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INNOVATION AND AUTHENTICITY
IN ISLAMIC FINANCE

By

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ABSTRACT

The paper tries to determine the primary cause or causes of the financial crises that have plagued almost every country around the world over the last three decades. Of particular significance are the 1998 LTCM breakdown and the current subprime mortgage crisis in the United States. It argues that one of the major causes of these crises is the lack of adequate market discipline in the financial system. This leads to excessive lending, high leverage and ultimately the crisis. Risk-sharing, which Islamic finance wishes to introduce, can help instill greater discipline in the system and curb lax lending. Effective operation of such a system in Muslim countries will, however, not be possible without the establishment of a number of shared institutions that do not exist at present. It is also necessary to adopt a number of specific measures to make credit available to small- and micro-entrepreneurs in order to make the existing financial system more equitable.

INTRODUCTION

Dr. Muhammad Iqbal, poet-philosopher of the Indo-Pakistan subcontinent, says in a Persian couplet:

I am, as long as I move;
Not moving, I am not.

This implies that forward movement through progress and development is the lifeblood of societies. If they do not move forward, they will ultimately start declining. One of the essential requisites for enabling societies to move forward is innovation. A well-known legal maxim of Islamic jurisprudence states that "something without which an obligation cannot be fulfilled is also obligatory." If it is necessary for a society to move forward to prevent stagnation and decline, innovation is also, therefore, indispensable. Don Sheelan (2007, p.3) has expressed the same idea recently by saying that "innovation is the lifeblood of an organization" and that "without it, not only is there no growth, but, inevitably, a slow death". There is, however, a snag that if the innovations are not well-conceived, or if they are misused, they may create problems rather than solve them.

The accelerated development that the world has witnessed after the Second World War would not have been possible without an unending stream of innovations. The financial system has decidedly played an active role in this development, also as a result of innovations, including the revolution in information and communications technology. The financial system is, however, now plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades (Stiglitz, 2003, p. 54). Not a single geographical area or major country has been spared the effect of these crises, which have engulfed even some of the countries that have generally followed sound fiscal and monetary policies.

This has created an uneasy feeling that there is something fundamentally wrong somewhere. Hence, there is a call for a new architecture (Camdessus, 2000, pp. 1 and 7-10; and Stiglitz, 2007, p.3) that demands an innovation that could help prevent the outbreak and spread of crises or, at least, minimize their frequency and severity. Since most of the crises that the world has faced are generally of a serious nature and have been recurring persistently, cosmetic changes in the existing system may not be sufficient. It is necessary to have an innovation that would be really effective. It may not be possible to figure out such an innovation without first determining the primary cause of the crises. This is how science makes progress; it tries to determine the cause or causes of different phenomena so as to enable us to find an effective remedy for their solution.

PRIMARY CAUSE OF THE CRISES

One of the generally recognized most important causes of the crises is excessive lending by banks. One cannot blame banks for this because, like everyone else, they wish to maximize their profits. The more credit they extend, the higher their profit will be. Excessive lending, however, leads to a rise in asset prices, giving rise thereby to an artificial rise in consumption through the wealth effect and a rise in speculative investment. Excessive lending becomes possible because of high leverage, and the higher the leverage the more difficult it is to unwind it in a downturn. Unwinding

gives rise to a vicious cycle of selling that feeds on itself and leads to a serious financial crisis. It is market discipline that is expected to exercise a restraint on leverage and excessive lending. Since this has not happened, there arises the question of what is the reason for it? Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so?

The market is able to impose a discipline through incentives and deterrents. These come through the prospect of making profit or loss. The major source of profit in the conventional system is the interest that the banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyze their lending operations so as *not* to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This does not happen in a system where profit and loss sharing (PLS) does not exist and the repayment of loans with interest is generally guaranteed.

There are two factors that save the banks from losses. The first of these is the collateral, which is necessary to manage the risk of default. The collateral can do this however only if it is of good quality. The banks are sometimes not very careful and rely heavily on the crutches of the collateral to extend financing for practically any purpose, including speculation. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrower's ability to repay. The collateral, cannot, therefore, be a substitute for a more careful evaluation of the project financed. Nevertheless, the banks do not always undertake a careful evaluation because of the second factor that provides them protection. This is the "too big to fail" concept that gives them assurance that the central bank will bail them out (See Mishkin, 1997, p. 61). Banks provided with such a safety net have incentives to take greater risks than they would otherwise (Mishkin, 1997, p. 62).

Given that banks lend excessively to maximize their profit, why is it that the depositors do not impose a discipline on the banks? They can do so in several different ways: by demanding better management, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not, however, do so because they are assured of the repayment of their deposits with interest (Mishkin, 1997, p. 62). This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses.

Instead of making the bankers as well as depositors share in the risks of business, the conventional financial system almost relieves them of the risks. The ability of the market to impose the required discipline thus gets impaired and leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt financing - dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

This shows that the absence of risk/reward sharing reduces market discipline, thereby introducing a fault line in the financial system. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources (BIS, 1982, p.3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The IMF acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are "likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises" (p.83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have high debt profile and for the private sector to live beyond its means and to have high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be.

This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period.

While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms, and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock, and property markets. Jean Claude Trichet, President of the European Central Bank, has rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds" (Trichet, 2005, p. 4).

If we examine some of the major crises in the international financial system like the one in East Asia, the instability in the foreign exchange markets, collapse of the Long-term Capital Management (LTCM) hedge fund, and the prevailing crisis in the U.S. financial system, we find that the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets due to the absence of risk sharing (see Chapra, 2007a, pp. 166-173). In this paper I will refer only to the collapse of the LTCM and the prevailing crisis in the US financial system.

