions. Only IMAN is authorized to create and supply Universals ' Ψ' to the member Islamic banks, member governments, member private sector development companies, corporations, voluntary sector's institutions, micro-enterprises, and households for financing socio-economic development-oriented projects on the basis of *muḍārabah* and *mushārakah.*

IMAN, with its head-quarters located at Makkah al-Mukarramah, will be having its regional and local offices for ensuring optimal monetary management at grass-roots level through a comprehensive and efficient mechanism of consulting all types of the relevant economic agents as well as for monitoring/participating in *mushārakah/muḍārabah-based* productive investments of all relevant economic agents. The aforementioned productive and progressive role of IMAN is expected to ensure the balanced development of all regions, sectors and segments of the society and economy. In this setting, the rate of return on IMAN*'s muḍārabah/mushārakah* approaches the average rate of profit of the entire economy. An increase in rate of return on IMAN's *muḍārabah/mushārakah-based* ventures is expected to increase the prices of shares (P_S) and vice versa. IMAN is envisaged to supply money to government, firms, Islamic banks, and the needy households in the form of *al-qarḍ al-ḥasan* from the point of view of eliminating economic hardships of all the concerned people.

It is important to note that IMAN*'s* money supply function, which addresses the genuine dynamic monetary needs of all microeconomic and macroeconomic agents of the pan-Islamic universal economy, resembles heart's comprehensive function of supplying only the actually needed quantity of blood to all organs of human body as well as withdrawing the undesired blood.

[84] Islamic treasury may issue a small amount of currency in the form of all coins.

[85] ICBBs are modelled along the lines of Islamic consensus-based banking which is explained in this paper's section entitled Conclusion and Policy Recommendations.

[86] Following is the proposed Islamic money demand function, based on the Islamically rationalized money demand (M_d) for progressive need fulfillment-oriented goods and services which are meant for consumption and productive investment in the framework of a progressive Islamic economy:

$$M_d //P = f(Y_{PIBHGS}, y_m, I, T_F)$$

The aforementioned $M_d//P$ denotes the demand for *real money balances*, Y_{PIBHGS} refers to Progressive Islamic Basket of the need fulfillment-oriented *Halal* Real Goods and Services meant for consumption and productive investment, y_m stands for the rate of return on IMAN's *muḍārabah/mushārakah*-based investments of shortest maturity, I indicate the Islamic institutional factors (e.g., *shūra, zakāh, taqwah*), and T_F symbolizes the state of financial technology (e.g., the innovative use of debit cards).

[87] IMAN's money supply function is stated below:

$$M_s/P = f(Y_{PIBHGS}, y_m, I, T_F)$$

aforementioned Islamic money demand function, and a progressive Islamic monetary transmission mechanism.[88] It is important to note that IMAN has not the complete discretion in the context of expansion of money supply because it will have to abide by the Islamic money supply rule of eliminating monetary hardships and facilitating growth-based real transactions through an Islamic *shūrātic* (i.e., consultative) framework. Thus, the Islamic money supply rule will be positioned in between discretionary monetary policy and Friedman's rule of adopting a fixed annual rate of growth of money supply "M". IMAN will estimate the demand for money and then the estimated demand for money will be targeted to be equilibrated with supply of base money alone[89] for satisfying the following monetary equilibrium condition:

$$M_d//P = f(Y_{PIBHGS}, y_m, I, T_F) = M_s/P$$

4. A Comparative Systemic Critique of the Alternative Models of Islamic Banking

The Islamic banking business in case of all the theoretical model of Islamic banking is instituted on the basis of at least a two-tier *muḍārabah* contract such that the first tier of *muḍārabah* is instituted between the Islamic bank and its depositors, and the second tier of *muḍārabah* is instituted between the bank and the parties to whom the bank provides the finance.

Here M_s/P denotes the supply of *real money balances.* It is important to note that IMAN's money supply is intrinsically directly linked with the really productive economic activity, employment, real income and prices. Therefore, systematic variations in money supply may have systematic impact on the real variables.

[88] The following Islamic monetary transmission mechanism functions in the interest-free framework of a universal Islamic economy which consists of four sectors called households' sector, private investors' sector including Islamic banks and financial institutions as well, central/regional/local governments, and the voluntary social welfare sector:

While continuously practicing the Islamic principle of non-inflationary finance, IMAN shall satisfy the Islamically rationalized demand for money of all the aforementioned four sectors on the basis of either *muḍārabah/mushārakah* or *al-qarḍ al-ḥassan.* In this background, due to IMAN's policy of accomplishing non-inflationary monetary expansion, the resulting increase in aggregate demand would lead to a growth in the output and income through the multiplier mechanism (i.e., an increase in *M* induced by an increase in money demand for accommodating additional transactions of the actually grown output in the framework of a growing universal Islamic economy → increase in y_m → increase in prices of shares → increase in both consumption expenditures and productive investment → increase in GDP of *Ummah*).

[89] This scenario originates from the proposed elimination of the power of banks to create inside money in the Islamic economy.

All theoretical models of the Islamic banking system, with the exception of models of the Islamic banking system contributed by Al-Jarhi(1981) and Anjum (2004) wherein the Islamic banking is accomplished on the basis of 100% reserve requirement, introduced the fractional reserve system-based Islamic banking. All the well-known theoretical models of the Islamic banking system, irrespective of the differences in their institutional structures and operational frameworks, are having explicit built-in linkages with Islamic macroeconomic goals of human development/empowerment in socio-economic and political contexts.

Instead of being explicitly premised in the geographically universal jurisdiction of the Islamic state (i.e., The Islamic Caliphate encompassing the whole globe), most of the existing well-known models of the Islamic banking are either premised in indifference to the national and universal aspects of the Islamic banking system or implicitly premised in the narrowest Western nationalistic framework of the ethnically and geographically disintegrated Muslim states.

Well-known earlier theoretical models[90] use terms 'banking without interest', 'interest-free bank', 'interest-free economy', 'Banque D'Affaires', 'Central Bank', 'treasury' instead of explicitly using comprehensive Islamic terms such as 'Islamic banking', 'Islamic bank', 'Islamic economy', 'Banque D'Affaires'Islamique', 'Islamic Central Bank', and 'Islamic Treasury'. True, the use of the adjective 'Islamic' is inevitable because, for example, merely a *muḍārabah*-based interest-free business of wine is not at all an Islamic business.

Siddiqi's model of the Islamic banking portrays many institutions of the Islamic banking system. But, it illustrates only some of the many possible progressive dimensions of the overall Islamic banking system because it is portrayed to be instituted by the Islamic state in isolation from the operation of other institutions of the Islamic economic system with the exception that this model presents a highly enlightening and systemic discourse in the context of accomplishing progressive public finance through a cooperative interaction among the Islamic state's government, its treasury, and the Islamic central/commercial banking system. It fails to envisage Sharīʿah Board as an integral part of Islamic banking.

By advocating a safe method of profitably investing the bank capital, in the sense that large amounts of funds are not invested for very long periods, Siddiqi's model of Islamic banking does not allow the Islamic bank to act as a perfect development finance institution because its policy design fails to finance the gigantic very long-term development projects[91] which are almost non-existent in most of the contemporary Islamic countries and which inevitably require highly risky investments of large sums for very long periods and for realizing economies of scale in production.

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[90] i.e., Models contributed by Siddiqi (1969), CII (1980), Al-Jarhi (1981), and Chapra (1996).

[91] e.g., motorways, large dams etc.

CII 's model of Islamic banking is a multidimensional practical problems-specific Islamic banking model. It became not only instrumental in practically instituting an official process of the Islamization of the entire national economy of Pakistan but also influential in conditioning the movements of the Islamization of banking all over the globe. Above all, it has become a touchstone of the degree of Islamicness of the banking services of the contemporary Islamic banks. Particularly, its recommendation of limiting the usage of the Islamically permitted modes other than profit/loss-sharing and *al-qarḍ al-ḥasan* to the minimum possible extent has left profoundest impressions in the minds of banking public due to which especially the financing performance of the Islamic banks, which overwhelmingly use *bayʿ mu'ajjal* as a financing device, has been eclipsed not only in the minds of banking public but also in the sight of certain economists.[92]

5. Conclusion and Policy Recommendations

Our latest extensive inquiry into the contemporary movement of the Islamic banking manifests the humane, social, dynamic, innovative, progressive, equitable and universal character of the fast evolving Islamic banking system on the global level due to its natural conceptual appeal which cuts across all regions, cultures, religions and economic systems. The panorama of crystallization of several distinct multi-faceted theoretical and applied models of the Islamic banking system as the variants of the originally published two-tier *muḍārabah* model of the Islamic commercial banking is a spectacular result of the continuous feedback/feed forward between theory and practise of the Islamic banking system which have been enriching the literature on the subject. Despite the spectacular pioneering achievements of the contemporary movement of Islamic banking, there exists a lot of the unexploited potential in the arena of the Islamic banking on the global level which can be exploited by realizing an autonomous pan-Islamic monetary regime-based synergy among at least several prospective constituents[93] of the Muslim *Ummah*.

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[92] e.g., Ziauddin Ahmad states (Ahmad, 1984), "Too much dependence on *Bayʿ Mu'ajjal/Murābaḥah* also means that the change that has taken place is more in the form than in substance." Similarly M. Fahim Khan states (Khan, 1998), "One very simplest view based on the practice of existing Islamic banks can be that we can take mark-up based financial system as an alternative to interest. Islamic economists, however, are critical of this approach on the ground that this will not reflect the true spirit of Islamic economic system and would simply be an instrument to bring interest from back door and hence nothing will change in the economy. Islamic economists believe that a true alternative to interest would be the introduction of profit-loss sharing based financial system in the banking system."

[93] e.g., Islamic states and their residents as well as Islamic minorities living in non-Islamic states, the IDB, Islamic banks/financial institutions, Islamic Treasury and Baytul Mal, Islamic money market, Islamic capital market, Islamic universal common market, Islamic

The first and foremost policy recommendation for realizing the zenith of Islamic banking is to officially promote a system of consensus-based Islamic banking which limits itself to the use of only those modes of the Islamic banking and finance which command the consensus of the Islamic economists as well as jurists. In this background, ICBBs are modelled along the lines of Islamic consensus-based banking which accomplishes corporate governance-oriented Islamic universal banking by using only those modes of the Islamic banking and financing (e.g., *mushārakah* and *muḍārabah*) which command the general consensus among the Islamic jurists and economists and, thereby, the confidence of the global Muslim community. In the Islamic consensus-based banking, the Islamically recognized welfare of the entire world's all stakeholders will be defended and promoted. Because of the non-controversial nature of the Islamic consensus-based banking, the banking and financing services of the ICBBs will become equally popular among the world's all Muslims, including those who otherwise have reservations about the indiscriminate use of modes of financing other than *mushārakah* and *Muḍārabah*, thereby leading to the branching out of ICBBs on the grass roots level and to their success as real development-finance institutions.

ICBBs, on their liabilities' side, can institute checkable demand deposits on the basis of 100% reserve requirements and *muḍārabah* deposits/*mushārakah* deposits/*wakālah* deposits/swift *ṣadaqāt* disbursement accounts/firm commitment-based participatory deposits[94] to be made available to an ICBB on its demand within one week or two weeks without any reserve requirements. On their assets' side, ICBBs can provide financing on the basis of 'service-charge-free *qarḍ*-i-Ḥassana'/*muḍārabah*//*mushārakah*/share-cropping-based *musāqah* and *muzāraʿah*, finance their own trading and investment activities, finance the establishment as well as the business of their own subsidiary companies, and provide fee-based services (e.g., services of money transfer, bank drafts, letters of credit, share brokerage, traveller's cheques, etc.). On the basis of *muḍārabah*/*mushārakah*/share-cropping-based *musāqah* and *muzāraʿah*, ICBBs can introduce financing instruments of equity participation, *muḍārabah* certificates, *mushārakah* certificates, *musāqah* certificates, *muzāraʿah* certificates and *al-qarḍ al-Ḥasan* certificates which have already been introduced in Malaysian economy for accomplishing non-inflationary financing.

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jurists/economists/bankers/banking public, media, and all other stakeholders of the global society.

[94] Idea of firm commitment-based participatory deposits of ICBBs introduced in this paper is an innovated version of the idea of Mannan regarding the introduction of firm commitment participation certificates (Mannan, 1993) as an Islamic bank's instrument which leads to the efficient employment of the funds such that the bank shall call funds only in case of emergence of its actual needs for financing its investment.

ICBBs will be extremely decentralized in decision making, which will be accomplished in consultation with all people living in their neighbourhoods/jurisdictions, regarding their financing activities. ICBBs will offer equal opportunity to all their clients on their liabilities' side as well as assets' side to freely negotiate the terms and conditions of their financial contracts especially the profit-sharing ratio with the authorities of ICBBs. ICBBs will institute a humane pattern of banking which is perfectly Islamic, progressive, state of the art (i.e., high-tech/efficient service-oriented), equitable, perfectly see-through/transparent/disclosed, and promoter of individual as well as social welfare through the heart-winning cordial bank-clientele relationship. ICBBs will have high-powered Sharīʿah Boards which will be working under IMAN's autonomous Central Sharīʿah Board located at the head quarters of IMAN. From the point of view of restoring/developing the confidence of the global Muslim masses in the Islamic consensus-based banking system, Sharīʿah Boards will completely avoid the use of Sharīʿah tricks. All ICBB's will necessarily be the members of the IMAN .

The rationale for instituting ICBBs arises in the background of the fact of persisting widespread misconceptions/skepticism in the context of resemblance between certain practises of contemporary Islamic banks and the practises of conventional interest-based banks, and the corresponding lack of confidence of the masses ranging from Pakistan to Indonesia in the contemporary Islamic banks' primarily used Sharīʿah-tricks-based modes of financing other than *mushārakah* and *muḍārabah* despite the fact that the contemporary Islamic banks seem to be satisfied with their growth/branching performance and with the Islamic compatibility of their overwhelmingly used modes of financing especially since[95] the publication of Hamoud's critique of principle of profit-sharing which could not satisfy even IDB prize winning Islamic economists like Abdel Rahman Yousri Ahmed. So, it is hypothesized that still there exists an overwhelmingly large segment of Muslim masses which could not be targeted by the Islamic banks and this segment can be easily targeted by scientifically instituting as well as by massively socializing the progressive practise of Islamic consensus-based banking system in the Islamic world. The Islamic consensus-based banking system will not only popularize and reinvigorate the Islamic banking and empower/develop the humanity but also marginalize those Islamic banks which misuse Sharīʿah tricks as well as the conventional interest-based banks which are inherently inequitable and inefficient. Inherent inefficiency of the conventional interest-based banks is proved

[95] i.e., since 1982.

by their history of widespread failures[96] despite the existence of official supporting mechanisms.[97]

Muslim masses' built-in-confidence in ICBBs will be the vehicle asset of the Islamic consensus-based banking system which will globalize and universalize the practise of the Islamic banking as well as lead to the development and empowerment of the Islamic money market as well as the Islamic capital market in the whole world. Europe is already on the way to feel and appreciate the flavour of the glamour, power, and prowess of the Islamic financial system. It is hypothesized that the progressive pan-Islamic monetary regime and its consensus-based banking system will culminate into the zenith of the movement of the Islamic banking and finance. For achieving the long-term developmental goals, application of 'increasing *mushārakah*' is being recommended along with the recommendation for the practise of the following principles:

- principle of transparency through appropriate disclosure mechanism
- principle of socializing Islamic banks and their products through regular social interactions among all stakeholders of the Islamic banking system for overcoming their problem of the scarcity of their social capital for ensuring the branching out of the Islamic banks on a massive scale
- principle of observing merit in allocation of the financial resources
- principle of realizing Islamic synergy through cooperation among the Islamic banks
- principle of individualized banking accomplished by negotiating profit-sharing ratio with each and every customer of the bank
- principle of decentralized decision making in the branches of the Islamic banks for the efficient allocation of financial resources through communitarian banking.

It is also recommended that introductory contents about Islamic economics and Islamic banking should be included in the subject of Islamic studies taught in high schools for creating deep-rooted awareness of the nature, significance and practise of Islamic banking. Finally, a permanent globally representative authoritative board of the Islamic jurists/economists and bankers merits to be set up for developing consensus on certain Islamic principles/modes/instruments/products/services from the point of view of instituting and promoting an ever-popular regime of the Islamic consensus-based banking system which can lead to standardization of the Islamic banking procedures/services/products, generate as well as exploit social capital, command the confidence of the global masses, and, thus, provide the

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[96] Failure of 2573 banking/financial institutions in the form of commercial banks and Savings & Loans (S&Ls) occurred in the U.S.A. in the period 1982-1994 (Thomas, 1997).

[97] e.g., Federal Deposit Insurance Corporation instituted on the basis of the Banking Act of 1933 in the U.S.

financial fuel to numerous engines of growth and human development in the universal framework of the Islamic economy.

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15

Non-Interest Resource Mobilization for Public Capital Projects: The Use of Islamic Endogenous Loans

Rodney Shakespeare*

Islamic opposition to ribā opens the path to an immensely creative possibility – a non-interest way of mobilizing resources for public capital projects. The way uses Islamic endogenous loans (repayable, interest-free loans issued by the central bank) which are counter-inflationary and always directed at productive capacity. Because they bear no interest, the loans allow the building of bridges, hospitals, schools, sewage works, tsunami warning systems etc. at one half or less of the present cost.

The loans can also be used for other aspects of the real economy:

- *Private capital investment in large corporations if new owners of capital are created*
- *Environmental capital investment (e.g. clean energy)*
- *Small and start-up businesses thereby freeing them from the crushing pressure of interest-bearing debt.*

Above all, the use of the loans will enable Islamic societies to give an intellectual, material and moral lead to the rest of the world.

Introduction

There is always a need for more public capital projects – anything from a road or hospital to housing or sewage works – but there is never enough money. Consequently, faced with a demand to build a capital project, a government will always start by saying that its income is insufficient and then add that, in any case, there are other, more pressing, claims on its resources.

Which is not unreasonable because there is a limit to the amount that can be raised by taxation and there are always many urgent things needing to be done. Besides, the government will say, even if we do agree to build the project, we will have to borrow the money which, because of the associated *ribā*/interest, will

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increase our already huge, and debilitating, National Debt.[1] Then, as a last afterthought, it will say that if a government prints money for its spending, the inevitable result is inflation.

Yet, whatever a government says, there is an undoubted need for public capital projects and much pain and misery results when they are missing or inadequate. A terrible recent example is the December 2004 death and destruction caused by tsunami (tidal waves) because countries surrounding the Indian Ocean did not have proper warning systems in place.[2]

So, is there a solution? Is there any new way of funding necessary public capital projects without raising taxation, increasing the National Debt – or causing inflation?

Yes, there is. It can be summarised in the phrase Islamic endogenous loans. While not being a magic wand capable of solving all problems, the loans do have the practical consequence of either:

doubling the amount of public capital projects obtainable for the present cost

or

allowing the existing amount of projects to be obtained at half the present cost.

