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Islamic Banking and Finance: Theory and Practice

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This book is written in the backdrop of a much debated process of Islamization and transformation of the banking and financial sector in Pakistan. The purpose of the book becomes quite clear in the beginning – it is intended to serve as a training manual for Pakistani bankers who need to learn new rules of the game. As such, the fact that Pakistan-specific issues abound in many pages of the text, does not come as a surprise to the reader. The focus of the entire text however, remains firmly on *riba* and *riba* alone. In the words of the author, the controversy over the connotation of *riba* has persisted all along, notwithstanding the fact that “the inaugural speech by the Father of the Nation, quaid-e-azam Muhammad Ali Jinnah at the State Bank of Pakistan Karachi, the three Constitutions adopted so far in Pakistan, reports of the Council of Islamic Ideology, and findings of various Commissions/ Committees constituted on the subject of Islamization of economy/ financial system, have unanimously called for eliminating *riba*.” (p xii, para 1). It needs to be understood and underscored at the outset that the actual process of Islamization of the financial sector and elimination of *riba* from the Pakistani economy is largely an outcome of a political debate and decision-making and is likely to be surrounded by controversy. The definition or connotation of *riba*, on the other hand, is no longer a debatable issue. There is a “general consensus” among scholars on what *riba* is and on the *Shari'ah* requirement of its prohibition. A “general consensus” of course, does not rule out a few lone and largely irrelevant voices of dissent.

The book suffers from a rather poor organization of the text, notwithstanding the author’s claim that “the book is an effort to provide reading material in a systematic way.” (p. xiv, para 2). Pages in the book have been devoted to material that are completely irrelevant and should have been edited out. For instance, the “Peer Review Comments” provided in the book may have been useful, but for the rather candid

admission by two of the peers that they did not have adequate time to peruse the book...and by a third that he does not have academic interest in the field of Islamic banking and finance! Another instance is the introductory chapter that provides a brief account of the evolution of Islamic banking and finance across the globe and follows up with a section on problems and challenges confronting Islamic finance in general and Islamic financial institutions in particular. The list of problems however, contains too many issues that confuse the reader who is yet to gain an understanding of the special characteristics of Islamic financial contracts, products, institutions and the like. This section perhaps, would have been more useful as the concluding chapter and not as the introductory chapter.

The second chapter deals with the philosophical, ethical and moral foundations of Islamic economics and finance. It begins with a description of *riba*, the cornerstone of this text, that is debatable. The opening sentence reads: “The structure of Islamic finance revolves around prohibition of any predetermined return derived on loan/debt (*riba*).” (p11, para 1). Such descriptions of *riba* implying predetermined or fixed returns are simply incorrect. The problem with this definition is that, by implication, conventional floating-rate-loans would now be deemed permissible, since the “pre-determined return” feature of *riba* is not present in such loans. On the other hand, since there is indeed a possibility of pre-determined returns in debts arising out of *ijarah* and *murabahah*, such valid transactions may be wrongly classified as prohibited, if one accepts the definition of the author. *Riba* literally means excess and *riba* is present whenever such excess is stipulated in the loan contract. The fact of the matter is that the author in this chapter makes no attempt at dealing with norms pertaining to *riba* – in loans and in sales; and relating to *gharar*, *darar*, *qimar*, *maysir* etc. in a systematic fashion one after another. The discussion on “philosophical basis of Islamic economics and finance” appears as a chemistry of various Islamic norms of ethics that lack objectivity and systematic presentation. It is full of generalized statements, such as: “the current practice of financial institutions, insurance companies, markets for futures and options are un-Islamic because of the elements of *gharar*, interest and gambling etc.” A further source of disappointment to the reader is that the above statement immediately follows a few sentences discussing *riba* in exchange and appears in the same paragraph! (p13, para 2). Another source of confusion appears a couple of paragraphs later, where one finds a discussion on “*al-kharaj bi'l-daman*” that is immediately followed by unrelated statements about *salam*, *murabahah*, *musharakah* and joint stock companies! The author should have kept in mind that the reader is yet to be introduced by him to the world of Islamic financing techniques. Unfortunately, more such instances of mix-ups follow. Objectives of *Shari'ah* are dealt with next with a quote from Imam al-Ghazali. The same section highlights the concept of a free market in Islam and goes on to say that economic stability and growth are also to be aimed at, since these “two objectives are regarded as highly desirable by renowned economists who have studied the economic system of Islam.” (p.17, para 3). The reader is left guessing about the identity of these “renowned economists.”