The Collapse of LTCM

The collapse of the U.S. hedge fund LTCM in 1998 was due to highly leveraged short-term lending. Even though the name hedge fund brings to mind the idea of risk reduction, "hedge funds typically do just the opposite of what their name implies: they speculate" (Edwards 1999, p. 189). They are "nothing more than rapacious speculators, borrowing heavily to beef up their bets" (*The Economist* 1998, p. 21). These hedge funds are mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector-positions that might be considered "imprudent" if taken by other institutional fund managers (Edwards, 1999, p. 190; Sulz, 2007, p. 175). They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others. They now account for close to half the trading on the New York and London stock exchanges (Sulz, 2007, p. 175).

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains, and the risks to which they are exposed would also be much greater. They, therefore, normally tend to operate in unison. This becomes possible because their chief executives often go to the same clubs, dine together, and know each other very intimately (Plender, 1998). On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York (*The Economist*, 1998, p. 21). Mahathir Muhammad, Malaysia's ex-prime minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian Ringgit in summer 1997, resulting in the collapse of the Malaysian economy (1997, p. C1; Stiglitz, 2007, p.2). It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the Thai Bhat and some other South Asian currencies.

The LTCM had a leverage of 25:1 in mid-1998 (BIS, 1999, p. 108; Sulz, 2007, p. 179), but the losses that it suffered reduced its equity (net asset value) from the initial $4.8 billion to $2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just $600 million, or one-eighth its original value, on September 23, 1998. Since its balance-sheet positions were in excess of $100 billion on that date, its leverage rose to 167 times capital (IMF, 1998c, p. 55). There was, thus, tier upon tier of debt, which became difficult to manage. The Federal Reserve had to come to the rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system, with spillover and contagion effects

around the world.[1] If the misadventure of a single hedge fund with an initial equity of only $4.8 billion could take the U.S. and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 9,000 hedge funds managing more than $2.8 trillion of assets got into trouble.[2]

A hedge fund is able to pursue its operations in secrecy because, as explained by former Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is "structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals" (1998, p. 1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such "highly sophisticated, very wealthy individuals" for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (IMF, 1998c, pp. 51 -53).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the United States. Even though the hedge funds were not regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing, and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk sharing by banks, stop excessive flow of funds to other speculators?

The Prevailing Imbalances in the U.S. Economy[3]

The lack of discipline in the financial system has also created for the United States two serious problems both of which ring a worrisome note not only for the United States but also for the world economy. These problems are the public-sector budgetary deficits and the private-sector saving deficiency. The federal government has been running budgetary deficits ever since 1970, except for a brief respite between 1998 and 2001. The budget moved from a surplus of $255 billion in fiscal year 2000 to a deficit of $400 billion in 2004 (Kohn, 2005, pp. 1–2; and IMF, 2007, p. 602). The deficit declined thereafter to $318 and $209 billion in 2005 and 2006 (IMF, 2007, p. 602), but is expected to rise further to $407 billion in fiscal 2009. Instead of declining, the deficits are expected to rise further in the near future when the baby boomers reach retirement age. The continuing deficits have already raised the gross public debt of the U.S. Treasury to more than $9 trillion in 2007 (Federal Reserve, Jan. 2008, Table 1.41), $79,000 in average for every taxpayer. Of this, the external debt is around 25 percent, virtually double the 1988 figure of 13 percent (Wikepedia, 2008, pp.1 and 5). The rise in external debt resulting from continuous current account deficits has had an adverse impact on the strength of the US Dollar in the international foreign exchange markets.

These deficits may not have created a serious problem if the US private sector saving had not declined precipitously. Net private saving (saving by households and businesses minus investment) has been declining as a result of the borrowing and spending spree by both households and firms. This may not have been possible without loose lending by the financial system. Over the last three years (2005-2007), the net saving by households has been less than 1% of the after-tax income, compared with an

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1. This was clearly acknowledged by Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own" (1998, p. 1046).

2. The number of hedge funds is from Financial Stability Forum (www.fsforum.org) The amount of assets they manage is for the third quarter of 2007 from Institutional Investor News and Hedge Asset Flows and Trends Report, 2008.

[3] See the address entitled "Imbalances in the US Economy" by Donald Kohn, member of the Board of Governors of the US Federal Reserve System, at the 15th Annual Hyman Minsky Conference, the Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, 22 April 2005 (BIS Review, 28/2005).

average of 8 percent from 1950 to 2000 (Kohn, 2005, p. 1; and OECD Economic Outlook 82, Annex Table 23). Government deficits combined with low private sector saving should have pushed up interest rates. This did not happen because of the inflow of funds from abroad. This inflow has, however, been only a mixed blessing because it did not only raise the U.S. net foreign indebtedness to a record high in both absolute terms as well as a percentage of GDP but also lowered interest rates which has promoted a steep rise in consumer spending along with a boom in residential real estate prices.

This brings into focus the crucial issue of how long foreigners be willing to continue lending. Confidence in the strength and stability of the dollar is necessary to enable it to serve as a reserve currency. This is, in turn, not possible without the willingness of foreigners to hold dollars. What will happen if the deficits continue, create loss of confidence in the dollar, and lead to an outflow of funds from the United States? This is not just a theoretical question. In the last 40 years, the dollar has experienced four bouts of marked depreciation. Since nearly two-thirds of the world's foreign exchange holdings are still in dollars,[4] a movement out of the dollar into other currencies and commodities, as happened in the late 1960s, could lead to a sharp fall in the exchange rate of the dollar, a rise in interest rates and commodity prices, and a recession in the U.S. economy. This might lead the whole world into a prolonged recession. The correction would then come with a vengeance when market discipline could have led to it much earlier with significantly less suffering. Accordingly, the President's Working Group on Financial Markets (PWG) has rightly concluded in its report on "Principles and Guidelines Regarding Private Pool of Capital" issued in February 2007 that the most effective means of limiting systemic risk is to reinvigorate market discipline.