2. *Ribā*/Interest is Not Only Wrong but Unnecessary

In order to understand the new way it is first only necessary to remind that *ribā* (interest) is wrong. The Qur'ān forbids *ribā* and that, for Muslims, is the end of the discussion.

Yet Muslims should also recognise that, leaving Qur'ānic injunction aside, there could be another, separate, argument against interest – namely, that interest is not necessary. If correct, the argument is peculiarly powerful because Western neoclassical economics (and the worldwide finance capitalism it generates) generally assumes interest to be something that exists, has always existed, and always will exist because it is, as it were, an integral part of nature.

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[1] National Debt is usually incurred by the central government of a country selling interest-bearing bonds. In the UK, in order to raise money, the government issues Exchequer or Treasury bonds i.e., government stocks or securities. The buyer of these stocks is given a commitment to repay the stock plus interest at a given date or dates. When banks buy the stocks, money is created by the banking system to do so. However, pension funds etc. also buy the stocks.

[2] The December 2004 earthquake off Sumatra, Indonesia had a magnitude of nearly 9.2 on the Richter scale. It resulted in tsunami directly killing at least 180,000 people and causing massive destruction. A large proportion of those deaths would have been avoided if a proper tsunami warning system had been in place.

Moreover – and this is being blunt – the argument that interest is wrong is not likely to carry much weight with the non-Muslims who may view Islamic religious belief as of little relevance to themselves. However, if interest is stated to be unnecessary then the ears of non-Muslims begin to prick up. After all, everybody knows interest imposes a considerable financial cost and the possibility of avoiding it is something which has appeal to all sane people, be they Muslim or non-Muslim.

3. Since Nowadays the Banking System Creates Money Out of Nothing There is No Justification for the Imposition of Interest

Of course, those of a cynical turn of mind will say that it does not matter if interest is necessary or unnecessary because interest is simply an imposition by those who own money and have the power to dictate the terms on which others can borrow.

Which cynicism is not unreasonable if people really are lending their own money. But suppose they are not lending their own money and, instead, are creating the lent money out of nothing simply by pressing computer buttons (which is what the banking system does today)? Where, then, is the justification for the imposition of interest?

There are, of course, the traditional justifications for the imposition of interest. Thus Nassau Senior[3] invented the term 'abstinence' seeing interest as the reward for abstaining from immediate consumption. Rather similarly, Alfred Marshall spoke of 'waiting'[4]. And the principle of time-preference was stated by Eugen von Bohm-Bawerk[5] who viewed a loan and the associated interest as a real exchange of present goods against future goods. Again, the underlying idea is of paying a price for getting something now rather than having to wait.

But if somebody creates the money to be lent out of nothing by pressing computer buttons why should that person be allowed the additional privilege of adding interest? That person has done no 'waiting' or 'abstaining'. And who said that person has the right to create the money in the first place? Indeed, those who create money out of nothing are normally deemed to be guilty of forgery and counterfeiting (for which there is always serious punishment).

Yet, today, money is created out of nothing by the banking system which has, in practise, been allowed not only to usurp society's prerogative to create money[6] but

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[3] 1790 – 1864.

[4] Principles of Economics.

[5] 1851 – 1914.

[6] In 1694 the founder of the Bank of England gave £1.2 million (@ 8% interest) to King William III to fight the war with France. This was the first UK National Debt and, in

also to usurp society's right to impose tax – for a tax, in effect, is what interest is except that the benefit of the 'tax' does not go to the government. Thus we have reached the crux of the matter which can be expressed in the question – Who (society or the banking system) has the ultimate right to create money (and, if wished, to impose interest)?

Of course, on hearing the question, there is an immediate flurry of objection, for example, pointing to the everyday cost of financial administration as being a reason for imposing interest. Which is not denied because the cost of administration can be a part of interest[7] as can provision for default.[8] And every investment – at least in the private sector – must in principle pay for itself. However, when the administration cost is minimal and when the collateral (security for a loan) is adequate or largely not involved,[9] and when there has been a scrutiny to establish whether the investment can pay for itself, it can then be clearly seen that interest itself is not necessary. Rather it is like a tax – and an unnecessary one at that – imposed, simply, by those who have the power to impose it. And, like taxes, it can go on being gathered for evermore, bleeding a country to death (as heavily indebted countries know only too well).

The conventional economist will then try to make another defence of the imposition of interest. In another version of the 'abstinence' argument he will articulate conventional savings doctrine. This says that, before there can be investment, there must be financial savings and physical savings. Indeed, at first it sounds reasonable to say that, before there can be investment, money must be obtained, and physical things (e.g., bricks and cement) must be available. But suppose the money is created out of nothing by the pressing of computer buttons[10] and suppose the bricks and cement are easily available (even though, when in short supply, their prices can rise or, if necessary, alternatives are available)? Where, then, is the justification for conventional savings doctrine?

So the question stays with us – Why should there be interest at all? Indeed, Muslims should recognise that, apart from being wrong, interest can be viewed simply as an unnecessary 'tax', and a very large one, whose receipts go only to a

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effect, the government's inherent right to issue money had been sold to the banking system. The National Debt principle has been copied worldwide.

[7] In the case of public capital investment the administration cost can often be low, even minimal. This is because the administrative cost is substantially borne by the borrower and not by the lender (e.g., as when a local government body collects fees and taxes with which to repay its debts).

[8] The provision might be for the default of the borrower or the default of other borrowers in general.

[9] For example, when a government undertakes the obligation to repay, or when specific provision is made for collateral.

[10] Nowadays, the international banking system creates the original principal of a loan out of nothing – by the pressing of computer buttons. It then imposes interest.

small percentage of the population and to foreigners.[11] In fact, it is hard to see any justification for the imposition of interest since the original principal is created out of nothing and interest generally has hugely deleterious effects on the economy and society as a whole.[12]

Muslims, therefore, should beware of outdated concepts such as the time value of money and conventional savings doctrine which are generally presented to the populace as unchallengeable slogans and everlasting truths. In reality, of course, they are cynical deceptions designed to maintain the malignant grip of money-lenders and other undesirable features of finance capitalism such as rich-poor division and economic colonialism.

4. The Cost of Capital Projects Can be Halved or More

Furthermore, in making the recognition that interest is not necessary, Muslims will easily come to a further recognition – that, if interest is eliminated, the cost of capital projects can be halved or more. This is because interest, particularly when compounded, adds hugely to the cost of a project. Indeed, in many cases, due to the accrual of interest, the money owed becomes incapable of ever being repaid. This is the basic mechanism which has caused the National Debt of most countries to rise to astronomical levels.[13]

5. The Conventional Definition of Endogenous and Exogenous Money is A Perversion and A Lie

Conventional Western economics and neoclassical finance capitalism, however, intent on maintaining the existence of interest, will still come up with one more attempted defence of interest (and of the banking practise of creating money out of

[11] Overall, the cost of interest causes 80% of the population to pay out much more than they receive; 10% are in balance; and the last 10% receive very much more than they pay out. Internationally, of course, the effects of compound interest are such that whole societies are trapped into an ever-increasing debt which they can never repay, and the attempt to repay in practice results in their economic resources being ripped off to outsiders. Kennedy (1995).

[12] The effects of interest are complex but in Aachen, Germany, interest on capital is 12% of the cost of rubbish collection; 38% of the cost of drinking water; 47% of the cost of sewage; and up to 77% of the cost of public housing. Indeed, it has been estimated that an amazing 50% of the price of all goods and services relates to borrowing costs (principal and interest). Kennedy (1995). See also Diwany (2003).

[13] But there is a remarkable exception – the Channel Island of Guernsey which, in the early nineteenth century, and having insufficient income to fund borrowing for an essential sea wall, decided to create its own money to build the sea wall and then take back the money (via fees and taxes) with the option of cancelling it. The practice has been continued so that, today, largely free of National Debt, Guernsey is prosperous (although the fact that Guernsey is a tax haven tends to mask the true source of prosperity which is freedom from National Debt).

nothing by pressing computer buttons). For them, interest is at the heart of everything that is materially successful and this can be understood by considering the conventional definition of endogenous money (which is alleged to be the key to all material growth and success) as that which issues from the banking system. Conventional economists then get very excited – indeed, give yelps of triumph – as they add that loaned money issuing from the banking system is especially virtuous because it serves the needs of the economy – particularly the need for productive capacity – and efficiently allocates resources.

But that is untrue. Firstly, a visit to any dictionary reveals that 'endogenous' has the meaning of ‘coming or growing from within’ (and 'exogenous' has the meaning of ‘coming from without’). Thus the conventional claim that money coming from the banking system is endogenous (and money coming from the state is exogenous) is a disgraceful twisting of words for it is essentially being claimed that government and other institutions at the heart of society are in reality outside society, and only the banking system is inside. That is a perversion of vocabulary.

Secondly, the claim of efficiently allocating resources, particularly for productive capacity, is a complete lie. Nowadays, the banking system does not allocate money to new productive capacity and, instead, allocates it to derivatives, to the bidding up of existing asset prices, to consumer credit, to putting individuals, companies and whole societies into debt, indeed, to anything but the real, productive economy.[14]

The perversion and lie are further compounded when interest is considered. Conventional endogenous money issuing from the banking system) bears interest and, very generally, interest doubles, or more than doubles, the cost of a capital project. Something which doubles the cost of a project cannot honestly be called something causing a ‘growing from within’ and something that hampers growing cannot honestly be claimed to be promoting growth.

6. All of The New Money Supply can be Directed at Productive Capacity

The perversion and lie, moreover, are seen to be outrageous when it is understood that a government, using the banking system and generally insisting on market and private property principles, can ensure that all of the supply of new money to an economy can go towards new productive capacity. In other words, by using what is summarised as Islamic endogenous loans, government can do what the banking sector claims to do, but does not.

The mechanism for the loans is simple. In the case of public capital projects (e.g., roads, bridges, hospitals, schools, waterworks, sewage works etc.), the national central bank (in Islam, Bait al-Mal) lends interest-free money to the

[14] Today, only a tiny percentage of the money supply goes into new productive capacity.

government for the purposes of the government's own capital expenditure. In due course, the lent money is repaid by the government to the central bank which can cancel the repaid money. No interest is involved, thereby halving at least the cost.[15]

In the case of the private sector, the central bank (Bete el Mar) lends interest-free money to the banking system which then lends it on to businesses on market principles including the ability to repay the money, and the existence of collateral. NB. In the case of large corporations, a key condition for the use of interest-free loans is that the investment is associated with the creation of new shareholders.[16]

The linkage of the money supply with the real economy (and at half the present cost) is something which can never be done by the banking system as it exists today, indeed, is incapable of even being understood by the present banking system. The linkage not only halves the cost of public capital projects but it is also important to note that the public projects can still be:

built by the private sector

managed by the private sector

and even, for that matter, owned by the private sector.

And since the loans are repaid and cancelled, there can be no inflation.

7. Islamic Definitions of Endogenous and Exogenous Money

Thus it can be seen that Islam is able to give true definitions to endogenous money and exogenous money – definitions which are completely different from the present perverse conventional definitions. Completely unlike conventional economics, Islamic economics is able to define Islamic endogenous money as state-issued interest-free (repayable and cancellable) loans which are always directed at new productive capacity. The loans are capable of being administered by the banking system on market and private property principles.

And Islam is also able to define exogenous money as interest-bearing money either coming from abroad or created by the international banking system operating within a country.[17] Such money, of course, if at all possible, is to be avoided.

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[15] Interest-free loans for public capital projects have been used by the Channel Island of Guernsey over the years. Guernsey has minimal national debt. Malaysia is believed to be experimenting with such loans and, of late, has achieved some remarkable feats of construction. Over the period 1939 - 1974 – a prosperous period – Canada used the loans and, today, many Canadian municipalities are demanding their use. In the USA, 3,400 governmental bodies (local boards, towns, cities etc) and six State governments support the idea – a Bill (HR 1452) reached Congress but was defeated by powerful vested interests. New Zealand has used such loans in the past.

[16] Ashford and Shakespeare, (1999).

[17] The usual conventional form of this money is that of interest-bearing loans which are not

8. Islamic Endogenous Loans are Directed at the Real Economy and cannot be Inflationary

Islamic endogenous loans combine efficiency with social and economic justice. Taking the form of state-issued, interest-free loans (administered by the private banking system) they are directly related to the real economy, made repayable and, when repaid, are cancelled or cancellable thus ensuring that productive assets always back a society's currency.

The cancellation of the money on its repayment ensures that there can be no inflation because a productive asset has been created and the money used to bring it into existence is eliminated. Indeed, Islamic endogenous loans create a counter-inflation i.e., more wealth and economic activity are created but with lowered prices.

9. Non-Interest Resource Mobilization for Public Capital Projects: the Use of Islamic Endogenous Loans

The first main use for Islamic endogenous loans is now easily seen – for public capital projects. Hospitals, roads, bridges, sewage works, waterworks, fire stations, schools and tsunami warning systems can be constructed for one half, or even one third of the present cost. Over time, the National Debt would reduce.

Moreover, the public capital projects can still, if wished, be built by the private sector, managed by the private sector, even owned by the private sector. The key point is that the cost, at the very least, is halved.

10. Other Uses of Islamic Endogenous Loans

There are, moreover, three other main uses for Islamic endogenous loans:–

Private capital investment in large corporations if such investment creates new owners of capital and is part of policy to enable all individuals, over time, on market principles, to become owners of substantial amounts of productive capital. By using state-issued interest-free loans, administered by the banking system on the market principles of binary economics,[18] a large company/corporation would get cheap money as long as new shareholders are created.[19]

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necessarily directed at productive capacity and furthering the needs of society; and which hand control of society either to a narrow elite or to outsiders.

[18] The main textbook on binary economics is "Binary Economics – the new paradigm", by Ashford and Shakespeare (1999). The word 'paradigm' is important because without a new paradigm – a fundamentally new way of understanding reality – the present conventional paradigm of neoclassical 'free market' finance capitalism will continue to dominate. If the present paradigm is to be successfully challenged, the new paradigm must comprehend

Environmental capital investment, particularly for clean, renewable energy. At present, using interest-bearing loans, a lot of green technology is not financially viable. With interest-free loans, however, it would become viable. Thus we could have, for example, clean electricity generation through tidal barrages, dams, windmills, wave machines, solar electricity, and geothermal power stations. It is a shocking thing that clean, green electricity generation is not at present substantially in existence and thus the world could destroy itself through global warming all because of the insidious grip of usury.

Small and start-up businesses thereby freeing them from the crushing pressure of interest-bearing debt. There would be no requirement for wide ownership. However, there would still be a requirement for collateral as security against the possible loss of the loan and it might be desirable for eligibility for the loans to be confined to socially beneficial businesses. That said, the key point is that interest-free loans could be used for small businesses in exactly the same circumstances as today except that the small businesses would not be suffocated by interest payments.

Together with the use for public capital projects, these three uses – for private capital projects if wide ownership is involved; green capital investment; and small business – would back the currency with assets, break the grip of usury and, because they are directly related to productive capacity, would be counter-inflationary. They would, moreover, would implement a genuine free, fair and efficient market; throw off foreign and financial elite control, address social and economic justice through the spreading of wide capital ownership and its associated capital income; and give hope for the environment.

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three key matters:– a new justice; a new monetary system; and a new understanding of how wealth is created.

[19] The techniques for doing this are those of binary economics. 'Binary' means 'composed of two' and there are two factors in production – labour and capital. Thus there are also two ways of genuinely earning – either though owning your own labour and/or through owning capital. The main object of binary economics is to ensure that all individuals in the population have access to both ways of earning. All really does mean all – carers, retired, sick, unemployed, women, children and men. Everybody, over time, on market principles, comes to own an increasing amount of productive capital paying out its full earnings. Binary economics gives a capital acquisition right, to every individual. Operating on market principles, using trust mechanisms, this right enables any individual to acquire efficient, income-generating capital assets. The assets pay for themselves out of their earnings and, thereafter, with full payout of earnings, provide capital income to the owners. See Ashford and Shakespeare, "Binary Economics – the new paradigm". See also the website of the Centre for Economic and Social Justice, Washington, D.C., USA, at www.cesj.org

11. Islamic Endogenous Loans Implement the Theorem of Jean-Baptiste Say (Often Called "Say's Law")

Neo-classical economics upholds Say's Theorem (often called "Say's Law"). The Theorem says that, in a market economy, the total market value of the wealth produced is equal to the total purchasing power created by the process of production and therefore that supply creates its own demand. The Theorem also requires that producers and consumers must be the same people.

But, at present, there is undoubtedly a huge potential supply which does not create its own demand. Moreover, producers and consumers are not the same people. That is to say, at present, Say's Theorem (Law) most certainly does not work in practise.

However, Islamic endogenous loans are capable of distributing future productive capacity, over time and on market principles, to everybody in the population thus ensuring that producers and consumers really are the same people. For the first time in history, the use of Islamic endogenous loans can ensure that Say's Theorem really does, in practise, become a true Law.

12. Benefits of Islamic Endogenous Loans

A supply of Islamic endogenous loans for both public and private sector (binary) projects is of immense importance because it is capable of ensuring, among other things:

- economic and social justice[20]
- a great lessening of *ribā*/interest
- a direct linking of new money to productive capacity
- a widespread ownership of productive capital
- an increase in political freedoms
- an efficient wealth creation
- a basic income for all inhabitants
- policy to unite inhabitants who have different linguistic, religious, geographical and ethnic backgrounds
- an ability of a society to control its own destiny as opposed to being ruled by outsiders and others
- a new economic system which, by a proper use of interest-free loans, spreads productive capacity to all individuals in the population so that they produce (and thus earn) independently of whether or not they also have a conventional job.

[20] Shakespeare R. and P. Challen, (2002). See also www.globaljusticemovement.net

13. Giving a Lead to the World

Islamic endogenous loans have huge beneficial potential. They will be central to ensuring that the *Ummah* becomes a new community of proud, self-reliant societies giving a moral, intellectual and material lead to a world sorely in need of such a lead.[21]

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[21] Choudhury (1997), (2004) points to the need for Islam to find a new, distinctive way forward. Choudhury leads the movement for an Islamic worldwide transformation using 100 per cent reserve, gold-backed endogenous loans directed at productive capacity and has made a series of publications on endogenous money and Islamic capital markets including Choudhury (1989), (1990), (1998) and (1999).

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Analysis on the Feasibility Study of *Mushārakah Mutanāqiṣah* Implementation in Indonesian Islamic Banks

Dodik Siswantoro*
Hamidah Qoyyimah*

Currently, most Islamic banks in Indonesia mainly use trading activities rather than the investing partnership scheme (70.81 %) for financing. In Islam, trading scheme is known as murābaḥah. Its mechanism is similar to common trading system, the difference is on the prefixed permanent profit determined in the beginning of transaction. There are problems associated with this trading scheme; they are double taxation, higher profit margin and inflexibility in adapting changing economic conditions. But, many Islamic banks apply this scheme as it is quite simple in determining the profit margin. In other countries, they use mushārakah mutanāqiṣah scheme instead of murābaḥah. Essentially, it is a partnership scheme that has rental scheme simultaneously. Its operation is like financial leasing, but it gives revenue sharing to the lessee until 100% ownership transfer. This paper tries to analyze the feasibility study of mushārakah mutanāqiṣah in facilitating house for consumers by using qualitative approach and sensitivity analysis. So far, problems that exist are the unresolved fatwā, complexity in calculation and forced rental cost caused by the strategic the house location.