The following section on “*Shari'ah* boundaries for financial transactions” provides a comprehensive summary of Islamic norms of ethics. The list of principles is quite

informative and includes principles of “justice, mutual help, free consent, and honesty on the part of the parties to the contract, avoiding fraud, misrepresentation and misstatement of facts and negation of injustice or *zulm*, prohibition of *riba*, *gharar*, *jahl*, *darar*, *maysir* and *qimar*.” (p. 17, para 4). However, after whetting the appetite of the reader, there is hardly any further discussion on these norms, *Riba* being the exception of course. All subsequent pages in this section and chapter are devoted to *riba* and *riba* alone. The author draws heavily on the text of Judgment of Shari'ah Appellate Board, Supreme Court of Pakistan for explaining the meaning and types of *riba*. In trying to offer a rationale for *riba* prohibition, the author perhaps makes an important omission of Mahmoud El-Gamal's recent contribution offering an economic explication of prohibition of *riba* (El-Gamal, 2000) and *gharar* (El-Gamal, 2001) (full text of papers are available and easily downloadable from internet), even while the bibliography at the end of the text contains a reference to one of the papers. El-Gamal is particularly critical of the “exploitation” argument used by some authors. According to him, “The prohibition of *riba* is *not* only about exploitation. This is not to say that the potential for rich creditors exploiting poor debtors is not one of the purposes being served by this prohibition” (El-Gamal, 2000, pp. 31-44).

This reviewer is inclined to agree with El-Gamal that the prohibition of *riba* cannot be fully explained by a simple appeal to exploitation of the poor argument. El-Gamal in his paper offers a theoretically robust explanation of the rationale underlying *riba* prohibition that is rooted in economics and ethics. Exclusion of such elegant explanations of rationale underlying *riba* prohibition weakens the coverage of the present text. In his discussion of *riba*, the author should have unequivocally highlighted the fact that most of the financial needs that can be served with contracts containing *riba* can be met without the need for *riba*. In particular, Muslims do not need to deprive themselves of credit to avoid paying *riba*; nor do they need to forego the time value of their wealth to avoid receiving *riba*.

The present text is conspicuous for its grossly inadequate treatment of *gharar* and other ethical norms. Some of these issues indeed find a brief mention in the chapter without any further elaboration. While the author does attempt to define *gharar*, he is unable to provide much clarity and also fails to provide a proper rationale underlying the prohibition of *gharar*. Again in the matter of *gharar*, a number of recent studies have been published which could have formed the basis of the author's discussion. For example, a recent monograph by Siddiq Al-Darir published by the Islamic Training and Research Institute, IDB, Jeddah (Al-Darir, 1993) offers a very comprehensive explanation of the many interpretations of *gharar* in terms of settlement of risk, inadequacy and inaccuracy of information, possibility of deceit, fraud, complexity in contracts and pure games of chance. Another important omission from the text is the contribution of Sami Al-Suwailem (Al-Suwailem, 2002) who attempted to develop an objective criterion to identify and measure *gharar* in exchange. He showed that a *gharar* transaction is a zero-sum game with uncertain payoffs. The present text does not contain any reference to these important contributions to our understanding of *gharar*.

Chapter three in the book is titled “*riba* put on trial and retrial” and has two parts. Part one deals with the proceedings and judgment of the Federal *Shariat* Court of Pakistan and the next part deals with that of the *Shariat* Appellate Bench of Supreme Court of Pakistan. Much of the material covered in this chapter is not original and has already been published elsewhere.