The Subprime Mortgage Crisis

The subprime mortgage crisis in the grip of which the US finds itself at present is also a reflection of excessive lending. Securitization or the "originate-to-distribute" model of financing has played a crucial role in this. There is no doubt that securitization is a useful innovation. It has provided lenders greater access to capital markets, lowered transactions costs, and allowed risks to be shared more widely. The resulting increase in the supply of mortgage credit contributed to a rise in the homeownership rate from 64 percent in 1994 to 68 percent in 2007 (Bernanke, 20 September 2007, p.1). However, even a useful innovation can have a negative impact if it is used in a way that reduces market discipline. Mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting (Mian and Sufi, January 2008, p. 4; and Keys et al, January 2008). Consequently loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers increased. According to Mr. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, "far too much of the lending in recent years was neither responsible nor prudent. ... In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly (Bernanke, 4 March 2008, p.1). The check that market discipline could have exercised on the serving of self-interest did not, thus, come into play. This sowed the seeds of the subprime debt crisis and led to not only the financial distress of subprime borrowers but also a crisis in the U.S. financial system which has had spillover effects on other countries.[5] Thus, we can see clearly that the lack of market discipline leads first to excessive lending and then to financial crises and the suffering of a number of people.

When the system has reached a crisis point, it becomes difficult to apply the brakes. Central banks have no choice other than to lower interest rates and provide liquidity to avoid a recession. The Federal Reserve has also done the same. It has lowered interest rates and provided liquidity to the market "to help alleviate concerns about funding" (Bernanke, 31 April 2007). While this will help reduce the intensity of the current crisis, it will also tend to aggravate the future crises by enabling the vicious cycle to continue. The liquidity made available now will enable the loose funding to continue. This will be followed by a financial crisis, which will again necessitate the pumping of further liquidity into the system to overcome the crisis. Therefore the more sensible thing to do is to simultaneously think of some effective way of introducing greater discipline into the financial system with a view to check excessive and loose lending. *The Economist* has rightly observed that "the world needs new ways

[4] At the end of the third quarter of 2007, 63.8 of the identified official foreign exchange reserves in the world were held in United States dollars (www.imf.org/external/np/sta/cofer/eng/cofer.pdf).

[5] Roughly 4.2 million mortgages were overdue or in foreclosure at the end of 2007, according to the Mortgage Bankers Association. An additional three million borrowers may default in the near future. (Herszenhorn and Bajaj, 2008, p. 2).

of thinking about finance and the risks it involves" (2008, p. 25). It is here where Islamic finance can make a valuable contribution to the international financial system.

THE ISLAMIC FINANCIAL SYSTEM

One of the most important objectives of Islam is to realize greater justice in human society. This is not possible unless all human institutions, including the financial system, contribute positively towards this end. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions. One of these is that the financier must also share in the risk so as *not* to shift the entire burden of losses on the entrepreneur, and the other is that equitable shares of bank lending should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is: "No risk, no gain". If we wish to have a gain we must also be prepared to share the risk. Introduction of risk/reward sharing in the financial system should help induce the financial institutions to assess the risks more carefully and to monitor more effectively the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the financial system, and go a long way in reducing excessive lending and making the financial system healthier. However, making just the banks share in the risk may not be enough because the desire to maximize profits may still induce the banks to indulge in excessive lending. It is, therefore, necessary to also motivate the depositors to play a more active role in the enforcement of this discipline. This will be possible if the depositors also share in the profit or loss.

However, since demand depositors do not get any return, it would not be fair to make them participate in the risks of financing. Their deposits must, therefore, be guaranteed. In contrast with this, investment depositors share in the profit and should, therefore, participate in the risks. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares, and withdrawing them will be like redeeming them. This will motivate depositors to monitor their banks, and demand greater transparency, better governance, and more effective risk management, auditing, regulation and supervision. Making the depositors participate in the risk would also help motivate them to take greater care in choosing their banks.

Instead of introducing greater discipline in this manner, the primary focus of the international financial system at present is on regulation and supervision. There is no doubt that prudent regulation and supervision are both necessary and unavoidable, and it is matter of great relief to know that there has been substantial progress in this direction under the aegis of the Basel Committee on Banking Supervision (BCBS). Regulation and supervision cannot, however, be relied upon totally because regulation may not be applied uniformly in all countries and to all institutional money managers as a result of off-balance-sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. The LTCM collapse and the prevailing financial crisis in the United States clearly show how banks can get into difficulties as a result of overlending even in an apparently well-regulated system. Regulation and supervision would, therefore, be more effective if they were complemented by a paradigm shift in favour of greater discipline in the financial system by making the banks as well as investment depositors share in the risks of financial intermediation. Just the bailing-in of banks, as is being suggested by some analysts (Calomiris 1998, Meltzer; 1998; Yeager, 1998) may not be able to take us far enough because the capital of banks may be only around 8 percent of their risk-weighted assets. What is also necessary is to strongly motivate not only the banks to undertake careful underwriting of all loan proposals but also the depositors to be cautious in choosing their bank and to monitor their bank's affairs more carefully. The establishment of depositors' associations may make it easier for them to do so.

Islamic finance should, in its ideal form, help raise substantially the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures through the *mudarabah* and *musharakah* modes of financing. Greater reliance on equity financing has supporters even in mainstream economics. Prof. Rogoff of Harvard University states, "In an ideal world equity lending and direct investment would play a much bigger role". He further asserts that, "with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply

muted".(Rogoff, 1999, p.40) The IMF has also thrown its weight in favour of equity financing by arguing that "foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily" (IMF, May 1998, p.82).

