An Overview

Salman Syed Ali * *and Ausaf Ahmad* **

Background

Islamic jurisprudence (Sharīʿah) explicitly prohibits interest (*ribā*) in all its manifestations. Islamic Banking and Finance in modern times grew out of the Muslims' desire to find out the ways and means to fulfil their financial requirements in view of prohibition of interest. Interest based finance had become the dominant system during the colonial period, and continued to be so in many Muslim countries even after their independence. In this backdrop Muslim intellectuals and economists started to write about Islamic economics and financial system, notably in the Indian Subcontinent and Egypt.[1] The early writings expounded the philosophy and the concepts of interest-free finance along with its effects on the socio-economic welfare of the society. During that era commercial banks had occupied centre stage of the finance industry in mobilization of savings and providing of loans. Naturally, the first models of Islamic finance purported to explain how a banking system could work without interest.[2] These theoretical models perceived two tired *muḍārabah* finance structure, in which the Islamic bank on one hand would receive deposits as agent (*muḍārib*) of its customers; and on the other hand provide finance to enterprise as principal [sleeping partner] (*rabb al-māl*). In this early period (1930s to 1960s), developments in Islamic finance took place on the intellectual side only. The first practical realization of a bank-like Islamic financial institution, on a small scale, was that of Mit Ghimar in Egypt which started in 1963 and closed down in 1967. Another independent experiment of Islamic finance started in Malaysia in the form of Sharīʿah

---

* Islamic Research and Training Institute, Islamic Development Bank.
** Formerly of IRTI, Islamic Development Bank.

compliant savings and investments scheme for prospective pilgrims (*hujjaj*) called Tabung Haji. The experiment remained unknown in the academic circles only to be discovered much later and recognized in the 1990s as a successful institution.

In the 1960s and early 1970s the developments were mostly on the theoretical plane devoid of any practical experimentation. However, the accumulated theoretical knowledge prepared the ground and developed sufficient collective will for the emergence of first Islamic banks one in private sector (Dubai Islamic Bank) and another as a multilateral organization (Islamic Development Bank) both of which came into being in the early 1970s. Many more Islamic banks and financial institutions were created in the following years (for details see Ahmad 2000). A combination of practical realities of the business and constraints of the regulatory environment forced the Islamic banks to rely mostly on *murābaḥah* and leasing contracts for the financing activities instead of the originally conceived *muḍārabah* contract in the second tier. So much is the use of *murābaḥah* that some authors referred to this practice as *murābaḥah* syndrome[3].

Islamic finance has grown beyond banking since 1990s and expanded to the realm of capital markets. Now Islamic financial industry comprises of Islamic banks, investment funds, asset management companies, house financing companies, and insurance companies. The industry is growing in double digits since last decade. This expansion has brought up a number of practical issues and problems that serve as guiding posts for determining the direction of applied research in the field. Such research has become more active. For example, we see that a larger proportion of the *fiqh* questions and issues discussed by OIC Islamic Fiqh Academy during the last decade pertain to financial matters rather than other social issues. Similarly, the number and frequency of practitioners' conferences have increased which on one hand results in wider dissemination of existing knowledge, networking among professionals from various geographical regions, and on the other hand also contribute to some addition to the body of knowledge.

The academic institutions most often remain unrepresented in such gatherings for a variety of reasons, hence their research focus elsewhere. In short, the practice of Islamic finance has outpaced theoretical development. As a result: (i) much of the development is focused on solving the immediate problems with lesser attention to the long-term direction setting basic research. An indication of low level of basic research is the decline in the number of theses and dissertations written on Islamic banking and finance each year. The impact of such decline in the basic research will show up after 10 to 15 years. There is, therefore, a danger of blurring of the distinction between Islamic and conventional finance in the future. There is a need to strengthen academic research in this field as well as to envisage a future role and place for Islamic finance. This will also give direction to the industry for its future growth.