Chapter four appears to hold interest of the reader as it contains the most useful material. Titled as “Alternatives to interest”, it provides in detail various modes of Islamic finance. It is divided into three parts. Part I covers the participatory modes of financing, such as, *shirakah/musharakah*, diminishing *musharakah*, joint stock companies and *mudarabah*. Part II covers financing through non participatory modes and includes *murabahah* with deferred payment, *musawamah*, *salam*, *istisna’*, *ijarah*. It also has a section on the so-called Time Multiple Counter-Loans Scheme that has not found much favor with the contemporary scholars and Islamic bankers. Part III is titled as “Some Sub Contracts” and includes *hawalah*, debt trading (*bay’ al-dayn*), *kafalah* (guarantee) and finally, derivatives. The chapter also seeks to inform the reader about the Islamic modes of finance in some countries other than Pakistan, such as, in Iran, Malaysia and Sudan. The section on derivatives comes as a disappointment as the author devotes a mere page and a half to this very interesting topic.

Chapter five is titled “Islamic capital markets and instruments” and focuses primarily on the new instruments that have appeared on the scene. It discusses how debt and equity-based instruments can be designed leading to development of Islamic capital markets. However, the same chapter also includes sections, such as, “central banking and monetary policy”, “monetary policy in Sudan” and the like. One wonders why the author should lead readers to confuse between capital market regulation and monetary policy. This chapter should have included a section on Islamic stock markets. The omission is surprising; and the organization of the text is poor. The next chapter titled “Operational guidelines and proposals” and the following chapter on “Analytical framework and unresolved issues” are equally poorly organized. For example, chapter six begins with a proposed structure for Islamic banks, when the structures of Islamic banks as suggested in the early writings of dr Nejatullah Siddiqi, dr Abbas Mirakhor and Mohsin Khan, dr Umer Chapra and the like, are presented in the subsequent chapter seven! Chapter six also includes three short sections on accounting aspects, risk management in Islamic banks and regulatory issues in the Islamic financial system, each spanning over a page to page and a half. The author presents some very quick ideas and concepts, which are difficult to comprehend by an average reader. Interestingly, risk management in Islamic banks and regulatory issues in Islamic financial system make a reappearance in the following chapter for some unknown reasons. Each one of these sections is based on a paper – the section on risk management in Islamic banks draws heavily on a paper by Tariqullah and Habib Ahmed and the section on regulatory issues in the Islamic financial system draws heavily on a paper by Luca Errico and Mitra Farahbaksh (references available in the text).

After devoting two rather informative chapters to “developmental role of Islamic banks” and “their cooperation with conventional banks”, the author is back to square

one. Chapter ten is titled as “*Riba* case: analysis of the arguments.” The chapter once again examines the arguments (there are sixteen of them) against *riba* as were produced in the *Shariat* Courts of Pakistan. Thus, the present text is more of a book on *riba* and its prohibition. Those who would like to be initiated into the world of Islamic banking and finance using this book as a “manual” are likely to experience some disappointment. The references are incomplete. Cited works fail to appear in the bibliography in some instances. The reader would find the glossary at the end of the text to be quite useful and informative.

Overall, the present work is rich in content, but needs a major reorganization in order to serve as a useful vehicle for learning Islamic finance. The author seems to have gathered considerable years of experience in training professional bankers, and such rich experience is reflected in the coverage. However, the author appears to be on the defensive about making a case for *riba*-prohibition, which perhaps explains the detailed coverage of court proceedings and decisions. A professional banker would be more interested, in the opinion of this reviewer, in prudent management of assets and liabilities of his organization and in creating new products and addressing new markets. A pre-requisite for this is a clear understanding of the unique *Shari'ah*-compliant financial structures. One hopes the author would take up the task of reorganization of the text and also include a more elaborate treatment of Islamic financial markets in the next edition of the book.

References

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