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable. Debt, however, gets created in a truly Islamic financial system not through direct lending and borrowing but rather through the sale or lease of real assets via the sales- and lease-based modes of financing (*murabahah, ijarah, salam, istisna* and *sukuk).* The purpose is to enable an individual or firm to buy now the urgently needed real goods and services and to make the payment later. The conditions, however, are that the asset which is being sold or leased must be real and not imaginary and that the transaction must be a genuine trade transaction with the full intention of giving and taking delivery. In the case of such sales or leases, the rate of return gets stipulated in advance and becomes a part of the deferred payment price. Since the debt is associated with real goods or services and the rate of return is fixed in advance, it will be less risky and, therefore, more attractive for banks, as compared with equity and PLS financing.

The predetermined rate of return on sales- and lease-based modes of financing may make it appear like interest-based instruments. It is, however, not so because of significant differences between the two for a number of reasons. First, as already indicated, the sales- and lease-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real assets. The *Shari'ah* has, in addition, imposed a number of conditions for the validity of these transactions. One of these is that the seller (or lessor) must also share a part of the risk to be able to get a share in the return. He cannot avoid doing this because of the second condition that requires the seller (financier) or lessor to own and possess the goods being sold or leased. The *Shari'ah* does not allow a person to sell or lease what he does not own and possess except in the case of *salam* and *istisna'* where the goods are not already available in the market but need rather to be produced before delivery. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. All speculative short sales, therefore, get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.

Second, it is the price of the good or service sold, and not the rate of interest, that is stipulated in the case of sales- or lease-based modes of finance. Once the price has been set, it cannot be altered, even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the banks if the buyer willfully delays payment. This is a major unresolved problem in Islamic finance. Discussions are, however, in progress among the jurists to find a *Shari'ah-* compatible solution.

Reducing Government Budgetary Deficits

The discipline that Islam wishes to introduce in the financial system may not materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability. If the governments borrow heavily from the central banks, they will provide more high-powered money to banks than is necessary and, thereby, promote excessive monetary expansion. It is essentially excessive liquidity which, along with high leverage, enables banks to resort to lax lending. It is, therefore, necessary to have independent central banks along with legal curbs on the government's ability to borrow so that they do not run deficits in their budgets in excess of what is permissible within the framework of growth with stability.

AUTHENTICITY

This brings us to the question of authenticity in Islamic finance. In ordinary language authentic, genuine, and bonafide mean that there is conformity between word and deed or, in other words, the practice is exactly in keeping with what is claimed. In existentialist philosophy, it draws a distinction between the self and the non-self and refers generally to the degree to which a person is true to his own personality, spirit or character. In religious parlance it reflects the degree to which a person is true to his beliefs in spite of difficulties faced in doing so.

The way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with the Islamic vision. It has not been able to come out of the straitjacket of conventional finance. The use of equity and PLS modes has been scant, while that of the debt-creating sales- and lease-based modes has been predominant. This may be condoned because of the near absence of the shared infrastructure institutions that are indispensable for reducing the difficulties faced in equity and PLS financing as a result of the principal/agent conflict of interest and the moral hazard However, even in the case of debt-creating modes, all Islamic banks and branches or windows of conventional banks do not necessarily fulfill the conditions laid down by the *Shari'ah.* They try to adopt different legal stratagems *(hiyal)* to transfer the entire risk to the purchasers or the lessees. The result is that the Islamic financial system, as it is being practiced, does not appear to a number of its critics to be a genuine reflection of Islamic finance. If the system does not make significant progress in terms of authenticity, it will lose credibility in the eyes of the Muslim masses and the rapid progress that it has been making may not be sustainable.

Why the Lack of Authenticity

This raises the question of why the system has been unable to make significant headway in the direction of attaining greater authenticity. One of the primary reasons is that the institutions that are necessary to minimize the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations have not yet been created. These institutions would enable the banks to obtain reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They would also help them receive repayments on schedule, and get justice promptly in case of dispute with, or willful procrastination of payment by, their clients. They would also enable banks to gain liquidity when it is needed by them in situations of liquidity crunch resulting from unforeseen circumstances. The establishment of such institutions would go a long way in providing a favourable environment. The longer it takes to establish such institutions, the longer it will take to move in the direction of greater authenticity. Some of the institutions that need to be created are briefly indicated below.

Centralized Shari'ah Board

One of the indispensable needs of Islamic finance for realizing greater authenticity is to get verdicts that are in harmony with not just the form but also the spirit of the *Shari'ah* so as to help realize its cherished objectives (*maqasid).* This demands that the members of the *Shari'ah* board should not only be men of exemplary integrity and well-versed in the *Shari'ah,* but should also be insulated from moral hazard. This is because the *Shari'ah* board members, in spite of being individuals of high integrity, are human beings and are liable to be exposed to moral hazard. The hazard arises because every bank itself hires its own *Shari'ah* board members and pays their remuneration. In addition to being costly, particularly for small banks, this practice leads to conflicting opinions which create inconsistency and uncertainty. It also carries the potential of creating a conflict of interest. It may tempt the board members to give verdicts that are more profitable for the banks but not in keeping with the spirit of the *Shari'ah.* To overcome this problem, it is necessary to adopt some effective measures. One of these is to make full transparency mandatory with respect to the products allowed by their *Shari'ah* boards. The risk of getting a bad reputation should help induce the *Shari'ah* boards as well as the banks to be on their guard.