Key words:
Islamic bank, *murābaḥah*, *mushārakah mutanāqiṣah*, leasing, Indonesia

Introduction

Islamic teachings prohibit interest. This supports Muslims to invest in real and productive sectors (Mohamed, 1999; Choudory, n.d); which helps create synchronization between the financial sector and the real sector (Siddiqi, 2002; Uthman, 2001). Currently Islamic banks have established their businesses without using interest rate. They emphasize on the concept of revenue sharing between two

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parties, who proportionally share their profits and risks that have been agreed in the beginning of contract.

Mushārakah mutanaqiṣah, being a derivative of *mushārakah*, is a financing product based on revenue sharing. *Mushārakah mutanāqiṣah* technically is a cooperation between two persons, working on the project that will diminish the interest of one party gradually (Arifin, 2000). This product, developed by Perbadanan Usahawan Nasional Berhard (PUNB) in Malaysia[1] and Lariba Institute at London,[2] may not be widely known by the society as Islamic bank in Indonesia have yet to offer this scheme.

According to Malek (2000), *muḍārabah* and *mushārakah* should be the main investment schemes in Islamic financial institution especially for Islamic bank. In Practise, Islamic banks in Indonesia use *murābaḥah* for their financing (see Table 1). This may be due to the lack of effort from Islamic bank to prioritize equity financing and their lack of knowledge in this area.

Table 1: The percentage of murābaḥah finance in Indonesia

Items of financing		Mar 03	Jun 03	Sep 03	Nov 03	Des 03	Jan 04
Muḍārabah financing	Share	14.75%	14.1%	14.7%	15.06%	14.36%	15.35%
Murābaḥah receivable	Share	71.2%	72.08%	71.39%	71.72%	71.53%	70.81%
Salam receivable	Share	0%	0%	0%	0%	0%	0%

Source: Bank Indonesia

2. Literature Review

The word *Shirkah* or *Sharikah* is taken from the word شرك - يشرك- شركا- شاركا- شركة. Literally, the meaning is cooperation, firm and group (Munawir, 1996). *Mushārakah* or *shirkah* means *ikhtilāt* (mixed), some *fuqahā'* define it as a contract between Arabs, who cooperate in capital and profit (Sabiq, 1998). While *mutanāqiṣah*, taken from the word يتناقص تناقص تناقصا متناقص , means to decrease gradually (Munawir, 1996).

Mushārakah mutanāqiṣah (diminishing partnership), according to Malek (2000), is a cooperation that can create a diminishing interest from one party to other party. He stated that *mushārakah mutanāqiṣah* can be used to acquire something through lending. This principle can help Muslims to avoid lending that is based on *ribā*. For example there are two parties, A (customer) and B (Islamic

[1] www.punb.com.my
[2] www.lariba.com

bank), teaming up based on the *mushārakah mutanāqiṣah* contract with agreement to give some capital (A gives 10 % and B gives 90 % from total capital) in the beginning. The ownership percentage of A will increase as from the Instalment payment each month. The rental fee as the revenue of the work will be shared according to the percentage ownership until A has 100% of ownership. However, it is not recommended to use conventional formula to determine monthly Instalment payment in Islamic financial system as it still involves *ribā* tendency (Kahf, 2001).

In house ownership payment, usually the price of the house and the down payment amount are known. The thing that should be agreed in the contract for Islamic bank is the period of Instalment that customer must pay. In *mushārakah mutanāqiṣah* the formula is as follows (Malek, 2000),

H : Price of the house

M : Down payment

S : Rental fee per month

A : Additional payment to the bank excluding the rent

m : Period of rent (in month)

$$= \left\{M + \frac{\mathrm{A} \times H}{\mathrm{S}}\right\} \left\{1 + \frac{\mathrm{S}}{\mathrm{H}}\right\}^{k} - \frac{\mathrm{A} \times \mathrm{H}}{\mathrm{S}}$$

for example $k = m$, so at the end of cooperation

$$\mathrm{Q}_{m} = \left\{M + \frac{\mathrm{A} \times H}{\mathrm{S}}\right\} \left\{1 + \frac{\mathrm{S}}{\mathrm{H}}\right\}^{m} - \frac{\mathrm{A} \times \mathrm{H}}{\mathrm{S}} = H$$

$$\left\{1 + \frac{S}{H}\right\}^{m} = \frac{H\left\{1 + \frac{A}{S}\right\}}{\left\{M + \frac{A \times H}{S}\right\}}$$

$$\mathrm{m} = \frac{\ln H + \ln\left\{1 + \frac{\mathrm{A}}{\mathrm{S}}\right\} - \ln\left\{M + \frac{\mathrm{A} \times H}{\mathrm{S}}\right\}}{\ln\left\{1 + \frac{\mathrm{S}}{\mathrm{H}}\right\}}$$

According to Malek (2000), the value of m above is not given precisely so that the close amount of the contract period is the value after m. Thus, the mechanism of *mushārakah mutanāqiṣah* is illustrated in the example as follows: A customer of Islamic bank wants to have a house with amount of Rp 200,000,000, and then he

pays Rp 60,000,000 for the down payment. It is assumed that he can pay the rental fee for Rp 1,000,000 and additional payment for Rp 500,000 therefore the Instalment that must be paid every month by the customer is Rp 1,500,000.

Using the *mushārakah mutanāqiṣah* formula, the period of Instalment can be determined as follows,

$$m = \frac{ln\,H + ln\left\{1+\frac{A}{S}\right\} - ln\left\{M + \frac{A\times H}{S}\right\}}{ln\left\{1+\frac{S}{H}\right\}}$$

$$\mathrm{m} = \frac{\ln 200{,}000{,}000 + \ln\left\{1+\frac{500{,}000}{1{,}000{,}000}\right\} - \ln\left\{60{,}000{,}000 + \frac{500{,}000\times 200{,}000{,}000}{1{,}000{,}000}\right\}}{\ln\left\{1+\frac{1{,}000{,}000}{200{,}000{,}000}\right\}}$$

$$\mathrm{m} = \frac{19.11382792 + 0.40546 - 18.890684}{0.0049875}$$

$$\mathrm{m} = \frac{0.62860392}{0.0049875}$$

m = 126.04 ~ 127 months (10.6 years)

The period of Instalment based on the formula above is 126.04 months. However according to Malek (2000), m does not give a precise value and therefore the actual value of m closest to the calculated one is 127 months (10.6 years).

3. Methodology

This research was conducted using two approaches, quantitative and qualitative. Since this issue is quite new, the qualitative approach is more dominant than the quantitative one. The methods of its data collection are:

a. Primary data collection, where some methods are interviewing particular experts, respondents and previous researchers. The questionnaire was taken by directing the object of the research to the respondents through e-mail.

b. Secondary data collection. Since the *mushārakah mutanāqiṣah* theory and data are rare, therefore the concept needs to be improved comprehensively through inputs and discussions with related foreign institutions.

4. Comparison of *Mushārakah Mutanāqiṣah*

The determination of the selling price of *murābaḥah* in Indonesia is usually based on the market price of the product and other specific factors. In the conventional bank, interest rate could represent its service fee and risk taken by the customers, who buy it. In addition, it can be also intended also as the price (service fee) that must be paid to the bank as that customer gets loan from the bank (Kasmir, 2001).

If Islamic banks decide not to use interest, the system could be based on profit sharing. In the selling of *murābaḥah*, the margin profit, which is the determination factor in the transaction, is usually determined at some amount for the profit of the bank-involved profit in the financing agreement. This margin profit must be paid according to the Instalment schedule. Therefore, the purchasing price is the cost of the house plus profit margin. The conventional banks' interest method is so different from that of Islamic banks' financing scheme. Generally, conventional banks use the floating rate method in which the interest paid really depends on the market's interest rate in a specific month and therefore resulting in varying monthly Instalments. Usually, most conventional banks in Indonesia offer fixed interest rate during the first year and then the floating rate onwards.

In *murābaḥah* transaction, the period of the contract depends on the agreement in the beginning of the contract and the profit. The comparison between conventional loan and *murābaḥah* can be shown as follow. Suppose a customer is willing to have a Rp 200 millions house with a down payment of Rp 60 millions with a conventional bank. The market's interest rate happens to be around 12.5% and the period of loan is 10 years (120 months). To determine the Instalment payment that must be paid, Kellison formula is used,

$$R2 = \frac{(H - M) \times j}{1 - (1 + j)^{-m}} = \frac{B_0 \times j}{1 - (1 + j)^{-m}}$$

Note,

B_0	$= H - M$	H	: the price of house
j	$= i / 12$	M	: Down payment
m	$= n \times 12$		

i : Interest rate per year

j : Interest rate per month

n : the loan period in year

m : the loan period in month

R_2 = 2,040,272.591

$$R2 = \frac{(200{,}000{,}000 - 60{,}000{,}000) \times 0.01041667}{1 - (1 + 0.001041667)^{-120}}$$

j = 12.5 % / 12 = 0.01041667

m = 10 x 12 = 120

From the conventional calculation method shown above, it is determined that the monthly Instalment is Rp 2,049,272.591, which includes the main loan and interest revenue. To find the main Instalment and the interest revenue, Kellison formula is used as follow:

$$P_0 = 2{,}049{,}272.591 \times \left\{1 - (1 + 0.01041667)^{-(120-0)}\right\}$$

$$P_t = R2 \times \left\{1 - (1 + j)^{-(m-t)}\right\}$$

$$P_0 = 2{,}049{,}272.59 \times \left\{1 - (0.288363)\right\}$$

$$P_0 = 1{,}458{,}338$$

From the calculation above, the main Instalment (reflecting the principal) is Rp 1,458,338 while the interest revenue is $R_2 - P$ = 590,934.59. At the end of the first month, conventional bank recognizes the interest revenue.

In *murābaḥah* principle, the method used is almost the same, which is the flat rate method. In addition, usually the rate used, if the interest rate of conventional bank 12.5%, is 21 % (Info Bank, 2004). Hence, the monthly Instalment amount that should be paid by the customer is,

$$AP = \frac{P}{m}$$

$$AP = \frac{140{,}000{,}000}{120}$$

AP = 1,166,666.667

AM = (P x mark-up rate)/m

AM = 140,000,000 x 0.21÷120

AM = 294,000,000/120 months

AM = 2,450,000

Note,

AP : Average Principle

AM : Average Margin

If so, the comparison among *murābaḥah*, *mushārakah mutanāqiṣah* and conventional method can be described as follows:

Table 2: The Comparison of the Conventional, Murābaḥah and Mushārakah Mutanāqiṣah

Price Rp 200,000,000,- Period 120 months (10 years) Down payment Rp 60,000,000,- Loan from the bank Rp 140,000,000,-		
Conventional bank	Sharīʿah bank (*murābaḥah*)	Sharīʿah bank (*mushārakah mutanaqiṣah*)
Interest rate per year 12.5%	Expected margin 21% per year	-
Instalment per month Rp 2,049,266	Instalment per month Rp 3,616,666.667	Rent per month Rp 1,949,266 Additional payment Rp 100,000 Total Instalment per month Rp 2,049,266
Bank's interest Rp 105,911,963.37*	Bank's margin Rp 294,000,000**	Bank's revenue Rp 93,616,324

Note: * 2,049,266 x 120 = 245,911,920 – 140,000,000 = 105,911,920.
** 21 % x 140,000,000 x 10 = 294,000,000.

From the table above, it can be seen that the profit of *murābaḥah* taken by Islamic banks is larger than the ones taken by conventional banks. This will not give any benefits to the customer of Islamic bank. Henceforth, the question that arises is whether it is allowed to increase the profit as the period also increases? From this phenomenon, Islamic banks seem to put more burdens to the customer as compared to their conventional counterparts. This particular Behaviour from Islamic banks may be classified as a *ribā* (Siswantoro, 2004, Rosly, 2000).

It also seems that there is a trade off between the concept of *tijārī* (looking for the profit) and *ijtimāʿī* (good thing). According to the *sunnah* (prophet's teaching), the first priority must be based on the mutual cooperation then followed by profit. This can be the difference between the conventional and Islamic banks in legitimizing their profit-taking (Thomas, 2001).

If we determine the monthly Instalment to be Rp 2,049,266,- then S + A = Rp 2,049,266,- for *mushārakah mutanāqiṣah* method (assuming constant Instalment). So, if the additional payment is Rp 100,000 then the rental expense is Rp 1,949,266. With this assumption the period of Instalment is:

$$m = \frac{ln\,H + ln\left\{1 + \frac{A}{S}\right\} - ln\left\{M + \frac{A \times H}{S}\right\}}{ln\left\{1 + \frac{S}{H}\right\}}$$

$$\text{m} = \frac{\ln 200{,}000{,}000 + \ln\left\{1 + \frac{100{,}000}{1{,}949{,}266}\right\} - \ln\left\{60{,}000{,}000 + \frac{100{,}000 \times 200{,}000{,}000}{1{,}949{,}266}\right\}}{\ln\left\{1 + \frac{1{,}949{,}266}{200{,}000{,}000}\right\}}$$

$$\text{m} = \frac{19.11382792 + 0.050028788 - 18.06771708}{0.00969914}$$

$$\text{m} = \frac{1.096139628}{0.00969914}$$

m = 113.0141052 ~ 114 months (9.5 years)

From the calculation above the period of Instalment is found to be 114 months or 9.5 years (see appendix 1). The Islamic banks' profit can be smaller if they use *mushārakah mutanāqiṣah* instead and the period will be shorter. This will benefit the customers but not for the Islamic bank involved as the profit is smaller. From this, there is a trade off among these three methods. One thing that should be highlighted is the benefit of the *ummat* must be the first priority.

5. Analysis

Generally, two factors cause the inability of Islamic bank in implementing *mushārakah mutanaqiṣah*:

5.1 Internal Factors

Due to the inherent nature as banks, Islamic banks posses the same main objective as their conventional counterparts, that is to get profit. However, it also has an additional constraint, which is their accordance to the Islamic teaching. To be more specific, these internal factors are:

A. The Financial Structure of Islamic Bank

As the period of loan is quite long, this can be quite of a constraint. This may be caused the financial structure in Islamic bank which the capital is not big enough to

cover the risk. However, Islamic bank unit as a branch of big conventional bank which may have experienced in house financing should be able to take this opportunity to use *mushārakah mutanāqiṣah* as a house financing or at least for short-term project.

B. Liquidity Risk

Mismatch between collection and distribution from the public and the period of investment can be a big problem for Islamic banks as it has occurred in Indonesia where many customers withdrew their saving at the same time, it creates illiquidity for the bank. Usually for house loans, it has longer period (more than 5 years). This can be a problem for Islamic bank. Some analyses regarding this scheme is shown (BMI prospectus, 2003):

Table 3: Period of Bank Muʿāmalāt Indonesia Finance for 2000, 2001 and 2002

Note	Period				
	2002	%	2001	%	2000
Less than 1 year	230,808,410 0.14	0.17	197,479,844 0.17	6.55	23,781,000 0.03
1 – 3 year	603,661,205 0.36	0.48	406,940,958 0.35	0.16	374,997,566 0.45
3 – 5 years	546,658,014 0.32	0.79	305,667,239 0.26	0.82	168,127,915 0.20
More than 5 years	307,933,809 0.18	0.26	245,020,766 0.21	-0.05	258,254,003 0.31
Total	1,689,061,438	0.46	1,155,108,807	0.40	825,160,484

From the table above, in 2000, the most preferred loan period is 1-3 years. This can be associated with the Islamic bank's lack of risk management. It can also be seen that there is no increase in loan for more than five years. In fact, most Islamic banks provide mainly loans with the period of below 9 years (Bank *Muʿāmalāt*, 7 years; Bank Syari'ah Mandiri 8 years). This is not as competitive as those of conventional banks, whose loans' period could be up to 20 years (Info bank, 2004).

C. *No Specific Rule for Mushārakah Mutanāqiṣah*

Specific rule or *fatwā* has not been issued for *mushārakah mutanāqiṣah* in Indonesia. This is because Sharīʿah Supervisory Board and in the Indonesian accounting standard no 59, which states that two transactions in one transaction such as *ijārah muntahiya bit tamlīk* is unlawful, forbids this two transactions in one. On the other hand, *ijārah muntahiya bit tamlīk* is permissible according to the law No 10/ 1998.

5.2 External Factors

A. *Interest Rate Fluctuation and Political Stability*

Interest rate loan in Indonesia is still volatile and quite high as it is related to the political stability in Indonesia. However, this is not conducive for Islamic banks as they are still new in the house financing business. *Mushārakah mutanāqiṣah* itself can adapt quickly to the Instalment payments, but it depends on the restricted variables as mentioned above. While in *murābaḥah*, the value of profit margin is positively correlated with the risk.

B. *Market Competition*

If Islamic banks enter the house financing business, they will become new entrants that have to compete seriously with other conventional banks that has established themselves well in this market. Other conventional banks like Bank Niaga, Bank Tabungan Negara, Bank Mandiri and Bank Central Asia have captured this market. It would be possible for the likes of Bank Niaga Sharīʿah if they want to enter this market. This is because the conventional banks, which offer house financing, have total assets of more than Rp 20 trillions while pure Islamic banks, such as Bank *Muʿāmalāt* and Bank Syari'ah Mandiri, have total asset of only Rp 2 trillion. But, other bank in Malaysia with similar assets can offer Islamic finance house for their customers (Info bank, 2004).

Using sensitivity analysis, the rental fee's sensitivity towards the change in independent variables (such as interest rate) can be determined. It examines the implication of the change of one variable to other variables, for example interest rate to the rental fee.

Below is a calculation, example of the 5-10% interest rate change's sensitivity on the *mushārakah mutanāqiṣah's* rental fee for a 5 years period loan. And then followed by table showing other interest rate changes and several different periods.