The present volume is a selection of papers that were presented at the International Conference on "Islamic Banking and Finance: Fundamentals and Contemporary Issues" held in Brunei from January 5 to 7, 2004; jointly organized by Islamic Research and Training Institute (IRTI) of Islamic Development Bank Group and Universiti Brunei Darussalam. The conference was an effort to disseminate the existing knowledge as well as to add some thing to it. Further, the conference had great significance for Islamic finance in Brunei: (i) It coincided with the creation of Center for Islamic Banking and Finance at the Universiti Brunei Darussalam, which is to become a centre of excellence and training in the country in near future, (ii) The conference also provided boost to the activities of Islamic Bank Brunei, (iii) The program of the conference was set in such a way as also to address the training needs of the finance professionals working in Islamic finance, (iv) Lastly, it provided networking opportunity to the professionals in the region.

In selecting the papers for this volume we have tried to keep a balance between theory and practice. The volume is divided into four parts. Part one deals with the fundamentals and the issues faced by Islamic finance at theoretical level. Part two addresses to various contemporary issues empirically through case studies. Part three deals with some legal issues in the practice of Islamic banking and finance. Part four gives an overview of the Islamic banking efforts in Brunei—the host country of the conference.

2. Conceptual Issues

Mabid Ali Al-Jarhi takes up the issue of philosophical underpinnings of Islamic finance. According to him, "The *philosophy of Islamic banking and finance* is a set of theories and ideas related to its understanding". He identifies three building blocks related to its understanding. First, the Islamic law (Sharīʿah) from which the very idea of Islamic banking has been drawn. Second, monetary and macro theory which helps explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of this prohibition. Third, banking theory itself, which helps to explain the nature of Islamic banking and finance as well as to assess its comparative performance.

Umer Chapra discusses the economic case against interest and asks why should we try to replace the interest based conventional system when it has been in existence for such a long time and has become highly sophisticated in its serving the society. Is the case against interest compelling and is there a strong enough rationale for a changeover to interest-free financial system? He argues that both on the criteria of equity and efficiency, the interest based system has shown a poor record. Poor performance of this system on socio-economic or equity considerations is well known and recognized by many. It is however, the efficiency criteria on which the interest based system is thought to be superior to interest-free financial system. However, recent financial crises in many parts of the world and their persistence bring into question the so called superiority of this system even on the criterion of efficiency. Economists have discussed various factors as the causes of such crises but no consensus seems to have emerged in identifying the cause of all causes. In absence of such a consensus conflicting remedies have been proposed and no effective reform program has emerged. Chapra argues that inadequate market discipline is the main cause of financial crises; but is it the ultimate one? What causes the erosion of market discipline? He points to the 'absence of risk sharing' as the root cause of all crises: "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 market as a result of the absence of risk sharing." He substantiates this position by discussing the cases of (a) the East Asia Crisis, (b) the collapse of Long Term Capital Management (LTCM), and (c) Foreign exchange market instability. He concludes that while sound macroeconomic policies and better regulation and supervision are always required, their effectiveness can be increased "if they are complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors as well as the banks share in the risks of business." The paper concludes that there is a strong rationale behind prohibition of interest, not merely for prevention of exploitation of the poor but also to make the financial system healthier and more stable. Increasing the share of equity and reduction of the share of debt can make the financial system more stable. The result may even be better if the credit is tied to purchase or lease of real goods and services instead of untied loans that contribute to speculative trade in society.

One of the objectives of Sharīʿah is protection of wealth or property.[4] Prohibition of interest is one of the manifestations of this objective. Other manifestations of this purpose can be seen in the Qur'ānic prescription to write out a contract[5] to avoid dispute; in disallowing of some forms of financial contracts (such as contracts involving *gharar* and gambling etc.); and in negation of unjust conditions in a contract. Financial contracts and the conditions stipulated in them are important in banking business as well as in financial markets because these affect the rights and obligations of each party. Financial engineering rests on combining and repackaging of contracts in manners that suit all the involved parties for distribution of risk and return. In conventional markets financial options are used to hedge the risk of one party at the cost of others. How can options (*khayyār*) in a contract effect savings and investment. What are the different *khayyār* discussed in *fiqh* literature? How similar or different they are form the financial options bought and sold in the present day financial markets? These are the types of questions raised in **Burhan Arbouna**'s paper entitled, "*Option Contracts and The Principles of Sale of Rights in Sharīʿah*" (Chapter 3). He divides *khayyār* into two classes: those that are legal rights associated with a contact by default, and those rights or options which are contractually created in a contract such as *khayyār al-shart.* It is this second type which are focused in the paper. He finds that these Sharīʿah options have many similarities with the conventional financial options but the differences are much greater in substance.