Another unavoidable measure is to establish a centralized *Shari'ah* board in the nature of a supreme court with members who are well-respected for their knowledge and integrity and who are also independent of banks. This will enable market participants to challenge any product which they feel is not in conformity with the spirit of the *Shari'ah.* It will also help standardize the products to the extent to which it is possible. Some differences of opinion are bound to remain. This may, however, be healthy for the financial system because it will promote innovation and also provide different

alternatives for doing business instead of imposing a rigid conformity. Transparency should, however, be made mandatory so that the bank's clients and depositors know which alternative the bank has adopted. This will also help raise market discipline by enabling the bank's customers to choose for themselves a bank whose operations are in their opinion more *Shari'ah* compliant. Since standardization is necessary for the creation of an international Islamic financial market, it is imperative to have standardization at the level of not only individual countries but also all Muslim countries.

***Shari'ah* Clearance and Audit**

Among the most crucial challenges before an Islamic bank is to create confidence in its depositors as well as all the other operators in the market about the harmony of its operations with the *Shari'ah.* For this purpose two important steps need to be taken. The first step is to get clearance from *a Shari'ah* board about the *Shari'ah* compatibility of all its products not only in form but also in spirit. The second step is to provide an assurance that all its transactions are actually in conformity with the verdicts of the *Shari'ah* board. The first step is like going to a legal expert to ascertain whether a specific mode of the banks operations is in conformity with the country's laws and, if not, what changes need to be introduced in it to make it so. The second is what auditors and banking supervisors do: ensuring that none of the bank's transactions violates the country's laws.

The *Shari'ah* boards are like legal experts. They can only perform the first task. It is difficult for them to perform the second task, which demands a review of all, or at least a random sample of, the different transactions that have taken place in different branches of the bank to ensure that they are in conformity with the verdict of the *Shari'ah* board. This demands a visit to the bank's premises to examine its operations in the same way as auditors and supervisors do. It is generally assumed that the *Shari'ah* boards do perform this task. However, members of the *Shari'ah* board do not have either the time or the staff to perform such a task effectively. The question that therefore arises is how to ensure the implementation of *Shari'ah* board decisions by the bank management. If this is not ensured the existence of the *Shari'ah* board loses its meaning. There are three alternatives, which may be considered for this purpose.

One of these is for the Supervisory Authority- in the country concerned to itself undertake the *Shari'ah* audit of banks in the course of its normal supervisory visits. This may not be considered desirable by Islamic banks in countries where the government and the Supervisory Authority are not favourably inclined towards Islamic banking. However it has the advantage that, if the Supervisory Authority performs the *Shari'ah* audit, they will also try to standardize the *fiqhi* decisions.

The second, more preferable, alternative is to establish independent *Shari'ah* audit firms in the private sector. These firms would have to hire and train sufficient staff to examine the transactions of banks with a view to determining whether they are in conformity with the *Shari'ah.* This alternative has the disadvantage that it would involve a proliferation of institutions. Inspectors from three different institutions would knock at the doors of banks at different times. The first of these would be from the Supervisory Authority to determine the conformity of the bank's operations with the country's laws and the principles of safe and sound banking. The second would be the *Shari'ah* auditors who would go to the bank to determine the conformity of its operations with the *Shari'ah.* The third would be the chartered auditors who would go to the banks to ensure that their financial statements have been prepared in conformity with the generally accepted accounting standards. Inspection by all these three institutions might not be convenient for banks because it would keep a number of their staff engaged in assisting these inspectors at different times, and thus add to their costs.

A third, and even more preferable, alternative is for the existing chartered audit firms to acquire the necessary expertise in the *Shari'ah* to enable them to undertake the *Shari'ah* audit. This will help avoid the proliferation of institutions with which Islamic banks have to deal. The banks would probably prefer this alternative because it will be more convenient for them to have the *Shari'ah* audit at the same time as the accounts audit.

Credit-Rating Agencies, Chambers of Commerce, and Trade Associations

Among the shared institutions are credit-rating agencies which rate banks themselves as well as their counterparties. While such institutions exist in industrial countries, they do not at present exist in all Muslim countries. Credit rating agencies may not be very helpful if they paint a rosy picture of the firms trying to raise equity or loans in the market. The experience of the Unites State in the case of structured subprime loans clearly indicates the shortcomings of credit rating agencies. Even though the concern for safeguarding their own reputation may serve as a check on rating agencies, a more effective regulatory framework needs to be developed to serve as a check on the moral hazard.

Legal Reform

Even though Islamic financial institutions have been established in nearly all Muslim countries, the basic legal framework under which they operate has not evolved in the light of the *Shari'ah.* Cosmetic changes have been made in the existing conventional legal framework. It is necessary to prepare a comprehensive legal framework to bring the financial system in harmony with the *Shari'ah*. Preparing such a framework may not be an easy task because it requires expertise in *maqasid al-Shari'ah*, the *Shari'ah* compatible modes of Islamic finance, and complexities of the international financial system. Such expertise is rare. However, it is in the process of development and, hopefully, it should be possible to develop a comprehensive legal framework for financial institutions and financial markets operating on the basis of the *Shari'ah.*

External Audit

The growing complexities of the banking business as well as crises that the international financial system has witnessed have raised the function of external audit to a position of critical importance in all financial systems. It is, however, even more demanding and challenging in the Islamic financial system. It would be necessary for the external auditor to ensure not only that the bank's financial statements are prepared in all material respects in conformity with the professionally accepted financial reporting standards but also that the profit or loss declared by the bank truly reflects the bank's condition and that its profit has been derived without violating the teachings of the *Shari'ah.*

It is conventionally not considered to be the task of auditors to perform *Shari'ah* audit. They are not even equipped at present to do so. However, if this task is assigned to them in the light of what has been discussed above under the subject of *Shari'ah* audit, then the external auditors will have to create the necessary expertise to perform this task. This would demand that the training of auditors also includes necessary training in the financial aspects of the *Shari'ah,* just as it includes training in auditing and law. If such training proves to be too cumbersome for the auditors, it may also be possible for the auditing firm to hire *Shari'ah* scholars and provide them with some necessary background in auditing to be able to perform the *Shari'ah* audit.