Rental fee when interest rate 5% :Rp 833,332.7102

Rental fee when interest rate 10% :Rp 1,666,666.26

Period :5 years (60 months)

$\Delta = 1{,}666{,}666.26 - 833{,}332.7102 = 833{,}333.5$

Sensitivity $= 833{,}333.5 \div 833{,}332.7102 = 1.000001$

$\% = 1.000001 \times 100 = 100.0001$

from similar calculation above, the results are:

Table 4: Analysis Sensitivity on Interest Rate

Interest Rate	Note	Period					
		60	72	84	96	108	120
5%-10%	Δ	833,333.5	833,333.5	833,333.5	833,333.5	833,333.5	833,333.5
	Sens.	1.000001	1.000001	1.000001	1	1	1
	%	100.0001	100.0001	100.0001	100	100	100
6%-12%	Δ	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
	Sens.	1.000001	1.000001	1.000001	1.000001	1	1
	%	100.0001	100.0001	100.0001	100.0001	100	100
7%-14%	Δ	1,166,667	1,166,667	1,166,667	1,166,667	1,075.387	850,054.9
	Sens.	1	1	1	1	0.92176	0.728619
	%	100	100	100	100	92.2	72.9
8%-16%	Δ	1,333,333	1,333,333	1,333,334	1,190,738	908,719.9	683,388.1
	Sens.	1	1	1	0.893054	0.68154	0.512541
	%	100	100	100	89.3	68.2	51.2
9%-18%	Δ	1,500,000	1,500,000	1,387,244	1,024,071	742,053.2	516,721.6
	Sens.	1	1	0.924829	0.682714	0.494702	0.344481
	%	100	100	92.5	68.3	49.5	34.4
10%-20%	Δ	1,666,667	1,666,667	1,220577	857,404.7	575,386.6	350,054.8
	Sens.	1	1	0.732346	0.514443	0.345232	0.210033
	%	100	100	73.2	51.4	34.5	21

Note: Δ : difference in rental fee increase
Sens. : sensistivity
% : sens. X 100

From Table 4 above, for a given change in interest rate, the rental fee becomes less sensitive as the period increases. Also, the higher the interest rate is, the less sensitive the rental fee is towards the rate changes for a given period. For example, as the interest rate increases from 7% to 14%, the rental fee starts to become less sensitive at a period of 9 years. And for 10% to 20% rate increase, rental fee starts to become less sensitive at a period of 7 years. From this point, there is a trend that as the interest rate and its change increase, rental fee's sensitivity starts to decreases at a smaller period.

Other analysis related to the issue above is the additional payment that must be paid to the seller. The buyer does not need to pay additional fee when the interest rate is at 15% with an 11 years (132 months) period and so on. This can be a problem if the buyer would like to accelerate the Instalment, as it will decrease the

profit for the Islamic banks. However, further analysis in this issue requires more in-depth research.

Table 5: Comparison of Mushārakah Mutanāqiṣah with Conventional Loan

Interest rate	Note	Period (months)					
		60	72	84	96	108	120
	0,00417	2,641,972.710	2,254,690.573	1,978,747.270	1,772,338.802	1,612,418.244	1,484,917.213
	S	833,332.71	833,332.97	833,333.11	833,333.10	833,333.26	833,333.21
5 %	A	1,808,640	1,421,357.60	1,421,414.16	939,055.70	779,084.99	651,584
	S + A	2,641,972.710	2,254,690.573	1,978,747.270	1,772,338.802	1,612,418.244	1,484,917.213
	%	0,315	0,370	0,421	0,470	0,517	0,561
	0,00833	2,974,586.26	2,593,617.29	2,324,165.76	2,124,382.97	1,971,016.07	1,850,110.32
	S	1,666,666.26	1,666,666.49	1,666,666.66	1,666,666.57	1,666,666.57	1,666,666.62
10 %	A	1,307,920.00	926,950.80	657,499.10	457,716.40	304,349.50	183,443.70
	S + A	2,974,586.26	2,593,617.29	2,324,165.76	2,124,382.97	1,971,016.07	1,850,110.32
	%	0,560	0,643	0,717	0,784	0,846	0,901
	0,01	3,114,222.68	2,737,026.95	2,471,382.59	2,275,397.80	2,125,792.57	2,008,593.28
	S	1,999,999.98	1,999,999.98	1,999,999.99	2,000,000	2,000,000	2,000,000
12 %	A	1,114,222.70	737,026.97	471,382.60	275,397.80	125,792.57	8,593.28
	S + A	3,114,222.68	2,737,026.95	2,471,382.59	2,275,397.80	2,125,792.57	2,008,593.28
	%	0,642	0,731	0,809	0,879	0,941	0,996
	0,0125	3,330,590.21	2,960,301.87	2,701,545.66	2,512,356.74	2,369,407.221	2,258.689,399
	S	2,499,999.99	2,500,000.00	2,499,999.99	2,499,999.99	2,242,053.14	2,016,721.42
15 %	A	830,590.22	460,301.87	201,545.67	12,356.75	0.00	0.00
	S + A	3,330,590.21	2,960,301.87	2,701,545.66	2,512,356.74	2,242,053.14	2,016,721.42
	%	0,751	0,845	0,925	0,995	0,946	0,893
	0,0167	3,709,143.72	3,353,395.65	3,108.867.901	2,933,448.050	2,803.710.235	2,705,579.411
	S	3,333,333.32	3,333,333.33	2,887,243.94	2,524,071.26	2,242,053.15	2,016,721.46
20 %	A	375,810.40	20,062.32	0.00	0.00	0.00	0.00
	S + A	3,709,143.72	3,353,395.65	2,887,243.94	2,524,071.26	2,242,053.15	2,016,721.46
	%	0,899	0,994	0,929	0,860	0,800	0,745

Note: S: rental fee per month, A: additional payment (assumption), S + A : total monthly Instalment, %: percentage of increase or decrease of rental fee to total monthly Instalment.

Mushārakah mutanāqiṣah can be the cheapest product but on the other hand, the formula is so awkward compared to other house financing schemes such as *murābaḥah* and conventional loan. Another main issue is the rental fee that is charged to the buyer. In this paper, the suitability of rental fee to the market price would be analyzed. Generally, the rental fee in Indonesia depends on the house location. From the table above when the interest rate is 12 % and the period is 10 years the rental for *mushārakah mutanāqiṣah* is Rp 2,000,000. We would like to

know some responds regarding this rental fee to some people. Thus, the author conducts questionnaire related to the rental price for specific location. Finally, only 10 respondents give their opinion in it. (the data sent by e-mail, using some mailing-lists which consist of about 4,000 people). It is quite difficult that few people are aware of the rental price of a house for Rp 2 millions per month with the selling price of house for Rp 200 millions. The results are as follows:

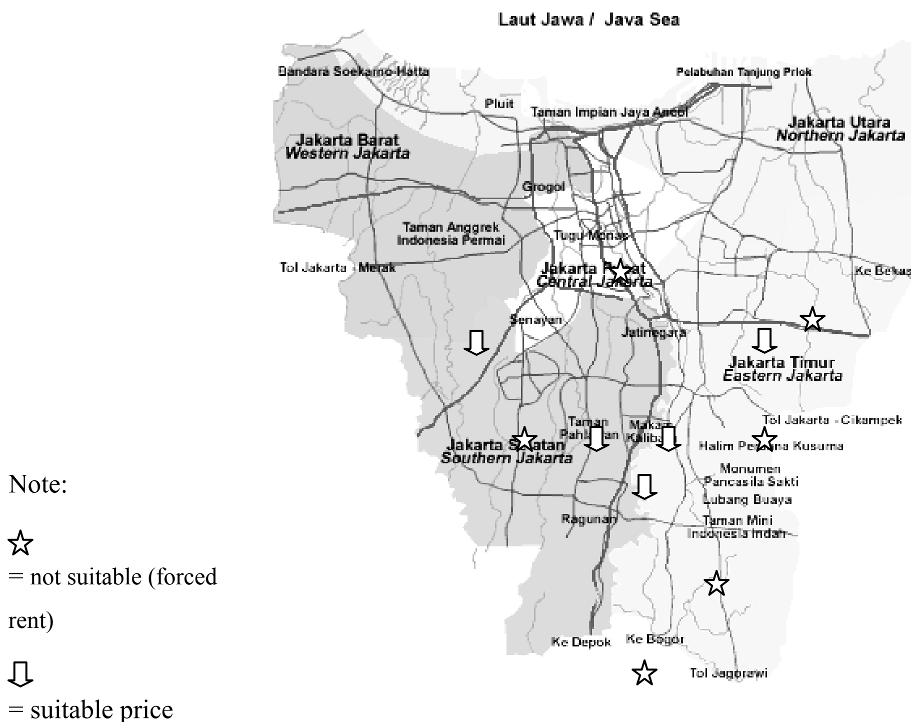

Figure 1 The location for forced rental fee (map of Jakarta)

From the figure above, some buyers may be reluctant to pay in the rental price above the market price. This can be called as forced rent if it is occurred.

The longer period of loan Instalment still increases the income for the bank. However, the increase is based on the contract of cooperation not being determined in the beginning like *murābaḥah* or related to the time value of money. Principally, the scheme of *mushārakah mutanāqiṣah* is more Islamic that is usually for building a new house, which the house has not been built yet. If *murābaḥah* (selling transaction) scheme were used, it would be strange as the house itself has not existed yet.

Table 6 Analysis of Increasing Income on Mushārakah Mutanāqiṣah

Interest rate	Note	Period (month)					
		60	72	84	96	108	120
12%	S	1,999,999.98	1,999,999.98	1,999,999.99	2,000,000	2,000,000	2,000,000
	A	1,114,222.70	737,026.97	471,382.60	275,397.80	125,792.57	8,593.28
	S + A	3,114,222.68	2,737,026.95	2,471,382.59	2,275,397.80	2,125,792.57	2,008,593.28
	Result	186,853,360.55	197,065,940.43	207,596,137.69	218,438,188.76	229,585,597.09	241,031,193.32
	Income	46,853,360.55	57,065,940.43	67,596,137.69	78,438,188.76	89,585,597.09	101,031,193.32
14%	S	2,333,333.33	2,333,333.32	2,333,333.32	2,333,333.33	2,242,053.14	2,016,721.42
	A	924,221.79	551,470.21	290,268.30	98,676.82	0.00	0.00
	S + A	3,257,555.12	2,884,803.53	2,623,601.62	2,432,010.15	2,242,053.14	2,016,721.42
	Result	195,453,307.13	207,705,853.98	220,382,536.48	233,472,974.00	242,141,739.41	242,006,570.47
	Income	55,453,307.13	67,705,853.98	80,382,536.48	93,472,188.76	102,141,739.41	102,006,570.47
16%	S	2,666,666.66	2,666,666.65	2,666,666.66	2,524,071.27	2,242,053.14	2,016,721.42
	A	737,861.34	370,191.03	114,022.29	0.00	0.00	0.00
	S + A	3,404,528.00	3,036,857.68	2,780,688.95	2,524,071.27	2,242,053.14	2,016,721.42
	Result	204,271,679.78	218,653,753.26	233,577,871.98	242,310,841.82	242,141,739.03	242,006,570.19
	Income	64,271,679.78	78,653,753.6	93,577,871.98	102,310,841.82	102,141,739.03	102,006,570.47
18%	S	2,999,999.98	2,999,999.94	2,887,243.94	2,524,071.27	2,242,053.14	2,016,721.42
	A	555,079.86	193,090.81	0.00	0.00	0.00	0.00
	S + A	3,555,079.84	3,193,090.75	2,887,243.94	2,524,071.27	2,242,053.14	2,016,721.42
	Result	213,304,790.39	229,902,534.15	242,528,490.73	242,310,841.52	242,141,739.00	242,006,569.99
	Income	73,304,790.39	89,902,534.15	102,528,490.73	102,310,841.82	102,141,739.00	102,006,570.47
20%	S	3,333,333.32	3,333,333.33	2,887,243.94	2,524,071.26	2,242,053.15	2,016,721.46
	A	375,810.40	20,062.32	0.00	0.00	0.00	0.00
	S + A	3,709,143.72	3,353,395.65	2,887,243.94	2,524,071.26	2,242,053.15	2,016,721.46
	Result	222,548,623.21	241,444,486.66	242,528,491.02	242,310,840.69	242,141,739.69	242,006,575.29
	Income	82,548,623.21	101,444,486.66	102,528,491.02	102,310,841.82	102,141,739.69	102,006,570.47

Note: S: rental fee per month, A : additional payment, S + A: total monthly Instalment, Result: income + capital, Income: result – capital (140,000,000).

Mushārakah mutanāqiṣah actually is a part of *shirkah ʿuqūd inan*. As two parties (customer and bank) agreed to cooperate in ownership of something or house with profit sharing.

Mushārakah mutanāqiṣah is not a part of *ijārah muntahiya bittamlīk* as the rental fee, determined by Islamic bank, is not shared by both parties. In *ijārah muntahiya bittamlīk*, rental fee becomes the exclusive right of the Islamic banks. Even though at the end there is a transfer of ownership, the process is still different. For customer if they use *ijārah muntahiya bittamlīk*, they must pay some money in addition to the house's rental fee. While, in *mushārakah mutanāqiṣah*, the customer will get part of the income from monthly rental and at the same time accumulate the ownership. In acquiring the ownership one can pay more money to accelerate the ownership-acquiring period. Therefore, it is quite clear that *mushārakah mutanāqiṣah* is part of *mushārakah*.

6. Conclusions

The problem in the implementation of *mushārakah mutanāqiṣah* may be the financial structure of Islamic bank and the not-so-conducive environment in Indonesia. This scheme needs a stability in interest rate and other factors that is under their normal condition. In addition, not all location is suitable as the market price for rental fee may vary. In *fiqh* area, it may not be a problem as this scheme is not *gharar*, which may arise from two transactions in one transaction and is forbidden in the Islamic teaching.

It would be good if there is an empirical research to analyze Islamic financial institutions, which have been adopting *mushārakah mutanāqisah* . Principally, there should be a proper justice between the bank and its customers to get a win-win solution.

Appendix 1

Month	Rent	Additional	%		Customer	Bank	200,000,000
					60,000,000	140,000,000	0.30
1	1,949,266	100,000	584,780	684,780	60,684,780		0.30
2	1,949,266	100,000	591,454	691,454	61,376,234		0.31
3	1,949,266	100,000	598,193	698,193	62,074,427		0.31
4	1,949,266	100,000	604,998	704,998	62,779,425		0.31
5	1,949,266	100,000	611,869	711,869	63,491,294		0.32
6	1,949,266	100,000	618,807	718,807	64,210,101		0.32
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
108	1,949,266	100,000	1,833,149	1,933,149	190,019,197		0.95
109	1,949,266	100,000	1,851,990	1,951,990	191,971,187		0.96
110	1,949,266	100,000	1,871,015	1,971,015	193,942,202		0.97
111	1,949,266	100,000	1,890,225	1,990,225	195,932,426		0.98
112	1,949,266	100,000	1,909,622	2,009,622	197,942,048		0.99
113	1,949,266	100,000	1,929,209	2,029,209	199,971,257		1.00
114	1,949,266	100,000	1,948,986	2,048,986	202,020,243		1.01
115	1,949,266	100,000	1,968,956	2,068,956	204,089,199		1.02
116	1,949,266	100,000	1,989,121	2,089,121	206,178,319		1.03
117	1,949,266	100,000	2,009,482	2,109,482	208,287,801		1.04
118	1,949,266	100,000	2,030,042	2,130,042	210,417,843		1.05
119	1,949,266	100,000	2,050,802	2,150,802	212,568,645		1.06
120	1,949,266	100,000	2,071,764	2,171,764	214,740,409		1.07

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17

Necessary Legal Reforms to Create Legal Basis for Effective Islamic Asset Securitization (*Ṣukūk*) in Indonesia

Reza Djojosugito*

The paper starts with the argument that Asset Securitization (ṣukūk) can be the main vehicle for the development of modern Islamic financial system. The effective Islamic ṣukūk can serve as a powerful tool to mobilize funds from the market which will certainly strengthen the operation of Islamic financial institution. However, creation of effective Islamic ṣukūk necessitates sufficient and sound legal system which is unfortunately the missing part of the endeavour. Indonesia has a sufficient legal stepping stone for the development of Islamic ṣukūk. However, due to its complex nature, some reforms need to be introduced in Indonesian legal system. The Paper reviews existing laws and regulations related to Islamic banking and asset securitization; recent developments in Indonesian Islamic financial sector and existing practices of international Islamic ṣukūk.

Introduction

This paper aims to put an argument for the introduction of some legal reforms which can create a legal environment which is conducive to the issuance of Islamic asset securitization. The paper elaborates on the reason why the asset securitization is the most appropriate financing method for resource mobilization for Islamic institutions and why the existing legal regime in Indonesia is not fully equipped for it and needs reforms.

At the moment, the mobilization of resources in Indonesia is done through Sharīʿah Bond, the terminology which is used due to lack of a better term. Though, the Indonesian Sharīʿah Bond has been sanctioned by the National Sharīʿah Board

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and it is not regarded as a debt instrument, Indonesian laws have a different perspective on them.

This issue can potentially attract unnecessary debate, therefore it is prudent to approach the issue of resource mobilization through other methods. At this juncture, the assets securitization seems to be an optimal choice. Looking back at the successful issuance of conventional asset-backed securities between 1996-1997 in Indonesia,[1] it is worth exploring the possibility of applying the techniques with some modifications for Islamic institutions.

2. The Importance of Asset Securitization

While mobilization of resources does not need to be conducted through securitization, it can be demonstrated that this vehicle is the most suitable one in case of developing Islamic financial instruments in conventional environments. One of the arguments for the suitability of the securitization is the clarity of the source of the stream of income.[2] The sub section below will explain the importance of asset securitization.

2.1 The Assets Securitization and Ideal Islamic Banking System

Islamic Banking is part of the broader concept of Islamic economics which aims at the introduction of value system and ethics of Islam into the economic sphere. Because of this ethical foundation, the concept of Islamic Banking for the follower of Islamic faith is more than merely a concept on how to do banking. It is the embodiment of the submission to Allah since following the Islamic precepts is a religious obligation. Based on this tenet, the Islamic Banking can be elaborated as a system of banking which provides just financing, is free from factors unlawful to

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[1] See Campbell, N., (1998) "Securitization in Asia: A Legal Overview", Asia Law & Practice Publishing Ltd and Euromoney Publications (Jersey) Ltd, Hong Kong at 4. Even though there are some doubts over some of the deals in regards to whether the sale of the receivables can be regarded as "a legal true sale", the outcome of some domestic transactions (such as the auto-loan securitization for Astra in 1996) suggests that it is possible under Indonesian law to securitize Indonesian receivables and achieve true sales. However, it is true that most of the transactions are cross-border and were completed out of Indonesia.

[2] The certainty of the source of income can be achieved through other Islamic method of financing, such as simple and straight forward *muḍārabah*. However, in the case of multiple investors and multiple investments, it is difficult to trace the source of income. While it is theoretically possible to do so through production of several books, namely one book for each category of investor, tracing the source of income for each investor can create administrative nightmare. The other example is *murābaḥah*. While the source of income in this type of financing is also certain, the use of *murābaḥah* itself has always attracted sarcastic criticism, being the mode of financing which is very similar in substance to conventional loan.

Islam and offers benefits not only to the shareholder of the bank but also to the stakeholder of the bank.