The paper contains an informative discussion on financial options and forward contracts; financial options and inconclusive contracts (*bayʿ muallaq*); difference between financial options and *arboon* sale; are financial options a form of tangible wealth or only rights; why the rights are not transferable through trade? The author proposes Sharīʿah compatible combination of contracts to create call and put option type results. For example, combining a contract for search services (*ijārah*) [to search and find a particular type of goods or a particular price for it] with a supply or sale contract [of that good] a kind of put option is created in the sense that the service charge is definite to keep in lieu of the search services; and it reduces the price risk for the goods seller—which, is the ultimate economic purpose of any put option. This setup, however, cannot be used for speculating on price movements and the size of its secondary market will depend on the extent of the market for such search services. The discussion in the paper identifies at least two new areas for further research. (1) The concept of sale of rights and the extent of its (non) permissibility with implications for risk management. (2) Combination of contracts and the cross-market effects of one contract on the market for the other.

In the context of banking, utilization of funds (through various financial contracts) is only one side of the business. The other side is mobilization of deposits. **Sayyid Tahir** addresses this side in his paper on "*Unresolved Issues In Islamic Banking and Finance: Deposit Mobilization*" (Chapter 4). He points out that most of the theoretical and applied work so far has been confined to Islamic financing. "The deposit mobilization side has been taken for granted. It is, therefore, not surprising that a closer look reveals little difference between workings of interest-based banks and Islamic banks on the deposits side." He asks the question: "Is the difference between Islamic and interest-based banking really thin on the deposit mobilization side? Or, is there some thing that is being missed?" Since the depositors have a variety of motives and risk preferences it is optimal to offer different categories of deposits. Each of these deposit categories will create a different kind of liability, responsibility and return for the bank.

More importantly, the paper argues that the present method used by Islamic banks, of pooling all types of deposits for investment and then distributing the generated profits to deposit holders is Sharīʿah incompatible and violates the principle of equity and justice enshrined in the rules of *muḍārabah*—the contractual basis on which investment deposits are collected. In order to avoid inappropriate asset transfer between current and future investment depositors as well as between various categories of depositors and the bank; he proposes use of segregated *muḍārabah* investment pools with separate accounting and profit distribution for each such pool. This is an innovative idea that requires further careful and detailed analysis.

While the segregated treatment will increase transparency and justice it will, however, also increase accounting and investment costs. The positive effects of separate treatment of different deposit categories on bank stability are clear, but the effect of segregation across time of the past and current depositors will require further study before its general acceptance. Supply and scope of investment opportunities and size of the individual banks all would have to be considered in determining the viability of such a proposal.

Banking regulations in the conventional system are predominantly for avoiding systemic risk. However, depositor/investor protection, enhancement of efficiency, and other social objectives are not totally ignored. Sharīʿah considerations give rise to issues of a different sort in which equity and justice acquire central role in establishment of stability, depositor/investor protection, efficiency, and other social objectives. Recently, Islamic Financial Services Board (IFSB) has issued (i) capital adequacy and (ii) risk management standards for Islamic banks. However, both pertain to solvency and stability. Moreover these pertain to prudence in banks' investment not with deposit mobilization and its treatment. Much work is still needed on the subject.