The experience of the auditing firm Arthur Andersen has clearly revealed that the auditor should be independent and objective and there should not be anything that indicates the auditor's vested interest in protecting the bank's management. It is only such impartial audit that would create trust in the auditor's report and promote confidence in the bank. Even though it is the job of the internal controls system to prevent, or detect and correct, material misstatements arising from fraud and error, the external auditor cannot be exonerated from the responsibility of ensuring that this has been done conscientiously. He will have to design and carry out audit procedures in a way that would help reduce to an acceptably low level the risk of giving an inappropriate audit opinion.

Shari'ah Courts or Banking Tribunals

Another indispensable requirement of the Islamic financial system is availability of some judicial facility that would help the banks recover their loans promptly from clients who unjustifiably procrastinate repayment and also help bank clients get prompt justice at a low cost when the bank is itself acting unjustly. The existence of *Shari'ah* courts or banking tribunals would be very helpful in getting prompt verdicts on the disputes of banks with their clients and vice versa. Normal civil court verdicts usually take several years in most Muslim countries.

The *Shari'ah* courts or banking tribunals would have a greater deterrent effect if the names of banks or their clients whom these courts have found to be guilty were also published in newspapers. The fear of getting bad publicity would help minimize contractual violations. Furthermore, the names of parties who violate habitually may also be sent to the chambers of commerce and trade associations for blacklisting them in order to create the same effect that social ostracism had in the Classical period when the Islamic financial system operated effectively (See Chapra and Ahmad 2002, pp. 2-8).

Audit Organization

It may also be desirable to have an audit organization jointly owned by banks to evaluate the profit-and-loss accounts of those of their clients who the banks feel have tried to cheat them in a PLS arrangement. The fear of being exposed to a thorough check of their accounts by such an organization would complement the market forces in helping minimize the effort made by users of funds on a PLS basis to short-change the banks.

The creation of such an audit organization would save the individual financial institution the need to hire a large staff of auditors. It would thus create a substantial economy in expenses for all financial institutions. It would also give assurance to investors who provide their funds directly to businesses that, in case of need, they will be able to have the accounts properly examined by a qualified, impartial institution.

The whole concept of `audit' may have to undergo a transformation in the case of primary modes of Islamic finance.[5] Conventional auditing is 'not expressly designed to uncover management frauds' (Elliot and Willingham. 1980, p. viii). If the auditor performs a diligent audit and evaluates the financial statements according to 'the generally accepted accounting principles', the professional obligations of the auditor have been fulfilled. The auditor has no responsibility to detect management malpractices or to determine the 'real' profit. He does not have the responsibility to check and to question (Lechner, 1980, p. 143). Accounting firms generally tend to accommodate their clients, particularly the big clients who hire them. The auditor would fail in discharging his responsibility in a PLS system if he did not try to detect and disclose dishonest and questionable acts of the management and to determine the real amount of profit so as to ensure a 'fair' return to the shareholders and *mudarabah* depositors.

Depositors' Associations

It is of crucial importance to establish mechanisms that would enable depositors to protect their own interest in a PLS financial system. Even demand depositors, and not just investment depositors, need such mechanisms because, even though demand deposits are guaranteed, the deposit insurance system does not generally insure demand deposits beyond a certain limit.

One of the mechanisms that could enable the depositors to protect their interest would be to have a representative on the bank's board of directors and also a voice in the shareholders' meetings? The ease with which shareholders as well as depositors can participate in meetings and use their votes to influence important bank decisions or to remove directors and senior management from office, can play an important role in improving corporate governance in banks. This may, however, be difficult for depositors to do effectively because they are far more in number than shareholders when even in non-bank corporations, shareholders do not necessarily attend such meetings. Moreover voting rights can be expensive for shareholders and depositors to exercise if they can do so only by attending the meetings. This would virtually guarantee non-voting. It is, therefore, necessary for depositors to appoint their representative on the board of directors. This would be easier if the formation of depositors' associations is encouraged. Such associations could also enlighten the depositors on the condition of the bank in addition to having a representative on the board and shareholder's meetings. However, until such time as such associations start functioning effectively, the external auditors may be assigned the task of acting as guardians of the depositors' interest in the same way as they are expected to guard the shareholders' interest.

Qualified Pool of Talent

To enable the Islamic system to fulfill the requirements of the *Shari'ah* as well as the BCBS and the IFSB and also ensure grater authenticity, it is necessary to train the management, staff and the clients of banks, as well as the general public, in the principles of Islamic finance. This will, however, not be enough. It is also necessary to create a large pool of experts and highly qualified professionals with in-depth knowledge of not only the *Shari'ah* and its objectives, but also Islamic and conventional finance and financial engineering. This would be possible if first-rate institutions were created for this purpose with the collaboration of financial institutions, central banks, universities and the governments. Directors and senior management of Islamic banks as well as *Shari'ah* advisers should also be required to take such courses. If the central banks as well as universities could make arrangements for this purpose, as is done in the case of conventional banking, the task of Islamic banks would become relatively easier.

Islamic Financial Market

The absence of a secondary market for Islamic financial instruments makes it extremely difficult for Islamic banks to manage their liquidity. Consequently, they end up maintaining a relatively higher ratio of liquidity than that which is generally maintained by conventional banks. This affects their profitability and competitiveness. It is, therefore, necessary to create an Islamic financial market. The establishment of the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM) and the Liquidity Management Centre (LMC) is a step in the right direction and will help provide the institutional infrastructure needed for an Islamic financial market.