Therefore, some basic characteristics can be drawn to identify an Islamic Banking. It is the element of justice which makes it prohibited for Islamic Banking to charge exorbitant profit. The distribution of profit depends on the magnitude of risk assumed, while the distribution of loss is based on the ability of one to bear such losses. Moreover, Islamic Banking is participatory in nature. An Islamic Bank is supposed to assume all normal risks of business that an entrepreneur/ a businessperson will assume. Profit or loss irrespective of its quantum should be shared between the bank and the customer. Return on the bank's investment is not normally the function of time and when the return is pre-determined, it is pre-determined in absolute terms and not affected by any delay or pre-payment.

Consequently, it is sufficient to say that, in economic sense, the Islamic Banking should avoid the potential huge divergence between real assets and real liabilities which may be translated into a Profit and Loss sharing banking with some elements of morality and justice.[3] It is true that in practice the Islamic Banking consists of Profit and Loss Sharing (PLS) and Non-PLS mode of financing in assets side. However, the heavy reliance on the Non-PLS mode often attracts sarcastic criticisms that most Islamic Finance techniques used at present bear no difference in substance to the conventional finance and that the superficial distinction of the Islamic and conventional finance is mainly centred in the use of Arabic names and in the disguised trade transactions for conventional transaction which are substantially similar to those of conventional finance. Even though this notion can be refuted by the development of myriad Sharīʿah justifications for a restricted scope of application of some conventional techniques, it is sufficient to say that efforts should be directed toward the revival of the early concept of double

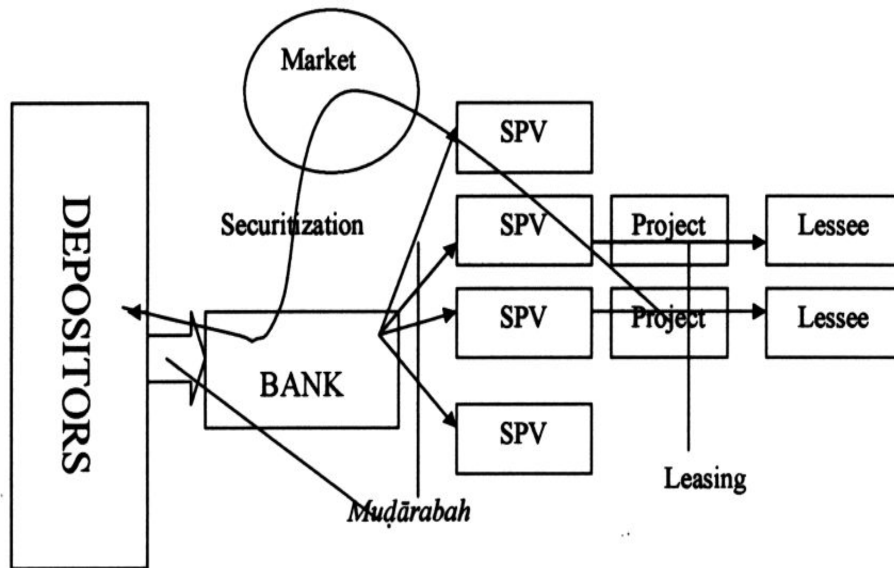
[3] Equality and Justice are the core principles of Islamic Economic System. These principles are manifested mainly in the form of prohibition of interest. However, the Islamic ban on interest does not mean that the capital is "free of charge" in an Islamic system. Islam recognizes capital as a factor of production but it does not allow this factor to make a prior or predetermined claim on the productive surplus in the form of interest. The permissible viable alternative is the profit-sharing system. The reason behind rendering profit-sharing admissible in Islam as opposed to interest is that in the case of the former it is only the profit-sharing ratio not the rate of return itself predetermined. Another rationale for Islamic finance is that wealth should be put into productive use in order that others may share in its benefits. It is therefore unjustified to charge an interest for the mere use of money. The owner of wealth should invest it in a productive and real transaction. However, profit-sharing is only one side of a coin. The other side is that losses should also be shared between the parties which can bear such losses, however, the inability to bear a loss will exonerate such obligation.

tier *muḍārabah* in Islamic Banking in order to minimize the effects of the above-mentioned sarcastic criticisms.[4]

In this context, the Assets Securitization can play a significant role through combination with project finance. Such connection will enable and encourage the creation of true double tier *muḍārabah* which was, so far, difficult to be implemented. This mechanism can create an internal system which allow the matching of different maturities of the first tier *muḍārabah* (the deposit) with the second tier *muḍārabah* (the investment).[5]

Below is the simplified diagram of the structure of the Islamic Banking which is based on the double tier *muḍārabah* model. (It is to be noted that the diagram is a very simplified one. The structure can be very complicated can consists of some hybrid structures or some enhancements).

Figure 1:Tthe double tier muḍārabah Islamic banking structure



[4] It should be stressed out here that it might be unrealistic to eliminate completely the element of debt/non profit loss sharing in the Islamic banking system. However, the point that the author would like to make is that the double tier *muḍārabah* should form the dominant facet of Islamic Banking.

[5] One factor that creates difficulty in matching the deposit *muḍārabah* and the investment *muḍārabah* is the illiquid nature of the *muḍārabah* investment. By using asset securitization, the *muḍārabah* investment is in fact, becomes liquid which make the redemption of the deposit *muḍārabah* much easier even in the case of the maturity mismatch between the deposit and investment *muḍārabah*.

The structure is based on two tier *muḍārabah* model, where the Depositors will place their fund as a *muḍārabah* deposit in the bank which in turn invests the fund through *muḍārabah* in several projects. Such *muḍārabah* is structured as a non recourse project finance transaction using leasing as a main vehicle where the repayment of the financing was convened only to actual revenues generated by the project. Then, each individual project is securitized and sold back to the bank. Because all projects are converted into marketable quasi equity security, the risk of maturity mismatch between the first tier *muḍārabah* and the second tier *muḍārabah* can be avoided.

2.2 The Assets Securitization as an Alternative Method for Resource Mobilization

In the absence of Sharīʿah money and capital market, the only available option for resource mobilization is to utilize the existing conventional infrastructure as long as such an infrastructure is not against the principles of Islamic Sharīʿah. For that purpose, the capital market is the most appropriate solution to this problem. As long as the means of mobilizing the capital is Sharīʿah compatible, the structure is acceptable. The recent Indonesian experience with the issuance of Sharīʿah bonds (in the form of *muḍārabah* or *ijārah* bonds) proved the point. However, this success is not without legal problems. While the trading of debt is not permitted by Sharīʿah. The legal status of Sharīʿah Bonds is still a debt.

It is without doubt that the conventional instruments which are most compatible with Islamic Sharīʿah is the equity instrument. However, for any institution considering to issue a debt-like instruments, changing its issuance into equity or giving up its equity position is not always desirable as it can dilute their interest or simply too expensive. Therefore, the desired alternative is to find a quasi equity instrument which behaves like a debt however has all necessary characteristics which can qualify it as an equity. In this juncture, the viable alternative to this is an instrument which is created through securitizing the assets of such an institution or any subsidiary thereof.

3. Indonesian Present Legal Environment

Indonesia has, for quite some time, laws related to Sharīʿah Banking. Indonesian laws have adopted dual banking system through the promulgation of Law No 10 year 1998 concerning amendments to the banking law[6] which forms a legal basis for the development of Islamic Banking in Indonesia and through the law No 23 year 1999[7] concerning Bank Indonesia which paved the way for the creation of the Sharīʿah based regulatory and supervisory frameworks. The attempt to create a Sharīʿah environment was quite promising and Bank Indonesia has been

[6] State Gazette No 182 year 1998
[7] State Gazette No 66 year 1999

very active in this regard. Soon after the promulgation of the Law No 10 year 1998 which gives Bank Indonesia the power to supervise and regulate the banking sector in Indonesia,[8] it promulgated several Bank Indonesia Regulations (Peraturan Bank Indonesia) which are intended to regulate the Islamic Banking. The regulatory regimes are quite comprehensive. They cover almost every facet of administrative aspects of Islamic Banking.

However, it is not the case for other financial institutions. Other Sharīʿah financial institutions or instruments such as asset securitization do not enjoy the same privileges as Islamic banks do. Other Sharīʿah financial institutions or instruments have to rely on laws for conventional system. Unfortunately, the law is not always very compatible with Sharīʿah.

3.1 Laws Related to Assets Securitization

Despite the fact that the Asset Securitization is one of the most important mechanisms for finance, Indonesia has not passed any comprehensive law for asset securitization. There is however, an attempt by the Government of Indonesia to create such a law.[9] Unfortunately, the draft law, if not modified, will have some issues with its compatibility with Islamic principles. The provision of the draft law which may have difficulty with Sharīʿah is the one which clearly states that the securitization can only be conducted over debts.[10]

However, despite the non existence on the laws in the level of statute, the law was implemented in the level of regulations in the Capital Market field. The Indonesian capital markets are regulated by the Ministry of Finance through the Indonesian Capital Market Supervisory Agency (BAPEPAM). Under the Capital Market Law of 1995, BAPEPAM sets policy guidelines and regulations and is responsible for the day-to-day supervision of the capital markets. In essence, it has the power to interpret laws and legislation on matters within its jurisdiction, and to establish rules and issue independent decrees to that effect.

In regard to assets securitization, BAPEPAM has issued regulations No IX.K.1 on Asset Backed Securities. It governs the elements of a typical asset securitization. However, it still has some characteristic which is not favourable to

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[8] See Article 24-35 of Law No 23 year 1999. It is to be noted that under the previous banking regime in Indonesia, despite the fact that BI sets and administers the operative rules and regulations related to banking operations, it was the Ministry of Finance that had the ability to enforce the rules, through its authority to issue and revoke banking licenses. See Nasution, A. (1994) "An Evaluation of the Banking Sector Reforms in Indonesia, 1983-1993," Asia Pacific Development Journal 1 (June 1994) at 78.

[9] At present, Draft Law concerning Asset Securitization is being considered in the concerned ministries of the Republic of Indonesia.

[10] See Article 3 of the Draft Law on Assets Securitization. This will create difficulties for Islamic Financial Institution as Sharīʿah prohibits selling debts at discount

the issuance of Islamic asset securitization, the explanation of which will be given in the subsequent sections.

3.2 The Legal Issue of Sale of Debts

The most important aspect of the asset securitization is that the sale of debt should be done as a "true sale" transaction to achieve the bankruptcy remoteness of the transferred assets.[11] The requirement of the Indonesian law is quite simple, namely that the transfer should be made through *cessie* and the only requirement is notification to the debtors.[12] While it seems simple, some non legal issues will arise. The originator most of the time is hesitant to inform the debtor for various reasons. However, while the requirement of notice may create difficulties, there is more pressing issue in relation to the rights attached to assets transferred. While Indonesian law has pronounced that all rights associated with the debts are transferred along with the transfer of debts,[13] it is not clear if the assets transferred are not in the form of debts. The same difficulties also arise in regard to debts which are the result of leasing or *muḍārabah* transactions, in the absence of any collateral being placed in the leasing or *muḍārabah* objects.

3.3 Laws Related to Leasing

Special mention should be made to leasing as this is the closest mode of financing to *ijārah*. Leasing is even often, if not always, equated to *ijārah*. Unfortunately, the leasing law in Indonesia is still underdeveloped. Leasing is still governed through the Presidential Decree No 61 year 1988 which was originally only intended to stipulate permitted activities to be carried out by a financial institution.[14] At the outset, this decree does not pose any legal hurdle for application of leasing according to Sharīʿah principles. However, the implementing regulation on leasing activities contains a requirement which may contradict the Sharīʿah principles. The Decree of the Minister of Finance No Kep.Men.Keu.RI.No1169/KMK.01/1991 put an obligation for the parties to a leasing agreement to put a clause which determines the liability[15] of a lessee in the event of non functionality of the object of the lease agreement.[16] The point of the above example is that while the decree neither permit nor forbid that those activities be carried out through Islamic means, this decree cannot be considered as the legal basis for Islamic leasing. Moreover, the fact that this Presidential Decree

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[11] It is possible to have asset securitization without sale of assets which is known as synthetic securitization. However, it is beyond the scope of this paper.
[12] Article 613 of Indonesian Civil Code.
[13] Article 1533 of Indonesian Civil Code.
[14] Article 2 stipulates the activities which are Leasing, Venture Capital, Trading in Commercial Papers, Factoring, Credit Card and Consumer Finance.
[15] It is true that the contract can determine that the liability being 0%. However it is clear that this regulation is not intended to be the basis of Islamic Leasing.
[16] According to Sharīʿah, the leasee to an *ijārah* contract cannot be held responsible for the damage or any loss due to the non functionality of the object of the lease.

was based on the laws which do no recognize the principles of Sharīʿah[17] can further support the above argument.

3.4 Laws Related to *Muḍārabah*

Muḍārabah is also an instrument whose regulation is still uncharted. The tendency of equating *muḍārabah* transactions with share cropping transactions can only make the matter worst. The *muḍārabah* transaction entails more than simply sharing revenue. The heart of *muḍārabah* is the transfer of asset in trust, namely, the transfer of assets into the ownership realm of the *muḍārib* for the benefit of the investor. The *muḍārib* owns the assets and is not merely the custodian of the assets. Indonesian laws unfortunately cannot protect adequately the parties to the *muḍārabah* transaction as the nature of the transaction is not within the ambit of its legal foundation. As transfer of ownership in the *muḍārabah* transaction resembles the common law trust,[18] Indonesia as a country following civil law system do not recognized dual ownership[19] in equity and at law. Unfortunately, such split in ownership is the essential facet of *muḍārabah* transaction which has not been covered by Indonesian law and cannot be governed by conventional Civil law principles.[20] It is however possible to cover the profit sharing aspects of *muḍārabah* transaction through the freedom of contract principle.[21]

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[17] This Presidential decree was based on the Constitution, the Commercial Code, Civil Code, Law No 12 year 1967 concerning Cooperatives and Law No 14 year 1967 concerning Banking. See the Recital of the Presidential Decree No 61 year 1988. It is to be noted that the Commercial Code and the Civil Code were initially intended for the European and were the codification of living values of the Netherlands/western society. Prior to Indonesian independence, the Islamic majority native Indonesians were subject to *Adat* law which consists of among other Islamic law.

[18] Some Islamic Financial Institution even used the terminology "trust financing" to denote the mechanism contemplated in classical *muḍārabah.*

[19] It is true that the notion of ownership in *muḍārabah* transaction is not exactly the same as the notion of ownership in common law trust. However, it is safe to say that both are similar. Therefore it is appropriate to take the example of the dual ownership of the common law system to highlight the problem associated with the implementation of *Muḍārabah* under legal regime following Civil Law system.

[20] The consequences which may arise are related to the status of the *muḍārabah* object in case of insolvency of the *muḍārib*, the liability of the *muḍārib* and the rights of the investor. As the explanation will make this paper unnecessarily long, the writer will not make elaboration on this issue.

[21] Both Common and Civil laws share this principle.

4. Indonesian Existing Practise and International Experience

4.1 Sharīʿah Bonds

Current *ṣukūk* in Indonesia are always manifested in the form of bond which is legally a debt instrument.[22] While the Sharīʿah pronouncement on the Sharīʿah bond stated otherwise, the legal fact on the matter is that the legal opinion always stated the Sharīʿah bond as a debt instrument.[23] This creates a dilemmatic legal problem. On the one hand, Sharīʿah prohibits selling a debt instrument not at the face value and on the other hand, the nature of the bond and market necessity requires that the bond is to be freely traded, namely at discount or at premium. It is true even in the case of *ijārah* bond where the bonds represent not the ownership of the asset but on the rental claims associated with the lease of the underlying assets.

However, even if the *ijārah* bond can be manifested in the ownership of the underlying assets and not merely in the rights to receive rental payment, another issue will arise, namely the liability of the owner of the assets. As an owner of an asset, the investor will be exposed to numerous risks which may result in the Sharīʿah bonds being less attractive than its conventional counterpart for rational investors.

4.2 The Practise of Assets Securitization

Another possible vehicle under Indonesian law is the issuance of asset backed securities. The Capital Market authority has since 1997 issued regulation on asset backed securitization. However, it is doubtful whether the vehicle can be used as a vehicle for Islamic *ṣukūk*. Asset securitization in Indonesia is done through a vehicle named Kontrak Investasi Kolektif or Collective Investment Contract (CIC) between the portfolio manager and the custody bank on behalf of the investors. This arrangement seems to attempt to mimic a trust special-purpose vehicle (SPV) for achieving the bankruptcy remoteness. In this arrangement, the investment manager has the task of managing the portfolio while a custodian bank becomes a collective depository of the securities.

Originators sell their receivables together with the attached security to the CIC. The CIC investment manager responsible for the portfolio, in turn, issues asset-backed securities for investors. The funds raised are transferred to the originators

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[22] In order to not creating unnecessary controversy, this paper will not name any specific case of Sharīʿah bonds for the following reasons: (a) It is not the aim of this paper to criticize the practice, (b) the Author do not have all documents pertaining to each single Sharīʿah bonds issuance in Indonesia, and (c) the Author does not wish to make any generalization on the issuance of Sharīʿah bonds.

[23] See The Legal Opinions issued in conjunction with the issuance of the Sharīʿah Bonds.

as contracted and the servicing of the receivables is a function that is normally contracted back to the originators.

4.3 International Practises Related to Islamic *Ṣukūk*

It is important to see international practices related to *ṣukūk*. While the issuance of *ṣukūk* took different forms and methods, there is one similarity among all the issuances of *ṣukūks*,[24] namely the use of trust structure, in the sense that there is always involvement of the splitting of ownership of the underlying assets into legal and equitable ownerships. This is the answer to the prohibition of the sale of debts under Sharīʿah which result in the certificate issued or traded represent an ownership over a real asset. In the case of the famous first Malaysian *ṣukūk*, the traded certificates represent the equitable ownership on the real estate parcel while in the case of Islamic Development Bank (IDB) *ṣukūk*, the traded certificates represent the equitable ownership on the pool of assets which consist of mainly real ownership.

In order to satisfy the Sharīʿah requirement, the underlying transactions are always in the form of leasing. It is because, leasing is the closest mode of financing acceptable to Sharīʿah which involve real ownership over a real assets. Such requirements resulted in all transactions structured to involve leasing of real assets, regardless of whether the intention of the would-be investor are in the ownership of the associated real estate. Another development is in the IDB *ṣukūk*. It is no longer necessary to have the pool of assets consist of only leasing assets. The issuance of *ṣukūk* will be still acceptable of Sharīʿah if the initial composition of the portfolio consist of 51% leasing and at any time not reaching below 25% of the portfolio.

While the *ṣukūk* structure is always done through a complex structured finance transaction, one fact can be rooted out from the complex structure that the foundation of the structure lies in the ability to split the ownership of the underlying assets into legal and equitable ownership.

5. Analysis on Indonesia Current Laws

5.1 Analysis of the Legal Aspects of Sharīʿah Bonds

The only justification for the Sharīʿah Bonds in Indonesia to be issued in the way they were issued is that the Indonesian Capital Market Agency still requires uniform format in issuing bonds. Therefore, the approach taken was adhering with all requirements regarding forms while maintaining the substance of the matter in conformity with Sharīʿah.