A useful first inquiry in this direction would be to assess how relevant for Islamic banks are the causes of financial distress identified for the conventional banking system. **Salman Syed Ali** contributed to this end in "*Financial Distress and Bank Failure: Relevance for Islamic Banks*", (Chapter 5). The analysis shows that while some causes do affect Islamic banks equally as they affect conventional banks, there are some others which are of lesser consequence. This is due to the particular sharing structure of Islamic banks with their clients and/or depositors which positively contribute to more stability of these banks. However, the small size and narrow ownership of Islamic banks pose its own problems as a source for financial distress.

There are also new dimensions to some of the conventional causes of financial distress when applied to Islamic banks. For example, moral hazard problem is at two levels in the two tier *muḍārabah* structure of Islamic banks which leads them to prefer *murābaḥah* financing and hence generates credit and liquidity risk. However, as opposed to interest based financing the *murābaḥah* contract does not contribute to credit cycles. This is owing to non-saleable nature of debt or its discounting. At the same time the financing cycle can operate in cases of *muḍārabah* and *shirākah* contracts through counter-cyclical monitoring costs and pro-cyclical incentives to monitor for the banks.

An important finding is that the despite inherent stability features financial distress in Islamic banks can stem from the current structure of these banks, the regulatory environment that restricts them from owning or equity participation in businesses and trading, and from the lack of support infrastructure institutions. Islamic banks can be indirectly affected if a generalized crisis occurs in the conventional banking sector which erodes confidence of depositors in the banking sector in general.

3. Empirics

The next three papers are empirical in nature describing the behavior of Islamic banks, their depositors, and evaluation of the performance of Islamic financial market indices.

Monzer Kahf in "*Success Factors of Islamic Banks*" (Chapter 6) points out that Islamic banks are profit oriented organizations with the difference that they have enjoined on themselves to conduct their affairs within the limit of the rulings of Sharīʿah and to comply with its overall objectives. These objectives imply that the Islamic banks would be eager to boost all forms of deposits, improve the quality of customer services, expand the base of banking services, protect capital, provide humanitarian and social services, as well as work towards the other factors that raise the profit margin. However, Sharīʿah compliance will also induce a different kind of relationship among the stakeholders (owners, depositors, and financed parties). The paper analyzes the experience of seven Islamic banks in achieving their objectives and measures their performance in assets growth, growth of invested assets, the growth of cash and deposits in other banks, the growth of customers' deposits in Islamic banks, changes in earnings, expenses, and net profits, and the commitment to the Sharīʿah and charitable and social contributions.[6] The analysis is based on the information obtained from the annual reports of these banks for three years 1999-2001.

The above relative performance results are then used to theoretically discuss various factors and considerations that may prove useful for success of Islamic banks. Among them are the role of banking efficiency, confidence in a bank, efficiency in investment management, financial engineering and marketing, preservation of shareholders and depositors' equity, provision of humanitarian and social services and other factors.

Some useful suggestions on the method of relative evaluation also propped up in the paper which have implications for the growing empirical literature on Islamic banking efficiency. For example, the study suggests that in order to compare relative profitability among Islamic banks the profit of the shareholders as well as the profit distributed to the depositors both should be considered as output. This is due to special nature of Islamic banks who are to work for the benefits of shareholders as well as the depositors.

Mahmood Ahmad in his paper "*The Attitude of Bank Customers and Professional Bankers towards Islamic and Conventional Banks in Bangladesh*" (Chapter 7) takes up the question whether the Islamic banking practices are any different from the conventional banking system. He examines apparent similarities and differences between both Islamic and conventional banks, which frequently tend to equalize both the systems. The analysis is supplemented by an opinion survey among 200 bankers and 200 bank customers in Dhaka Bangladesh to examine these apparent similarities and differences of Islamic and conventional banking systems.

The survey found that bankers are more aware than the customers about the nature and working of Islamic banking. While both groups are aware about prohibition of interest and the alternate in the form of profit sharing; the customers generally think that the Islamic banks are not much different from conventional banks in the final outcome. Some contradictory results are also found.