The IFSB will help promote uniform regulatory and supervisory practices and prudential standards for Islamic *financial* institutions in the same way as is done by the BCBS. The IIFM will enhance cooperation in the field of finance among Muslim countries and financial institutions by promoting product development and harmonizing trading practices. This will serve as a catalyst for the development and promotion of a larger supply of *Shari'ah*-compatible financial instruments. The LMC will serve as an operating arm of the IIFM in the effort to facilitate the creation of an interbank money market that will enable Islamic financial institutions to manage their assets and liabilities effectively. It will create short-term *Shari'ah*-compatible investment opportunities by providing liquid, tradable, asset-backed treasury instruments *(sukuks)* in which these institutions can invest their surplus liquidity. It will also facilitate the sourcing and securitization of assets and trade actively in *sukuks* by offering buy/sell quotations. The three institutions will together help establish an Islamic financial market by removing the drawback experienced by Islamic banks as a result of the lack of standardization of terms and instruments and the non-availability of quality *Shari'ah*-compatible assets for trading in the secondary markets. This should help the Islamic financial system to expand at a faster rate in the future and create for itself a larger niche in the financial markets of Muslim countries.

Lender of Last Resort

Islamic banks also need some facility akin to the lender-of-last resort which is available to conventional banks to overcome liquidity crises when they occur suddenly as a result of unforeseen circumstances. Such a facility is available to Islamic banks at present on the basis of interest and is, therefore, unacceptable because of its incompatibility with the *Shari'ah.* Its use exposes them to charges of lack of authenticity. It may be worth considering the creation of a common pool at the central banks to provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percentage of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (that is, drawings do not exceed contributions) over a given period of time. In a crisis, the central banks may allow a bank to exceed the limit, with appropriate penalties, warning and a suitable corrective programme. This will, in a way, be a more organized means of replacing the framework for mutual cooperation that prevailed among the *sarrafs* during the Classical period.

Reform of the Stock Market

Reform of the stock market is also necessary in the light of Islamic teachings to ensure that share prices reflect underlying business conditions and do not fluctuate erratically as a result of

speculative forces. The discipline that the *Shari'ah* helps introduce through the prohibition of short sales or the sale of what one does not own and possess, should greatly help in realizing this goal. In addition, rules and procedures need to be streamlined and enforced to protect investors and ensure stability and sanity in the stock market. This will help raise the confidence of savers and investors in the system and enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such a reform would constitute one of the most important pillars for supporting the edifice of an interest-free and equity-based economy.

ADDING ANOTHER DIMENSION OF JUSTICE

While the introduction of risk/reward sharing will help promote justice between the financier and the entrepreneur, it is also necessary to ensure that the benefit of the nation's savings that financial institutions mobilize is also shared equitably by all sectors of the economy. This is because the financial system plays a dominant role in the determination of the power base, social status and economic condition of individuals in the economy (See Claessens and Perotti, 2007).

Hence no reform of the financial system may be meaningful unless it is also restructured in conformity with the socio-economic goals of Islam. The system has, however, tended to promote inequalities of income and wealth in almost all countries around the world and particularly so in countries which lack proper bank auditing and supervision and where the political system promotes cronyism. Arne Bigsten has rightly observed, that "the distribution of capital is even more unequal than that of land" and that "the banking system tends to reinforce the unequal distribution of capital" (1987, p. 156). Khwaja and Mian have shown in a recent paper that banks tend to favour politically connected firms (2005). This bodes ominously for society because it leads to the recruitment of entrepreneurs from only one social class and to the failure to utilize the society's entire resource of entrepreneurial talent (Leadbearer, 1986, p. 5).

For example, in Pakistan, for which data are available on the distribution of commercial bank deposits and advances by size, small depositors having deposits of less than one million rupees ($16,129) were 28.2 million in number and constituted 99.6 percent of all depositors in 2002. They contributed a total of Rs. 919.9 billion or 61.3 percent of the banks' total deposits. Small borrowers borrowing less that Rs. 1 million and constituting 96.4 percent of all borrowers were, however, able to get only Rs. 84.9 billion or 10.5 percent of the banks' total advances. In sharp contrast with this, depositors of more than 10 million rupees, who constituted only 0.03 percent of all depositors and provided only 24.8 percent of all deposits, were able to get Rs. 628.8 billion or 77.6 percent of total advances (See the Table below). What this implies is that less than 1 percent of the borrowers were able to get more than three-fourths of the total advances. Small borrowers, thus, received far less than what they had contributed to the banks. It is even worse in nationalized banks where a number of politically well-connected big borrowers are even able to get their loans written off. (Khwaja and Mian, 2995).Given such an inequitable allocation of advances, along with corruption, one cannot but expect inequalities of income and wealth to continue to rise, rather than decline, in the future - an outcome which is contrary to the socio-economic objectives of Islam.

DISTRIBUTION OF COMMERCIAL BANK DEPOSITS AND ADVANCES BY SIZE IN PAKISTAN
(Amount in Million Rupees)

	2002			
	No. of Accounts	**% of total**	**Amount**	**% of total**
Distribution of Deposits				
Less than Rs. 100,000	26,525,861	93.70	510,998	34.06
From Rs. 100,000-1,000,000	1,677,031	5.92	408,935	27.25
From Rs. 1,000,000-10,000,000	97,785	0.35	208,204	13.88
Above Rs. 10,000,000	7,204	0.03	372.334	24.81
Total	**28,307,881**	**100.00**	**1,500,471**	**100.00**
Distribution of Advances				
Less than Rs. 100,000	906,198	78.04	22,659	2.79
From Rs. 100,000-1,000,000	213,402	18.38	62.284	7.68
From Rs. 1,000,000-10,000,000	31,293	2.70	96.620	11.91
Above Rs. 10,000,000	10,305	0.88	628.836	77.62
Total	**1,161,198**	**100.00**	**810,399**	**100.00**