However, this approach is not without problem. This approach creates inconsistencies, especially related to the treatment of the bonds under Indonesian law. Indonesian law still view bonds as a debt instrument. Despite some quarters

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[24] Except for straight forward *muḍārabah* or *muqāḍarah* bonds.

argue that allowing Sharīʿah bonds has resulted in the broadening of the definition of bonds, Indonesian laws still regards Sharīʿah bonds as a debt instrument. The paradox of this treatment is that as trading in debt instrument not in its par value is unlawful in the view of Sharīʿah, the issuance of Sharīʿah bonds is just to allow such trading in debt.

5.2 Assets Securitization and its Sharīʿah Compliance

While majority of Sharīʿah scholars prohibit trading of debts, the rulings on the trading on debt-like instrument or non-debt instrument which behaves like debt do not enjoy the same consensus.[25] Moreover, trading on proof of participation (whether in the form of shares of a company or unit trust) in a portfolio which consists of mainly debts might be considered at the trading in debts. This fact can potentially create difficulties in using asset securitization as a basis of Islamic *ṣukūk* in Indonesia. The Indonesian draft law on asset securitization requires that the asset to be securitized is in the form of debt.[26] Fortunately, in the existing regulations of BAPEPAM, there is no express requirement that the portfolio of the Collective Investment Contract consist of only debts. According to paragraph b of the Regulation IX.K.1, it is possible to have non-debt financial assets in the portfolio. However, while a lease rental payment can be categorized as a financial asset, it is not clear whether an asset which is subject to lease can be categorized as a financial asset.

The second issue is whether the transfer of the assets will attract moral hazard problem. While in the conventional asset securitization the only moral hazard problem is the possibility of the originator applying different treatments between the sold assets under servicing agreement and the unsold assets, the problem will add with the requirements for operation and maintenance of the lease assets if the whole asset and not only the lease payment is transferred to the portfolio.

The third issue is related to the CIC model required under existing BAPEPAM regulation. Even though has been used several times, the effectiveness of the CIC model remains questionable. The major issue is whether the CIC which does not have separate legal personality, can legally enter into contracts with other parties, such as investors and services, in the same way that a trustee can.

The bankruptcy remoteness of the CIC scheme is still untested. The CIC is basically an SPV which insulates the securitized assets from the insolvency of the originator. While in the conventional asset securitization, the SPV exists solely to sell and hold the securitized assets and may not have obligations other than to those to be paid with the securitized assets, in the Sharīʿah asset securitization, the SPV

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[25] The ruling regarding IDB's *ṣukūk* permit the trading of a certificate which represents ownership over portfolio of assets consisting both real assets and debts. The caveat is that the initial composition of the portfolio should be 51 % of real assets and in any case should never reach below 25% of real asset.

[26] Article 3 of the Draft Law on Assets Securitization.

might have additional obligations as the SPV will hold the real assets and not merely claims.

5.3 Transferring Equitable Ownership

As a civil law country, Indonesian law has the principle of the unity of ownership. Therefore, it is difficult to assign and transfer only the part of the interest, namely equitable interest on the ownership of the income generating assets. While many problems can be sufficiently averted by simply splitting and securitizing the equitable ownership of the asset, the nature of Indonesian law does not permit such separation. Therefore some reforms are to be made into Indonesian law to allow such separation.

5.4 Problems with Non-Straight Forward Debt

While Indonesian law has a provision related to the rights attached to a debt, the lack of laws related to leasing pose another problem. The provisions of Article 1533 of Indonesian Civil Code only extend to the security attached to a debt. In the case of transferring lease payment, the relationship between the lease payment and the lease assets is not very clear. The lease payment is not automatically secured by the lease assets as the obligor of the lease payment and the owner of the lease asset are always different.

Another issue is related to the lease asset itself. While Sharīʿah compatible lease is limited to operating lease and not extended to financial lease. There is a problem of the ability to assign future debts. Under *ijārah*, the payment of the rental is given for the enjoyment of the lease assets. Therefore, each payment of rental is considered a separate payment for the enjoyment of the lease asset and not an instalment of an existing debt. This will create problem of notification and transfer as the notification has to be done for each and every rental payment.[27]

6. Proposal for Reform

Generally, Indonesia lacks the legal framework for complex financial innovations. The development of the Indonesian *ṣukūk*, in particular, is hampered by various shortcomings in the legal system. These include the difficulty of assigning and transferring the part of the interest on ownership, namely equitable ownership of the income generating assets and the lack of legal protection for the holders of non-straight forward debt.

This issue necessitates a legal framework which can accommodate the splitting of ownership of a real asset into equitable and legal ownerships. However, as the separation will affect the fundamental nature of Indonesian legal tradition, some reform should be introduced. The reform is needed in regard to the unitary principles in property ownership, in the sense that the ownership is no longer

[27] Article 613 of the Indonesian Civil Code.

unitary if viewed or dealt with in different realms. At this juncture, the principle of equity of the common law system may be introduced so that the separation of the property ownership does not alienate the rights of the legal owner of a property. Therefore, it is suggested that the equitable ownership be recognized in the same way as the common law jurisdiction perceived ownership over property.

Such reform will benefit the development of Islamic financial institutions in the sense that it will eliminate paradox resulting from different view points of laws and Sharīʿah over the same matter.

In concrete term, the splitting of the ownership will resolve all problems associated with the issuance of asset backed securities. Firstly, it will enable the recognition of *muḍārabah* transactions; Secondly, it will avoid resorting to the debt issuance for resource mobilization; Thirdly, it will ease the creation of bankruptcy remote vehicle; Fourthly, it will avoid moral hazard of the originator and the liability of the investor pertaining to the asset; Lastly, it will ease the problems in dealing with future debts; and finally it will avert the problems associated with the rigidity of property ownership principles in general.

Finally, it is to be mentioned that the reform proposed herewith is by no means a complete proposal. It is just considered as a first step and intended to make it possible for the current legal system to align with the Sharīʿah requirements.

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Comments

on "An Inquiry into Alternative Models of Islamic Banking" by Iqbal Anjum

Asad Zaman[*]

Introduction

The author has performed a valuable service by giving a historical review of alternative models of Islamic Banking. Because of the very broad scope of the paper, many of the arguments are sketchy and there are a very large number of facts listed without much cohesion and integration. More detailed comments are as follows:

2. The Rationale for Islamic Universal Banking

Because the paper is thick, and the language otiose, it is very hard to follow the main line of the argument presented by the author. Therefore it will be useful to summarize it as follows:

Paragraph by paragraph summary:

1. Islam requires purging evils of interest from modern current banking system while retaining its beneficial features.
2. Conventional European banking system was based on the financial necessity and benefits of intermediation by providing surplus money available with savers to those who want to do productive investments.
3. This refers to evolution and specialization in USA Banking following political and economic necessities of the post-Depression era – however, it is too general, and does not fit will with the previous paragraph.
4. Western banking was introduced during colonization, and these institutions remained in Muslim countries following decolonization.
5. Thus the challenge for Muslim countries is to transform these institutions into those which are compatible with Sharīʿah, retain the

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benefits of transferring money from savers to investors, but do not have the disadvantages of the Western institutions. The only disadvantage mentioned here is the frequent financial crises associated with banking in the West.

6. It is stated that these developments will bring about empowerment of humanity and development, and must be done at the level of the *Ummah* rather than on a national basis.
7. Due to lack of cohesion at the level of the *Ummah*, Muslim public has been trapped into buying into Western institutions and using the dollar as their base currency. This prevents us from having an independent monetary policy and also makes us very vulnerable to various types of economic warfare which could be waged against us.
8. In view of these concerns, Islamic economists have developed models of banking which will be more humanitarian and development oriented, as well as giving us financial freedom. These models have provided the basis for the launch of innovative experiments in Islamic banking.

The above is a cogent and cohesive argument. However it could be made much shorter. Also, this section requires more references and greater precision in reasoning. That would create a greater impact on the audience, and also be easier to follow and understand.

3. Evolution of the Theoretical Models of Islamic Banking

This section is very much in need of subsections. Furthermore it is very unbalanced in its presentation. MNS models is presented in excruciating detail, most of which is unnecessary. Some other models are presented so briefly that it is not clear what their essential features are. All models should be given a roughly equal and brief treatment and much more time should be spend on comparisons and contrasts between them.

1. The first paragraph states that M.N. Siddiqui presented the first model of Islamic banking. Since then, several models have been presented. The author proposes to introduce, comprehensively understand, compare and contrast these alternative models. In the remaining section, the author presents an exhaustive analysis, replete with details of each of the proposals he discusses. However, there is little comparison or contrast. Furthermore, there is no distinction made between the main features of the alternative systems and how they compare with conventional. Apparently trivial details of no significance from the broader macro perspective are elaborated at length. This section needs to be substantially revised and condensed to focus on the main features of the alternative system (leaving out technical details which do not affect these features). After the main features are highlighted, it would be possible to compare and contrast them with each other, and also to asses them against conventional banking.

2. The first proposal to be discussed in M. N. Siddiqui's (MNS) proposal. From pages 8 – 20, the MNS proposal is explained in excruciating detail. Many of these details seem to be of no relevance at all to the main theme of the paper. If we are trying to compare and contrast the major features of alternative banking systems, then we cannot focus too much on the micro details of the transactions. Issues relating to how shareholders in the ownership of banks must have quarterly accounting, and similar detail, is irrelevant to the macro performance of the system. Only those details of relevance to the macro performance of the Islamic banking system and how it compares to conventional banking and to alternative proposals should be mentioned.

3. After 12 pages of details of MNS banking proposal, the paper transits without any warning or subsection heading to the CII (Council of Islamic Ideology) proposal for Islamic banking. Again, the proposal is discussed in great detail. However the discussion is couched in language used by CII, without explanations of the technical terms, or any comparisons or contrast to the previous MNS proposal. In fact the two are radically different approaches to Islamic Banking and the differences and the reasons for these would be very worthwhile to study. Six pages are devoted to details of the CII proposal; again many of these details seem to be of no relevance to the big picture or the theme of the paper. These should be eliminated, to focus on the major issues.

One of the major issues is the following. The MNS model was a purely theoretical model. At the time, there did not seem to be enough political space to actually implement Islamic Banking. Therefore the model assumed that we have a free hand to create a system according to our own specifications. In contrast, the CII model is constructed with a view to implementation, in the expectation that the economy is due to be Islamized. This is why it deals much more with details of how implementation is to be carried out in many different types of transactions which actually occur. It also recognizes the need for compromise with existing practise, since Islamization cannot occur overnight. This can account for many of the differences between the two models.

4. Jarhi's (1980) model for Islamic banking is presented next, with help of figures and diagrams from Jarhi's papers. This is a 100% reserve banking system, which differentiates it clearly from the previous two. Since this is currently not practised anywhere, it is not at all clear whether or not it would be functional. What would the strengths and weaknesses of such a system be, relative to both conventional banking and relative to alternative models for Islamic banking? We do not know and the author does not comment on this issue.

5. Ansari's(1983) model is presented next. This model is substantially different from the previous ones because it focuses on the social context, and specifically builds communities with shared interests and common goals into the picture. Thus it is quite different from the earlier models which are purely economic, take social structures as given and do not attempt to take these into account. There are some

analogies to the communes and communal living created in Israel, and the economic aspects of this model would be worth comparing and contrasting with the economic experiences of these communes.

6. Chapra's model focuses more on the Muslim agents in economy than the others. He assumes that motivated Muslims will have a different money demand function, since they will avoid luxuries and conspicuous consumption. His monetary model focuses on the Islamic aspects, such as basic needs fulfilment, providing employment opportunities for the poor, etc.

7. IIIE Blueprint is discussed next. This is similar to the CII proposal, in the sense that it is meant for immediate implementation, and therefore does not propose radical changes in either social structure, nature of banking institutions, or the character of the people in the society. Instead, it concentrates on making the minimal changes necessary to achieve an Islamic system in a practisal and feasible way.

8. Jarhi & Iqbal (2001) present another model of universal Islamic banking. While some details are given, it is not clear how this model differs from the CII or IIIE proposals.

9. Khan (2002) presents a monetary model for an Islamic economy. It appears that the main purpose of this model is to show that price stability and growth can be achieved by the Central Bank within the constraints posed by Islamic banking. Again, there is no clarity on similarities and differences between Khan's model and others.

10. Hassan et. al. (2003) model Islamic banks as un-leveraged interest free financial intermediaries working under Sharīʿah. Their model emphasizes corporate governance and interactions between 7 categories of mutually functionally integrated stakeholders. It is not clear the extent to which this model is compatible with, similar to, or different from any of the other models presented. It appears to be focused on different aspects of the same Islamic model as some of those described earlier.

11. Finally, Anjum (2004) present his own model. This is the most idealistic of all the models, in that it assumes a united *Ummat*, which operates with consensus according to full Islamic principles. In this ideal world, there is only one Islamic currency which has replaced the dollar, and numerous institutions of a purely Islamic nature have emerged. It is envisaged that the *Khilafat* has been re-established so that the *Ummat* is united under one leader.

In summary, this is a very valuable overview of a large amount of literature on Islamic Banking.

4. Retrospective on Applied Models of Islamic Banking

The previous section dealt with theoretical models of Islamic Banking. In Section 4, Anjum Iqbal presents a summary of applied experience with Islamic Institutions. He presents a chronological list of Islamic institutions, and then proposes to take a detailed look at 10 of them. We give a brief summary of the 10 institutions examined.

4.1. Data showing the excellent financial performance of "Tabung Haji," a Malaysian savings institution, is presented in some detail. What would be of more relevance to the present papers theme is details of how this institution works. Which of the 11 theoretical models described earlier does it correspond to? What accounts for its success – which types of Islamic transactions does it engage in? There is a general suspicion that Islamic banks perform essential the same operation as conventional ones, but re-label their transactions. This would not seem to be the case with Tabung Haji, but some evidence for this would be useful. In particular, one could compare the performance of Tabung Haji with other conventional banks in Malaysia.

4.2. Mit Ghamr Bank of Egypt is mentioned in one paragraph. Again it is unclear what the range of operations was and how it was structured to avoid interest – which of the several possible theoretical routes described in the models of section 3 was taken by it.

4.3. IDB is a special purpose institution, not exactly a bank. It finances development projects on an Islamic basis, and also serves as an equivalent of the IMF for the Islamic World.

4.4. Islamic Bank of Bangladesh. This is described at some length, and the Islamic modes of operation used by it are also described. There are many encouraging features of this report, including its engagement in welfare activities, in stark contrast to conventional banking. Some discussion of its relation to the theoretical models, as well as comparison/contrasts with other successful Islamic institutions such as Tabung Haji would have been welcome.

4.5. Amanah Mutual Funds are not really a bank, but rather a mutual fund in the USA which trades in common stock of firms classified as Islamically permissible by a Sharīʿah board. The issue of the extent to which this is permissible, and how it falls into the categories of Islamic banking described earlier would be worth examining in greater detail.

4.6. Ansar Cooperative Housing Corporation. This Canadian corporation provides an innovative alternative to conventional mortgage financing. This is one element of banking operation and worth examining in some detail as many alternatives have been proposed and some are in fact operational. In a paper of this length, I believe this could be profitably omitted, since this is not a bank per se. At least, no information is presented on whether or not it functions as an alternative to

a conventional bank. A detailed examination of conventional mortgages, Islamic alternatives, and their relative merits would be full length paper in and of itself.

4.7. Islamic Investment Bank Limited (IIBL). Operations of IIBL are described briefly and then it is mentioned that it has gone bankrupt in the wake of a financial scam. If this topic is to opened, then one needs to discuss the potential for financial scams within and Islamic framework, and mechanisms required to minimize this risk. Alternatively, this example could be omitted from the list of successfully functioning Islamic banks. Obviously, it is not the goal of the author to present all Islamic financial institutions, rather only a selection from them. In this case, would it not be better to focus on successful ones as the ones to learn from and emulate?

4.8. Bank Muamlat (Indonesia). This bank is described in detail over 4 pages. Apparently it is a large, modern, fully functional Islamic bank which offers a complete range of conventional services. If such a bank exists, what is the need of the other models? It would appear that the Islamic alternative has already been found and is working well and efficiently. All we need to do is to imitate an existing successful model. To fully evaluate this issue, we need more details on whether or not there are any controversies about Sharīʿah compliance of operations of this bank, and what obstacles exist in implementing the same banking model in other Islamic countries.

4.9. Abu Dhabi Islamic Bank. Again this seems quite similar to the previous case, and raised similar questions.

4.10. Bank Sharīʿah Mandiri: Five pages are devoted to this bank, which again appears to be a fully functional modern Islamic bank. If such a bank exists, do we need to do more work on Islamic banking? It would appear that solutions have already been found and are only in need of implementation. The questions which arise here are the same as those raised earlier. In particular, the interface with conventional banks and the interest based world financial system is a source of concern; complete insulation is not possible and some transactions run the risk of being counter to Sharīʿah.

5. A Comparative Systemic Critique of the Alternative Models of Islamic Banking.

While there is a tremendous wealth of information in the rest of the paper, this section is the heart of the paper, with it comparisons of alternative models of Islamic Banking. Unfortunately, while the paper is replete with trivial details of some of the models which do not pertain to the larger issues under discussion, some of the key terms which need to be understood for making comparisons in this section are not defined. A two-tier *muḍārabah* is the basis for all Islamic banking, but it is not explained here. It is said that Islamic models are constructed on the basis of either Anglo-Saxon fractional reserve type banking or the German/Swiss/Japanese type, with the exception of the 100% reserve model of

Jarhi. However what these types are and how they compare with each other with respect to stability, efficiency of financial intermediation, conformity to Islamic requirements, etc. Are not mentioned.

Anjum says that all theoretical models have explicit built in linkages with human development goals. However, some of the models described appear to be purely technical and these links are not described in the summary.

The fourth paragraph states that "implementation of the narrowest nationalism-based models of the Islamic banking, by ignoring the humane universal dimensions of the Islamic banking system, has been very costly for the masses of the individual Muslim states in terms of colossal welfare losses." I don't think this has been adequately documented – at least, it is not clear that a real feasible alternative exists. The idea of a Muslim Dinār, while attractive, has certain clear cut drawbacks related to the theory of optimal currency areas.

Two paragraphs are devoted to a critique of the MNS model, summarized via a comment by Yousri. Yousri's comment refers to banking practise and not the MNS model, which has not actually been implemented anywhere. Critique of current practise would be much more useful. Of interest is the issue of how well the critique applies to the two or three successful large Islamic Banks cited. Also, completely missing from this paper is any coverage of Iran and Sudan. In particular, it is often claimed that the only genuine Islamic Banking experience has occurred in the Sudan.

The last two paragraphs claim a watershed role for the CII model. This claim is important and interesting. It would be very worthwhile if some historical evidence or documentation to show this was available. As it stands, it is mere assertion.