In contrast to collecting deposits as loans or investment (in *muḍārabah*), it appears that Islamic banks in Bangladesh are still using *wadīah* and *amānah* concepts.[7] The paper concludes that "Islamic banks have become, to an extent, successful in the field of deposit mobilization, but socially beneficial and development oriented utilization of these deposits did not happen. Employment generation and a flow of resources towards the lower and middle classes, particularly in the rural areas, have not taken place. Still, Islamic banks are involved in the heroic role of eliminating *ribā* from financial dealings in Muslim countries".

Abul Hassan and **Antonios Antoniou** in their paper "*Equity Fund's Islamic Screening Effects on Financial Performance and Its Performance Analysis*" (Chapter 8) take us away from banking institutions and focus on financial markets. Financial markets would form an integral part of Islamic finance. Academic papers have only recently started to discuss or analyze Islamic ethical equity funds. In the present paper, Hassan and Antoniou examine the potential impact of Islamic screening restrictions on investment performance by comparing the performance characteristics of a diversified portfolio of Islamic screened stock index Dow Jones Islamic Market Index (DJIMI) with conventional benchmark Dow Jones Global Index (DGI). The paper also assesses the degree of correlation in price movement and volatility among the Islamic stocks (DJIMI), Islamic technology related stocks (DJIM-Tech Index) and UK Islamic stocks (DJIM-UK).

The methodology builds upon the fact that "being an index, the DJIMI provides a unique opportunity to assess the impact of the constraints on performance free of other considerations such as investment style, fund objects and timing that have clouded the analysis of the performance of ethical mutual funds." The data used is for the period January 1996 to March 2003 during which an up- and a down-turn of the market had occurred. Sharpe and Treynor measures, Jensen Alpha, and volatility are calculated. The study shows that the impact of Islamic screens is not adverse. However, the Islamic index tended to be biased towards technology stocks during the sample period which helped it when that sector was progressing; but the same negatively affected it when price bubble of technology stocks collapsed. Overall, the performance of Islamic index is closely related to the performance of stock markets worldwide.

4. Legal Issues

The Islamic banking system without the law is futile and meaningless. The legal system is supposed to regulate and license the Islamic banking business, besides imposing control and supervision on the affairs of the Islamic banks. The legal framework is also important for defining the characteristics of contracts and their enforcement. Thus, it helps in development and introduction of new financial products. With the rapid development of the Islamic banking and finance in different places, the law must also be able to keep up with the speed of that development. Thus the study of development of legal regime becomes an important area.

The next two papers provide case studies of the legal framework for operations of Islamic finance and raise the issues therein respectively in the context of Malaysia and Indonesia.

Norhashimah Mohd. Yasin in her paper "*Legal Aspects of Islamic Banking: Malaysian Experience*" (Chapter 9) covers the legal framework governing Islamic finance in Malaysia. She describes the relevant laws and delves into various issues in the development of law and its application to Islamic banking. The paper highlights the difficulties of present legal framework in implementation of Islamic finance contracts.

It informs us that Islamic banking in Malaysia is governed by two laws: (i) the Islamic Banking Act 1983 (IBA) which exclusively governs full-fledged Islamic banks (Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad), and (ii) the Banking and Financial Institutions Act 1989 (BAFIA) which regulates conventional banks and their Islamic Banking Divisions (IBDs) or Windows. The nature of both laws are different.

A difficulty with the legal framework for Sharīʿah laws in Malaysia is that the application of Islamic law is limited only to family law and religious offences; and it is the jurisdiction of individual States. The law relating to commerce and business (*muʿāmalāt*) is still either the statute law or the English law. Sharīʿah Courts only have jurisdiction over matters falling under the State list. Consequently, Sharīʿah compatibility in enforcement of financial contracts and dispute resolution becomes uncertain—a legal risk. The author quotes that two leading cases of Islamic banking relating to *Bayʿ Bithaman Ajil* (BBA) were decided by the Civil Court (High Court) and not by a Sharīʿah court. In the absence of a fully comprehensive legal framework for Islamic banking, precedence becomes important source for law. Thus far, there are very few cases which could be used for reference.