Source: Derived from data given in State Bank of Pakistan, *Statistical Bulletin.*

The problem, however, is that the effort to reduce excessive lending may worsen the inequalities further by depriving primarily the small borrowers from being able to get credit because of their lack of political connection and their being considered, rightly or wrongly, as subprime. Therefore, what needs to be done is to introduce some suitable innovation in the financial system to ensure that even small borrowers are able to get adequate credit to enable them to realize their dream of establishing their own micro-enterprises. Any society where the poor are not able to get out of wage slavery by establishing their own enterprises and satisfying their basic needs satisfactorily from the higher income earned thereby, cannot be considered a just society. Dr Muhammad Yunus, founder of the Grameen Bank, has aptly emphasized that financing for self-employment should be recognized as a right that plays a critical role in attaining all other rights (1987, p. 31). The Select Committee on Hunger established by the US House of Representatives concluded in its Report that "the provision of small amounts of credit to micro-enterprises in the informal sector of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies" (1986, p.v). The Islamic financial system has hardly made any progress in accordance with this vision.

Experience has shown that micro-enterprises have generally proved to be viable institutions with respectable rates of return and low default rates. They have also proved to be a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings *(The Economist,* 16 February 1985, p. 15). Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 per cent since the Bank's inception (Yunus, 1984, p. 12; Wikipedia, 2008, p.3).

No wonder a number of countries have established special institutions to grant credit to the poor and lower middle class entrepreneurs. Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance in the interest-oriented microfinance system. A timely study by Dr. Qazi Kholiquzzaman Ahmed, President of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 percent.[6] This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also borrow from money-lenders. This engulfs them unwittingly into an unending debt cycle which will not only perpetuate poverty but also ultimately lead to a rise in unrest and social tensions (Ahmed, 2007, pp. xvii-xix; see also Sharma, 2002).[7] No wonder, the Minister of Finance for Bangladesh described microcredit interest rates in that country as extortionate in an address he delivered at a micro-credit summit in Dhaka in 2004.[8] It is, therefore, important that, while the group lending method adopted by the Grameen bank and other microfinance institutions for ensuring repayment is retained, microcredit is provided to the very poor on a humane interest-free basis. This may be possible if the microfinance system is integrated with *zakah* and *awaqf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance in Muslim countries not only to avoid interest but also to prevent the misuse of credit for personal consumption.[9]

Another problem faced by microfinance is that the resources at the disposal of microfinance institutions are inadequate. This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks to enable the use of a significant proportion of their vast financial resources for actualizing a crucial socio-economic

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[6] This is highly plausible because some other studies indicate even higher effective rates of interest. According to Nimal Fernando (2006), Principal Microfinance Specialist in the East Asia Department of the Asian Development Bank, the nominal interest rates charged by most microfinance institutions in the region range from 30 to 70 percent a year. The effective interest rates are even higher because of commissions and fees charged by them (p.1). According to Mannan (2007), the effective rates range from 54 to 84 percent (pp. 2 and 12).

[7] According to Sharma (2002), "while the Grameen Bank model of micro-credit has landed poor communities in a perpetual debt trap, the rising number of loan defaulters has given a serious setback to the Bolivian experiment (p.2).

[8] Cited by Fernando, 2006, p.1.

[9] For some details see IRTI/IDB (2007), p. 30; and Feroz (2007), p. 42.

goal. Commercial banks do not at present fulfill this need and the Select Committee on Hunger is right in observing that “formal financial institutions in these countries do not recognize the viability of income generating enterprises owned by the poor” (1986. p. v). This may be because it is too cumbersome for commercial banks to get directly involved in the business of financing micro-enterprises. They do not, however, have to do this. They can operate through their own subsidiaries or through the institutions that already exist for this purpose, like the agricultural banks, cooperative banks, development banks and leasing and finance companies. Nevertheless, it is important to reduce the risk and expense of such financing for not only commercial banks but also the microfinance institutions.

The risk arises from the inability of micro-enterprises to provide acceptable collateral. One way of reducing the risk is to use the group lending method which has already proved its effectiveness. Another way is to establish the now-familiar loan guarantee scheme which has been introduced in a number of countries. To reduce the burden on the loan guarantee scheme it may be possible to cover the losses arising from the default of very small micro-enterprises from the *zakah* fund. A third way is to minimize the use of credit for personal consumption by providing credit in the form of tools and equipment through the *ijara* (lease) mode of Islamic finance rather than in the form of cash. The raw materials and merchandise needed by them may be provided on the basis of *murabahah, salam* and *istisna‘* modes. If they also need some working capital, it may be provided as *quard hassan* (interest-free loan) from the *zakah* fund.[10]

The additional expense incurred by commercial banks in evaluating and financing microenterprises also needs to be reduced. In the case of financing provided to the very poor, the expense may also be covered from the *zakah* fund, one of the primary purposes of which is to enable the poor to stand on their own feet. For those who are not eligible for *zakah* but still deserve some help, it would be worthwhile for the governments to consider subsidizing a part of the cost, at least in the initial phase, in the interest of helping realize the cherished goals of increasing self-employment opportunities and reducing inequalities of income and wealth. As the system matures, the dependence on *zakah* as well as the government subsidy may tend to decline.

Microenterprises may not, however, be able to make a significant headway unless a substantial improvement is made in the environment for microenterprises through better access to markets and provision of the needed physical and social infrastructure. Such an infrastructure, including vocational training institutions, roads, electricity and water supply, will help increase the efficiency of microenterprises and reduce their costs, thereby enabling them to compete successfully in the market.

[10] For some details on the risks associated with these forms of financing, see IRTI/IDB, 2007, p. 30.

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