6. Policy Recommendations

The policy recommendations here seem idealized and optimistic. It is not explained whether lack of confidence of the masses is valid and the major bank operations are in fact Sharīʿah tricks, or whether banks are sincere, but the masses have a misconception. Furthermore, the forces aligned against a genuine change towards Islamic system are also not given proper consideration.

7. Conclusion

Overall, this is a very rich, detailed and valuable paper, which makes a substantial contribution to the literature of Islamic economics. Further work along the lines indicated in my comments should allow us to make progress in evaluating relative merits of the various options available in the literature and arriving at useful directions to pursue for the future of Islamic Banking.

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Comments

on "Non-Interest Resource Mobilization for Public Capital Projects – the Use of Islamic Endogenous Loans" by Rodney Shakespeare

Shamim Ahmad Siddiqui*

(1) This is a very interesting paper on the issue of financing of public projects without involving the institutions of interest. By and large, I am sympathetic to many of the ideas presented in this paper. The author is vehemently against the institution of interest. He is perturbed to see the power of the commercial banks who not only use the money owned by the shareholders and the depositors, but even money created from nothing to impose interest on the borrowers. He has little hope that the economies based on western capitalist ideologies will ever recognise the problems created by the institution of interest and consider to do away with it unless they could observe an economic system that uses an alternative mechanism. As Islam clearly prohibits this institution, he earnestly believes that Muslim societies are in a position to come up with a viable alternative and may also influence western economic thinkers. The author asks Muslims economists and financial experts to go beyond the Qur'ānic injunction that prohibit interest and look at the benefits of an alternative mechanism. He calls for adopting a new paradigm and reject the notion that modern market economies cannot function without interest. On this I am in total agreement. I also share his view that the ownership of capital and the income generated by it should be spread through the masses. In my view, this has always been one of the major goals of Islamic banking and finance.[1]

(2) After reading it several times, I have the impression that on a number of issues, perhaps due to the space limitation, the author has chosen not to go for a detail analysis or discussion. Also, he seems to be more interested in bringing in a change in the way we think about the working of the commercial banks in today's capitalist system. What I intend to do in this report is to (i) add some further

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[1] Another goal or capability of *profit and loss sharing* Islamic banking is to provide financial stability. For further discussion of potential benefits of Islamic banking, please see Siddiqui (1994 a) and Siddiqui and Fardmanesh (1994b).

arguments in favour of some of the points made in the paper (ii) suggest to the author to make clarifications on some issues that I think are not very clear to the reader, and (iii) give some of my own proposals to strengthen his case for a new economic paradigm (that avoids institution of interest).

(3) As the title of the paper suggests, the main thrust of the paper is to propose that all public projects be financed through the central bank's own money which he describes as the "*endogenous money"* contrary to the conventional treatment of that money as *"exogenous money"*. Conventionally, endogenous money is referred to the money created by the banking system through advancing loans as banks are required to keep only a fraction of their deposits as cash. As per author's criticism of conventional use of endogenous and exogenous money is concerned, in my opinion, it does not have an effect on his main arguments unless he shows that conventional economics somehow puts greater 'value' to endogenous money compared to the exogenous money referred to the money created by the central bank directly. If this is the case, references could be cited.

(4) The author claims that public projects, if financed through the commercial banks, cost more because of the payment of interest. By avoiding interest, cost of the project could be substantially brought down or more projects could be undertaken for the same outlay. One point that has been emphasized at several places in the paper is that, public projects financed by the Islamic endogenous money or the central bank's money will not create inflation as they would increase the productive capacity of the country. I suggest the issue of inflation be given more space in the paper. There could be several reasons for a period of inflation in a country. One possible reason is an excess demand (relative to supply) for goods and services that is created by income generated through the work on huge public projects even if financed by the central bank's *endogenous* money. If the country is able to produce the goods and services demanded by the receivers of new income without increasing their prices, there won't be inflation. Alternatively, with a comfortable level of foreign exchange reserve and favourable current account, the country may allow a liberal import regime to prevent excess demand in different markets. Many oil producing countries have launched huge public works programme with their own money (i.e., central bank's money) without experiencing any inflation.[2] However, if none of these two is possible, then there is a possibility of inflation if the increase in demand for goods and services is more than increase in supply or increase in supply is only possible at higher prices. Many developing countries have experienced this problem when they tried to finance public projects by excessive increase in money supply whether or not this increase in money supply was made through printing of central bank money or by allowing the banking system, through different monetary policy instruments, to create more

[2] Brunei Darussalam is one such country where money supply has no impact on inflation rate as most of the goods are freely imported and the exchange rate is very stable due to huge foreign exchange reserve and continued trade surplus.

money. Even if projects are funded by foreign sources, prices may go up if there are bottlenecks in the supply of essential commodities.

It is true that government public projects like dams, highways and other infra structure projects have the potential to increase the productive capacity of a country. However, the gestation period for such projects is generally long whereas income and demand for goods and services is generated much earlier creating upward pressure in prices unless supply is fairly elastic. A prudent government, however, could make a better planning by efficiently choosing the size of public projects outlay and the corresponding amount of central bank's money depending on its production capacity and its ability to import essential commodities. One way out would be to use a part of the newly created money, and come up with appropriate incentives package for domestic as well as foreign direct investors, to increase the productive capacity of the country for different goods and services to meet the anticipated increase in their demand.

An interesting example in this regard is Pakistan that has recently experienced relatively high economic growth and started mega projects. However, instead of making sure that essential commodities are available at stable prices, it increased the support prices of many agricultural goods and was slow on formulating and implementing an appropriate import policy of essential commodities. The result has been an abnormal increase in inflation that has shadowed the otherwise impressive increase in Gross Domestic Product.

(5) The author raises the issue of bank's ability to create money and has asked the question, "*Who (society or the banking system) has the ultimate right to create money* (and, if wished, to impose interest)? To be fair, we must admit that this right to create money is given by the government through the central bank by allowing the banks to use bulk of their deposits to invest. The banks are technically financial intermediaries channelling the funds from the surplus units (households and businesses) of the economy towards the deficit units (households and businesses and the governments). Furthermore, the profits made through this process are supposed to go to the depositors (the shareholders of the banks in a profit and loss sharing Islamic banking system), and the government through taxes. Of course the profits are relatively higher when banks are allowed to create money (required to keep only a fraction of their deposits as cash or reserve) than what it would be otherwise. There is, therefore, a need to see if the profits earned by the banks are fairly distributed among the depositors, government (representing the society) that allowed fractional reserve banking, and the shareholders of the bank. If it could be shown that at present, the banking sector is making abnormal profits and not paying an appropriate amount of tax to the government or they are not paying reasonable rate of returns to the depositors, proper actions could be taken.[3]

[3] Indeed, this comment is made in the context of modern western system of banking based on the institution of interest. It is claimed that under this system the banks provide many

One can also suggest that commercial banks may not be allowed to create money and asked to keep 100% percent reserve unless the depositors agree to put their savings in an investment account and agree to allow the banks to use their money for investment purposes. Of course in that case the depositors may have to take some risks of the investments made by the banks and they also demand a relatively higher expected rate of return. The central bank can also have an investment account with all the banks and allow them to utilise this amount for making proper investment. The government would become an active partner along with those depositors who decide to put their savings in investment accounts. Practically, this is an Islamic banking model that I think should get the attention of Islamic bankers.

(6) In my opinion, it is important to recognize why commercial banks under the current capitalist system are naturally reluctant to opt for long term social projects. One of the main aspects of the western banking system is that it guarantees the value of deposits and any interest payable on them and the right of the depositors to withdraw their money from different accounts accordingly. A number of instruments and regulations are formulated to make sure that this does happen. The banking sector remains under the surveillance of the central bank. The types of investment the banks can make are restricted. The banks are not supposed to be heavily indulged in risky investments including trading in stocks. The idea is to make loans or investment where the principal and interest accruable is made safe through the requirement of appropriate collateral. Furthermore, as the banks have to give interest at regular intervals, they normally invest in businesses that could guarantee positive returns at regular intervals. This prevents many of them from directly investing in the long-term public or private projects. They rather opt for short term fixed return loans and short and medium term government and corporate bonds to earn “certain income” at regular intervals. I will comment in coming paragraphs that the whole situation changes when we consider a *profit and loss sharing* Islamic banking system.[4]

(7) The idea of 100% reserve is not new and had been proposed earlier by prominent western economists in the context of conventional banking system and its destabilising ability to expand or contract money supply in the economy. The case of Islamic banking system would be somewhat different. If the banks are required to run under *profit and loss sharing* Islamic banking system, the one hundred percent reserve requirement should be imposed on non-investment accounts. Banks should neither be allowed to use these accounts for investment nor

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services to their depositors free of cost (including financial intermediation) and they also pay for insuring the deposits.

[4] The implications of *profit and loss sharing* Islamic banking where most of the funds will be used for equity finance would be quite different from the current Islamic banking system that heavily uses debt like financing and fails to achieve any thing significantly different from the conventional banking system.

should they be required to pay any returns. They can use their own (share holders') funds and the *investment* deposits owned by the public and the government to make loans and invest. There will not be any money creation by the banks. The money could only be created by the central bank and channelled to the market through its investment accounts in all commercial banks. The government would then get a proper return on its accounts. This way the benefit of creating money will directly go to the society. The investment depositors and the government will effectively become shareholders of the bank. The government in particular and the investment depositors in general would be able to influence banks' direction of investment. I am sure the author who, like me, wants to see a larger number of ordinary people becoming owners of the capital should favour this outcome.

The author claims that interest is an unnecessary tax imposed by the banks and it increases the cost of the projects. Of course public as well as private projects could be executed without payment of interest if the funds are available without cost. That is only possible if the government provides all the necessary funds with zero interest. As we have discussed earlier, this may not be always possible without creating a period of inflation. Under the Islamic banking framework we just discussed in the previous paragraphs, the central bank or the government may allow the commercial banks to use money in its accounts at the banks to finance particular projects at a very low or even zero charges. The banks could be paid for its services by the government, again through its accounts at the banks and if necessary through new money creation. The criteria to select a project that meets efficiency and distributive requirements could be chalked out between the banks and government representatives.

(8) The author says that economists would defend interest as a payment for abstinence, waiting or time preference. He, however, asks why the banks should be charging interest, that do nothing of this sort. However, if one accepts the notion that banks' ability to create money depends on the savings and deposits made by general public who must be rewarded through interest (for their act of saving and making a sacrifice as they have positive time preference), the bank may have a case for charging interest. For this reason, it is important to deal with the issue of time preference in more detail.

Bohm Bawerk, the most influential thinker to defend interest, had claimed that people who are otherwise rational in their economic decisions behave *irrationally* when it comes to making inter-temporal choices for consumption due to their defective imagination. Siddiqui (2002) attempts to see if people in general are really *irrational* and have defective imagination. Like Frederick et al (2002), he shows that what is being labelled as discounting of future payments and time preference could actually be a reflection of avoidance of uncertainty or impact of

inflation or missing an investment opportunity or a combination of these and more factors.[5]

In his pioneer work on discounting in project evaluation under an Islamic economic system, Zarqa (1983) rigorously dealt with the issue of time value of money and concluded that a positive time preference is neither a principle of rationality nor an empirically established predominant tendency among consumers. It is simply one of the three tendencies among consumers, the other being zero and negative time preference each of which is rational and observable under its own conditions.[6] Zarqa (1983) provides a good survey of the issue of time preference in western economic tradition. He claimed that the overemphasis on positive time preference among some western economists could be ideologically explained by its presumed suitability as defence of the institution of interest against Marxist attacks.

If the case of positive time preference is weakened, then it could be argued that people primarily save for their future needs and do not necessarily deserve a positive return on their savings. If they want the value of their savings to grow (a rational and legitimate desire) they should be asked to invest themselves or through different financial intermediaries. It is then the responsibility of the government to provide a fair and conducive environment to meet the legitimate need of all people whether they are able to make big or small savings. It is important to note that in many countries the bulk of bank funds consist of large number of deposits held by small savers. In the current system most of them receive a very low rate of return on their savings as they are not recognised as the real investors and agree to opt for fixed returns. The *profit and loss sharing* Islamic banking system is a step to provide a fair alternative to the legitimate need of the people.

The next goal for those who oppose the institution of interest is to show that interest is not indispensable. According to Ali Khan, "… interest is not indispensable for the functioning of a private ownership economy."[7] He also claims to show the irrelevance of the rate of interest, assuming it exists, for an optimum

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[5] Frederic et al (2002), pp. 381-83.

[6] Zarqa (1983), p. 209. He further argued that as time preference need not always be positive, it couldn't provide a valid base for discounting. He, however, claimed that discounting is one of the definite requirements for efficiency in investment in both the private and the public sectors. He suggested that, for private projects, rate of return on projects with similar risks should be an appropriate rate of discounting. Zarqa (1983), p. 219. For pubic projects the discount rate should be adjusted downward to reflect the common view that such projects are less risky and the objectives are more complex. Zarqa (1983), pp. 230-31.

[7] Please see Ali Khan's comments on Zarqa (1983) in Ziauddin Ahmed, Munawar Iqbal and M. Fahim Khan (eds.) *Fiscal Policy and Resource Allocation in Islam*, International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah & Institute of Policy Studies, Islamabad, p. 242-243.

allocation of resources in an idealized model of a private ownership economy.[8] Muslim economists and others in the west or east who are against the institution of interest should join hands and continue to work in theoretical and practical fields for a viable alternative.

(9) It should be recognised that people (and states and their agencies) have need for financial resources for both consumption and investment purposes and a society has to develop a mechanism and system to meet these needs in a way that is fair and efficient. However, what is fair may be looked at differently among different societies and even within a particular society. The results of a recent case study of Cambodia Women's Development Agency (CWDA) will be interesting to quote. CWDA is an NGO in Cambodia that provides short term loans to its clients on an annual rate of interest of 60% (5 % per month).[9] The results of the study show that almost all borrowers who have received loans from this NGO are satisfied and would continue to borrow in the future. The reason is that these borrowers are very poor and small loans taken from this NGO allow them to do small business and get a much higher *monthly* rate of profit than the 5% rate of interest per month. These people have liquidity constraint and do not have access to any government loan and loans from commercial banks. The NGO has developed a method of loan collection that is very effective and it covers its operating costs. The default rate is very low.

It could be argued that most of the clients of this NGO are unable to get a full time job on the on going wage rate or the wage rates are very low. They welcome a loan that allows them to make a good income even though the rate of interest is extremely high.

In an Islamic system individuals could also provide small funds or a private commercial firm on *muḍārabah* basis to the cash strapped people. This could generate a reasonable rate of return to both providers and the users of the funds. Alternatively, the Islamic government can establish special organisations (such as the Khushali Bank in Pakistan) or NGOs and ask them to provide loans on zero interest and the cost of running such organisations are covered through general tax revenues or money creation by the central bank.

(10) For other people who may not be so poor, loans for consumer durables such as automobiles and housing could be provided by some government agencies. Alternatively, they could be provided by the commercial banks by using the money available through central banks' accounts in the banks. The government could then pay a lump sump amount to the banks for handling such loans that should be much lower than what normally banks charge to their borrowers for consumption loan. Indeed these loans will be provided to the consumers for their essential needs and

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[8] Ibid, p.243.

[9] Vien Ky (2005) "A Critical Study of Lending Policies of Cambodian Women's Development Agency: A Case Study of a Non-Government Organization", MBA Thesis, Faculty of Business, Economics and Policy Studies, University of Brunei Darussalam.

not promoting unwarranted consumerism that many commercial banks are involved today (*not excluding* those who claim to be Islamic banks).

This consumerism had gone so bad that even a rich country like Brunei had to impose ceilings on the amounts commercial banks (including the Islamic banks) can lend to the consumers. This has to be done after it was noted that for years a very large number of households in the country were heavily indebted. The advice given by religious leaders to avoid over-spending and be prudent, were generally unheeded by the general public who were simply lured by the availability of loans by the commercial banks. Most of these loans were used for buying goods that were either not essentials or could be bought with lower spending. Apparently, the same commercial banks failed to inject enough funds as loans to new small or medium size enterprises. I completely agree with the author who criticises the banks for promoting consumerism and calls for a better utilisation of their funds to spread ownership of capital and increase the productive capacity of the economy.

(11) People save for their children and for their own possible needs in their old age and for future uncertainties. It can be argued that, normally, household savings decisions are independent of the expected rates of returns on those savings.[10] After the saving decision is made by a household, another decision is made about the composition of the portfolio which varies according to the risk averseness and the rate of returns and other characteristics of different assets. If risk free assets are not available, people can still diversify their portfolio specially if there are avenues provided by the economy.

As I have suggested elsewhere, an Islamic reform in stock markets where most transactions would be made on expected dividend payments rather than speculation would provide such an avenue to both the savers as well as to those who need funds for investments. Indeed, not all users of funds will be able or eligible to issue shares to raise funds. For many of them, especially for those who run small or medium enterprises, commercial banks as well as special lending institutions will be needed. As said earlier, in order to avoid interest, the government (meaning the society as a whole) would need to meet the cost of running specialised lending institutions. In old days population was less and the need of funds for consumption and investment was limited. Individuals in the society were supposed to support those who need resources for consumption or small amount needed for doing businesses. As the societies have become larger and complex, things cannot be handled at individual levels and the society has the responsibility to do it through the agencies of the government.

Similarly, not all the people will find it convenient to directly participate in the stock markets or even deal with the brokers. However, if the stock markets become

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[10] I have qualified this statement by "normally" to allow the possibility where a very high possibility of getting an abnormally high return over a reasonably short period of time, may influence the society as a whole to increase savings at the margin.

places where economic agents primarily go for dividend income rather than speculative capital gains, commercial banks could be allowed to put a substantial part of their deposits in stock markets (like mutual funds) and pay relatively higher returns to their depositors. The other part of commercial bank deposits could be used to invest in equity based modes of Islamic finance such as *muḍārabah* and *mushārakah*.

Muḍārabah and *mushārakah* are pre-Islamic. They became more significant after the advent of Islam that clearly prohibited interest. The use of these techniques was relatively easier in simple societies where people knew each other and transaction costs were low. Siddiqui (1994a) discusses the problems of implementing a *profit and loss sharing* Islamic banking and concludes that they are not insurmountable. One should also admit that there are many advantages of modern society that were not available earlier such as book keeping, forensic accounting, monitoring techniques, information technology, legal and juristic framework, etc. Furthermore, the structure of equity based techniques of finance could be changed in a way that they become acceptable to both parties without altering its essential characteristics.[11]

Another advantage of the modern world is the use of paper money and government's ability to create it. It also allows her to collect taxes more efficiently and easily. Together it gives her tremendous control and authority to eradicate interest and promote social justice a cherished goal of Islam.

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[11] For instance, it is argued that Islamic banks or providers of the funds could be allowed to look into the accounts of their user of funds or in their major business decisions.