While the author has focused only on Malaysia, but her conclusions are generally valid for other Muslim countries as well, that "in spite of the rapid development of Islamic banking and finance in Malaysia, the legal regulatory regime is lagging behind. Legal reforms are urgently needed in order to facilitate the smooth running and operation of the Islamic banking system."

Reza Djojosugito's paper focuses on Indonesia. The paper "*Legal Aspects of Islamic Project Finance and Asset Securitization in Indonesia: A Vehicle for the Development of Islamic Banking*" (Chapter 10) reviews existing laws, as well as the one in draft form, related to Islamic banking, project finance and asset securitization. The paper emphasizes the importance of project finance and asset securitization for Islamic banks, as this combination is closer to the participatory modes and open to a lower degree of moral hazard problem than found is two tier *murābaḥah*. However, the legal framework in Indonesia, which is based on Civil Law, does not provide enough support or legal basis for such combination to work. The paper discusses various legal issues and unresolved *fiqh* issues related to leasing and asset securitization which can form a bridge between conventional and Islamic banking. It proposes some reforms in the legal framework which include: introduction of principle of equity and imposition of the doctrine of the binding force of precedent.

Cecep Maskanul Hakim in his paper "*Islamic Bond: Indonesian Experience*" (Chapter 11) informs that there has been a number of *murābaḥah* bonds issued in the Southeast Asia., but very few *muḍārabah* bonds have been issued so far. Cecep argues for promotion of *muḍārabah* bonds. The primary initiative for profit sharing bonds, so far, has been driven by (i) need of Islamic banks for investment alternatives to manage their excess liquidity, and (ii) to develop Islamic capital market. Cecep's paper highlights the multiple impacts of issuing *muḍārabah ṣukūk*.

5. Review of Islamic Banking Activities in Brunei

Finally, the paper by **Hajjah Salma** "*Islamic Banking in Brunei and The Role of CIBFM*" (Chapter 12) discusses the history and development of Islamic banking in Brunei. Highlighting the need for training of the professional bankers in the field of Islamic banking and finance it informs us about the new initiative of Brunei in the form of Center for Islamic Banking, Finance and Management that has been established at Universiti Brunei Darussalam with academic and industry partnership.

Notes

[1] For details on the history and intellectual evolution of modern Islamic economics and finance, see Islahi (1997) and Kahf (2005).
[2] Qureshi (1946), and Siddiqi (1967) and (1983).
[3] See Yousef (2005).

[4] Other purposes are protection of life, progeny, intellect, and faith. For details, see Masud (1995).

[5] Sūrah al-Baqarah, Ayyah 282.

[6] These banks are: Jordan Islamic Bank, Islamic Bank of Qatar, Shamil Bank of Bahrain, Bahrain Islamic Bank, Dubai Islamic Bank, Arab Banking Corp Islamic Bank and Kuwait Finance House.

[7] Sayyid Tahir (Chapter 4) in this volume explains why this is not a suitable concept for deposit mobilization. AAOIFI also advocates using *muḍārabah* or loan contracts for deposit mobilization.

References

Islahi, Abdul Azim (1997), *History of Economic Thought in Islam: A Bibliography*, Jeddah, Scientific Publishing Centre, KAAU.

Kahf, Monzer (2005), "Islamic Banks: The Rise of a New Power Alliance of Wealth and Shariah Scholarship" in Clement M. Henry and Rodney Wilson edited, *The Politics of Islamic Finance*, Karachi: Oxford University Press, pp.17-36.

Qureshi, Anwar Iqbal (1946), *Islam and Theory of Interest,* Lahore: Sheikh M. Ashraf.

Siddiqi, Muhammad Nejatullah (1967), *Bila Sudi Bankari* (Urdu) (Banking without Interest), Lahore: Islamic Publications; Revised version in English (1983), Leicester: The Islamic Foundation.

Yousef, Tarik M. (2005), "The *Murabaha* Syndrome in Islamic Finance: Laws, Institutions and Politics" in Clement M. Henry and Rodney Wilson edited, *The Politics of Islamic Finance*, Karachi: Oxford University Press, pp.63-80.