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Comments

on "The Analysis on the Feasibility Study of *Mushārakah Mutanāqisah* Implementation in Indonesian Islamic Banks" by Dodik Siswantoro and Hamidah Qoyyimah

Dadang Muljawan[*]

Basically, the paper reviews the pricing of three different types of financing i.e. *murābaḥah, mushārakah-mutanāqisah* and flat rate interest payment. These three methods of payments would result in different confidence levels particularly when there are uncertainties in the financial environment. The more expensive the offered products are, the less acceptable these are to the market. Therefore, the pricing is one of the most important aspects besides, of course, the Sharīʿah compliance; since it reflects the level of the operational efficiency of the industry.

From practical point of view, the public acceptance of the Islamic financial products would depend upon two major things: Sharīʿah compliance and pricing as they would affect investors' satisfaction. This applies to the both sides: asset side as well as liabilities side. These two types of satisfactions have a trade off particularly when they are contradictory to one another. A customer would seek the optimal level wherever it is available. The optimality would be achieved when the marginal cost equals the marginal benefit. This means that a Sharīʿah minded customer would choose the Sharīʿah products when the marginal excessive cost is at the same level as the marginal benefit taken from the choice to Sharīʿah compliant products.

When we talk about the level of acceptance of Sharīʿah banking products, we should start our discussion from how the financial structure of an Islamic bank is built. This would require us to understand the preference of the investors when they put their funds with the Islamic banks. Ideally, the investors/depositors of the Islamic banks could only expect the returns based on the real performance of the bank ex-post. However, there is a strong possibility, particularly when the Islamic banking system is the market follower, that the market preference would be driven by the interest rate. In this case, the cost of capital of the Islamic bank would also be affected by the interest rate movements. If this condition applies, the investment

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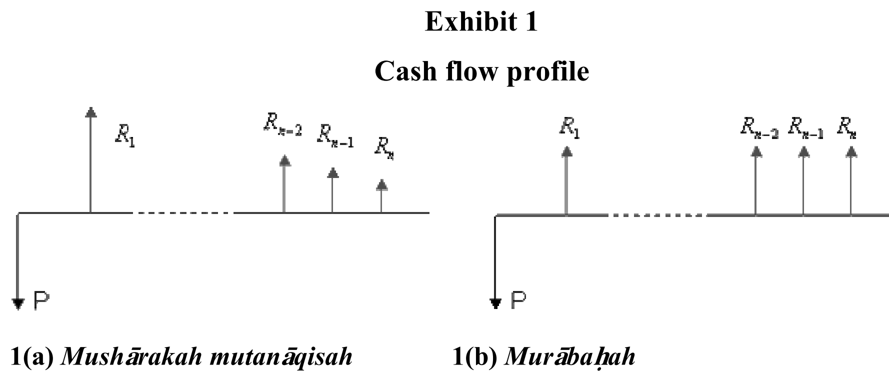
managers of the Islamic banks should always adjust the price of the products so that the Islamic bank could entertain the investors well. In Indonesia, the Islamic banking is at its infancy, while the Sharīʿah minded customer-base would only be built through sufficient customer education and time. In this scenario one could predict that the market preference would be significantly affected by the interest rate as benchmark of the return.

The Islamic non-PLS products are usually built on the flat payment basis. The investment managers should be able to synchronize the level of return to the cost of capital; otherwise, the bank would suffer from financial losses since the cost of funds follows the market rate. The assets and liabilities committee of the bank should have sufficient information when predicting the future condition of the market which is reflected as risk premium.

If we compare the three schemes of financing, we find they are essentially only of two types. We have the *murābaḥah* and flat payment financing at one hand and *mushārakah mutanāqisah* at the other hand because *murābaḥah* and flat payment scheme generally have the same cash flow profile. The two main types – *mushārakah mutanāqisah* and *murābaḥah* – are compared in terms of their cash flow profiles in Exhibit 1, panel 1(a) and 1(b):

Exhibit 1

Cash flow profile

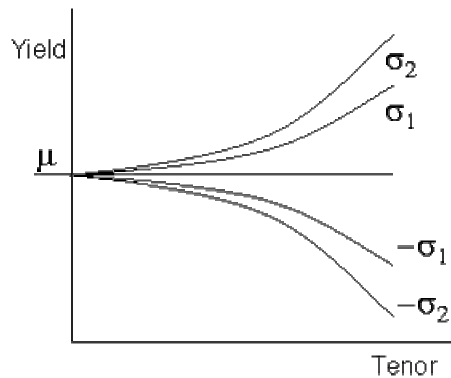


1(a) ***Mushārakah mutanāqisah*** **1(b)** ***Murābaḥah***

As mentioned earlier, both financing types are exposed to the interest rate movements. Given a correlation index of the Islamic bank depositors, the level of risk exposure towards interest rate is a function of interest rate volatility and the correlation level.

Exhibit 2

Yield curve

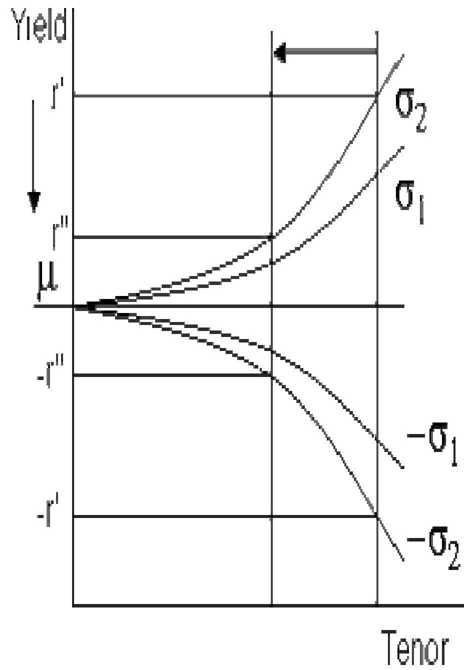


If the depositor preferences are perfectly correlated on the liabilities side, the bank will be more exposed to the interest rate risk as it is in the conventional bank. The risk would depend upon the volatility of the interest rate. Exhibit 2 illustrates different yield curves as a result of different market volatility where $\sigma_2 > \sigma_1$. If the preferences of the depositors are not correlated to the interest rate movements, the bank would be exposed to the lower interest rate risk.

Referring back to the cash flow profile, the basic difference of the *mushārakah mutanāqisah* as compared to the *murābaḥah* financing, lies in the proportion of the income to the bank which is accrued at more advanced rate in *mushārakah mutanāqisah*. This type of financing would be considered more superior to the *murābaḥah* contract since a larger portion of is not anymore exposed to the interest rate movements. This means that the weighted-average of the income is shifted to the shorter tenor as illustrated in Exhibit 3.

Exhibit 3

The comparison of the yield curve



Concluding my comments on the paper, firstly, I personally believe that the applicability of fixed payment types of financing would depend upon how the cost of capital of the Islamic bank is constructed besides, of course, the ability of the investment managers when calculating the risk premium against the interest rate movements. Secondly, given that the *mushārakah mutanāqisah* is another type of fixed payment scheme, it could deliver a lower risk exposure.

Comments

on "The Analysis on the Feasibility Study of *Mushārakah Mutanāqisah* Implementation in Indonesian Islamic Banks" by Dodik Siswantoro and Hamidah Qoyyimah

Saiful Azhar Rosly[*]

The involvement of the academia in product design for Islamic banking applications has been somewhat lagging given the monopoly of information by practitioners and policy-makers. To some extent it readily explains the poor state of research and development in the Islamic banking companies. Worst still replication of conventional facilities has kept creativity low and convergence into the mainstream domain is becoming more evident.

It is refreshing to see that academics have a significant role to play in product design as vividly evident in this paper. This courageous attempt by the authors to enrich Islamic banking portfolios by forwarding the new model must not be overlooked by practitioners as it is written with a pure heart and noble intention.

Overall, the paper is well organized and provides a comparative approach to rationalize the application of *mushārakah mutanāqiṣah* (MM). Amongst others, the study shows:

- that the MM product requires the customer to pay less monthly installments (i.e. rentals only) compared with loans and *murābaḥah.*
- But the bank revenue from MM is the lowest compared with loans and *murābaḥah.*
- The MM product cannot offer facilities with long maturities as it will diminish bank's profit.

The *mushārakah mutanāqisah* (MM) model is not new but yet to appear in the Islamic banking balance sheet. Under a banking law that separates commercial and investment banking, Islamic banks must deal with the following issues:

- Legal entity under which the *muḍārabah* system is set up

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- Application of true leasing

1) Legal Entity

Commercial finances (e.g. to household and business) in banking transaction normally appear as “loans and advances” while purchases of asset by banks appear as “ fixed assets”. The latter are strictly overheads. This is because under existing colonial banking laws, banking companies are not allowed to purchase physical asset solely to generate profits.

The MM model entitles the two parties to set up a legal entity and record the purchase of the property in their respective portfolios. The next question is under what transaction would the MM financing be recorded in the balance sheet? Should it be stated as *financing* or *fixed assets*. The paper may need to elaborate on this point since MM cannot appear in the banking structure without an appeal to change the banking law to allow banks to buy and sell physical assets such as homes and automobiles. The paper can also mention what the banking law has to say about joint-venture (JV) between a banking and a non-banking company when the latter wishes to purchase a piece of property (i.e. as office premise) using MM facilities.

2) True Leasing Model

At the initial leasing period, the MM model designates a higher share to the financier and a smaller share to the customer. Under a *true leasing* model, the paper needs to further explain the tax benefits derived from ownership of the asset (i.e. the depreciation tax yield and investment tax credit) and how these tax benefits are ultimately transferred to the customer (i.e. in the monthly rentals) as his ownership share increases over time from the share buyback system.

The MM product must operate on a true leasing (i.e. *ijārah ‘ain*) model where the lessor (i.e. owner - who is represented by the financier and customer) is expected to carry maintenance costs (e.g. municipal tax, repairs) over the duration of MM financing. How would these liabilities be imputed into the monthly rentals should be captured well by the MM product. To this effect the paper can improve on Malek formula. Some new parameters such as tax shield and credit as well as owner’s liabilities can be added on the existing one (i.e. A = additional payment to the bank excluding the rent).

It is important therefore *to determine whether the rental charges will increase* o*r decrease* when the *muḍārabah* adopted a true leasing model with new parameters such as 1) tax shield (*ts*) 2) tax credits (*tc*) 3) tax burden (*tb*) and 4) liabilities (*l*) are made endogenous to the system.

The formula as given by Malek[1] does not really do justice to the MM issue, namely the determination of rental monthly charges. Although it is relatively easier

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[1] Reference to Malek is cited in Siswantoro and Qoyyimmah's paper in this volume.

to comprehend loan and *murābahah* monthly instalment computations as given by the authors, they can do better by explaining how the rental payments (S) in Malek formula is determined in the first place. The rental charges must not be based on conventional formulas of financial leasing but only those variables that carry the *muḍārabah* and true leasing (*ijārah*) features.

It is highly likely that the Malek formula is based on financial leasing which is none other than term loan under a hire-purchase scheme. On this matter the authors should be cautious in making special inferences about the merits of MM.

The paper cited five constraints that may impair the implementation of MM in Indonesia, namely, small capital, liquidity risk and lack of consistent legal injunctions on MM, interest rate volatility and competition.

The risk factor in MM can be further elaborated by the authors to mean 1) ownership risk 2) operational risk 3) default risk most typical in the true leasing business. By holding ownership risk, the *muḍārabah* entity is exposed to depreciation and appreciation of the property. Operational risk refers to cost overrun in maintenance and default risk usually refers to rental payments failure.

The fact that the MM model is a floating rate option compared to the fixed rate *murābaḥah* facility should give it (i.e. MM) an advantage over *murābaḥah*. With interest rate volatility quite serious in Indonesia, the MM model should safeguard both bank and the customers since the rental charges can be altered (i.e. after periodic expiration of lease) to reflect changes in the cost of funds. The same cannot be applied to *murābaḥah* financing.

The authors made a good effort to show that MM rental payments can be higher than actual rentals. To some extent it may not be a strong selling point in theory but people will not use MM only when the rental charges are significantly higher than monthly loans and *murābaḥah* payments.

Finally, accelerating payments on the MM scheme as mentioned by the authors (i.e. sensitivity analysis) will reduce profits for the Islamic bank. This is also common in loans and *murābaḥah.* The Islamic bank should welcome the MM model since it practically allows acceleration to secure liquidity and make profits on volumes rather than maturities.

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Comments

on "Necessary Legal Reforms to Create Legal Basis for Effective Islamic Asset Securitization (Sukuk) in Indonesia" by Reza Djojosugito

Saiful Azhar Rosly*

The issuance of the global *ṣukūks* by the Qatar, Bahrain and Malaysian governments has prompted similar *ṣukūk* issuance in Indonesia. In this respect, the author has made an honest attempt to explore the possibility of Islamic bond (*ṣukūk*) issuance via asset securitization in Indonesia by looking at its existing legal environment.

Before proceeding on my comments, it is important to note that the issuance of fixed income instruments such as bills, notes and bonds constitute the sale of debt securities by the issuing company or government (i.e. Debtor) to the investors (i.e. Creditor). In this regard, the bond sale does not implicate an asset securitization process but an issuance of a debt certificate or security backed by collaterals.

Asset securitization is the structured process whereby interest in loans and other receivables are packaged, underwritten and sold in the form of “asset-backed” securities (ABS). The receivables can include auto loans, real estate loans, student loans and credit card receivables.

Whereas, asset securitization enables the credit originators to transfer some of the risks of ownership to parties more willing to manage them. By doing so, it gives them broader funding sources at more favourable rates and also help them overcome potential asset-liability mismatches.

Islamic asset securitization (IAS) however has been used to describe the Sharīʿah compliant structured process leading to the issuance of a Sharīʿah compliant security or *ṣukūk*.

In Malaysia for example, IAS can mean three structured processes, namely:

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a. Issuance of Islamic private debt securities (IPDS) such as coupon (BAIDS) and zero coupon Islamic bonds (MuNif) using the contract of *bayʿ al-ʿīnah* and *bayʿ al-dayn* at discount.
b. Issuance of asset-backed securities (ABS) that also employ the contract of *bayʿ al-ʿīnah* and *bayʿ al-dayn* at discount.
c. Issuance of global *ṣukūk* with *ijārah* as the income generating vehicle.

In this paper, the author has specifically focused at Islamic ABS where the author has raised two important issues that warrant serious look by both market players and Islamic jurists, namely:

- The nature of the *ṣukūk* security – debt or equity
- The subject matter of securitization, namely the tangible asset or property.

Let's look at the issue one by one.

The Nature of *Ṣukūk* Security – Debt or Equity?

The Qur'ānic prohibition of interest as *ribā* (Al-Baqarah:275) automatically prohibits the purchase of fixed-income instruments that both offers capital preservation and contracted-fixed interest income. In this way the *ṣukūk* is expected to avoid providing the same to investors.

The paper has mentioned that existing Indonesian legal environment (i.e. Draft law) has clearly stated that securitization can only involve the issuance of a debt security. The same applies to Kontrak Investasi Kolektif or Collective Investment Contract (CIS) known also as Cagamas Bhd. in Malaysia that only caters for the issuance of debt security.

In Malaysia, existing guidelines on debt securities contained in the Securities Commission Act (SCA) 1993 have also defined Islamic bond as a debt security and debenture, hence providing investors capital protection and upfront fixed income (i.e. Indebtedness). Debenture is defined in Section 2 of the SCA in a manner that requires an element of indebtedness of a corporation. In this sense, the Private Debt Securities (PDS)

Guidelines issued by the SC in 2000 has constrained the issuance of Islamic bonds to debt securities alone contracted under the principle of *bayʿ' al-ʿīnah* and *bayʿ al-dayn* with BBA and *murābaḥah* branding. The guideline could not be used for the issuance of Islamic bonds with equity features. In 2004, the Securities Commission has decoupled Islamic bonds from the definition of debentures and introduced a new term "Islamic Securities" in a new set of guidelines, namely the Islamic Securities Guidelines (ISG) 2004. Indonesia should be able to extract some points from the ISG to make way for the Islamic equity issues in CIS.

The Subject-Matter of Securitization – Tangible asset

The paper is also written to describe the process of asset securitization in Indonesia with specific reference to asset-backed securities (ABS). One pertinent

issue raised is the ownership of securitized asset. Conventional ABS deals with the sale of receivables (i.e. claims on future cash flows arising from debt obligation – securitized asset) by the Originator to the SPV but Islamic asset securitization usually entails the sale of tangible assets. I will use two examples of tangible assets in the case of *ṣukūk al-ijārah* issued by the government of Malaysia and Qatar:

Malaysian Ṣukūk Assets – The Selayang Hospitals, The Tengku Ampuan Rahimah Hospitals, a Government-owned hospital, a parcel of land along Jalan Duta on which Government living quarters are being constructed.

Qatar Ṣukūk Assets – Land Parcels belonging to the Qatar Government

The SPV for CIC in Indonesia serves as a bankruptcy remote legal entity but only on claims to future cash flows (i.e securitized assets), namely the receivables. The *ṣukūk* model however uses a different mode of securitization, namely securitization of tangible assets and not the securitization of rental receivables arising from the (leasing) *ijārah* business.

Existing ABS in Indonesia deals with the securitization of receivables. In this sense, it does not have an inbuilt mechanism to cater for insolvency against a pool of tangible assets as evident in the *ṣukūk* model. In this regards, the author is correct to say that some reforms in the Indonesian law must be introduced to make the issuance of *ṣukūks* possible.

This issue of asset segmentation is therefore critical. The Sharīʿah legitimacy of *ṣukūk* trading (i.e. buying and selling of *ṣukūks* in the secondary market at above or below face IPO value)

rests on the existing juristic opinion that the paper must be backed by tangible assets up to 51%. Any less than that (ie. 51%) will make the *ṣukūk* prohibited for trading. Unless, investors hold the *ṣukūks* to maturity, trading is not an issue. But liquidity is one critical requirement of an efficient financial system. Without liquidity, financial transactions cease to move steadily to fulfil the demand and supply of capital.

Finally, the securitization of *ijārah* receivables (i.e. Rental) is not within the scope of the current global *ṣukūk ijārah*. This is true since the main emphasis of the global *ṣukūk* is the securitization of physical and tangible assets from which rentals can be earned. It is different from conventional asset-backed securities that focus on the securitization of future income flows, namely the rentals.

Likewise, it is premature to indulge into talks about securitization of *muḍārabah* profits (i.e. Future income flows arising from a *muḍārabah* project) as the latter is unknown by virtue of contractual agreement. Securitization of *ijārah* rentals and securitization of *ijārah* assets can mean two different things. The former (i.e. as the author has clearly mentioned) has not yet received global Sharīʿah compliant status while the latter constitutes current global *ṣukūk ijārah* practises acceptable by all schools of *fiqh.* It emphasizes on the income generating

capacity of tangible asset via *ijārah* mechanism and certainly not the securitization of idle assets (i.e. property of value but unable to generate cash flows).