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AIMS AND SCOPE
· ISLAM AND CIVILISATIONAL RENEWAL (ICR) offers an international platform for awakening the civilisational potential of the Islamic legacy. Revitalising synergies between Islamic and other civilisations in a spirit of self-enrichment through discovery and research may facilitate renewal within Muslim societies and more significant contributions by Muslims to the global human community.
· ICR explores contemporary dynamics of Islamic experience in legal and religious practice, education and science, economic and financial institutions, and social and intellectual development.
· We seek viable policy-relevant research yielding pragmatic outcomes informed by the best values and teachings of Islam as well as of other contemporary civilisations.
· ICR is inter-disciplinary, non-political and non-sectarian. We seek to contribute to prospects of peace among all nations, and assist the conceptual and societal transformation of Muslims.
· ICR encourages a fresh discourse for self renewal informed by an inclusive tolerant approach to diverse schools of thought and expression of ideas. The intent is to integrate over 1,400 years of Islam’s civilisational resources of diversity, dialogue and coexistence for meaningful exchanges with other world civilisations.

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EDITORIAL

I am pleased to present to our readers a special issue of ICR devoted to Islamic banking and finance (IBF), an increasingly vibrant field in which Malaysia, ICR’s home, has made great strides and shown itself to be a leader and pace-setter. An interesting selection of six original contributions to the field comprises our “Articles” section.

The field of Islamic banking and finance has not escaped the damaging effects of the recurrent financial crises the world has been witnessing, notwithstanding its core of inner resilience. Apart from the ripple effects of the crises, IBF has also encountered numerous challenges of its own and has come under criticism for many of its shortfalls. This was why we decided to take stock of the situation in this issue of ICR.

Starting from our base in the country, Malaysian Shariah-compliant screening practices are presented and analysed in detail by a team led by IAIS Deputy CEO / Principal Fellow, Associate Professor Dr Mohamed Azam Mohamed Adil. They find that these screening practices operate on the basis of a clear and generally well-known list of activities that are Shariah non-compliant. This comprehensive listing of non-compliant activities is available to all companies operating in the country. Companies that are engaged in Shariah non-compliant activities would be rejected, while those that are not involved in any of the prohibited activities are deemed to be Shariah-compliant. The problem posed to regulators and to the architects of screening practices is that of assessing the compliance of those companies who are engaged in a mix of activities, and determining the ratios for Shariah compliant to Shariah non-compliant activities.

An incisive, frank and critical appraisal of Islamic banking and finance is undertaken by Yusuf Jha, a Chartered Sharia auditor and advisor formally certified by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and now Manager for Shariah consultation and documentation review at the Abu Dhabi Islamic Bank. In his article “From Goldsmiths to Modern Banking,” Jha asks IBF practitioners whether what they are currently practicing is not simply normalising current banking problems within an ‘Islamic’ framework, rather than providing Shariah-based solutions that could help tackling the crises of the modern banking system. ICR applauds such forthright questioning! In response, Jha asks: Is it not time that Islamic Finance itself undergo a reformation from within? Jha calls upon IBF to “rise beyond interest and the institutions and social settings it has brought about” and suggests IBF should propose a new mechanism for the supply of money, to create a supportive financial environment that decreases reliance on debt and increases sense of community.

Taking a broader historical perspective on the topic, IAIS Principal Fellow Karim Douglas Crow sets forth concisely and cogently the dimensions of the implicit debate on the origins of backwardness in the Muslim world that emerges from a reading of the work of Muslim economic historians, Timur Kuran and Murat Çizakça. The debate...
is a continuing one but it seems clear that the basic vision for any renewal of Islamic economics and finance must emerge from within, inspired by Islam’s own resources, and adapting ideas and developments that are compatible with core Islamic principles.

Abdul Karim Abdullah provides a comprehensive review of the age-old problem of debt undoubtedly the root of the financial crises the world has been experiencing in recent years. After setting forth the dimensions of the debt conundrum past and present, Abdullah ponders the effects of indebtedness on economic growth and asks what can be done to overcome indebtedness. He then proposes some actionable recommendations on achieving this.

Sheila Ainon Yussof presents a state-of-the-art assessment of on-going efforts in Malaysia to “beef up on Shariah-compliance surveillance” as befits a country that boasts “the world’s first comprehensive legal framework for the Islamic finance industry”. To this end her article undertakes a comprehensive appraisal of the latest landmark legislation, The Islamic Financial Services Act of 2013, a model for achieving Shariah-compliance introduced to upgrade Shariah governance efforts in the country’s banking and finance sector. Her evaluation of the new act also includes a set of policy recommendations for strengthening Shariah governance.

Lastly, Lateef Kayode Adeyemo and Kamil Koyejo Oloso provide for a Nigerian perspective on Islamic banking and finance, looking at products that have come of age but whose growth and geographical spread has given rise to challenges that may constrain the further growth of the industry, if left unaddressed. They assess the issues and propose actionable solutions.

The Articles section, however focused on Islamic Finance and Banking it may be, is balanced by ample and diverse Viewpoints. These address a variety of political and social issues arising from current events and developments in the Muslim world. Specially worthy of note in this issue is an exclusive ICR interview with former Prime Minister of Malaysia Tun Abdullah Ahmad Badawi, followed by an in-house examination of the much debated conundrum of Islam and Democracy. As always, the issue also features cogent Book Reviews and incisive notes on recent Significant Events in which IAIS has played a part. The joint appeal to Sunni and Shi’a Muslims penned by Dr. Mahathir Mohamad and His Excellency S. Muhammad Khatami, two prominent leaders, one from Sunni Malaysia and the other from Shi’i Iran, will be of vital interest to ICR readers, offering a prospect of peace-building. This is an urgent call upon all Muslims to refrain from sectarian violence that has been spreading in recent years in countries of the Middle East and Pakistan.

In conclusion, I would like to thank all our contributors and my colleagues in the ICR Editorial Committee for their continued cooperation and support.

Mohammad Hashim Kamali
Editor-in-Chief
ARTICLES

SHARIAH-COMPLIANT SCREENING PRACTICES
IN MALAYSIA

Mohamed Azam Mohamed Adil, Catherine S.F. Ho,
Mansor Md. Isa, Ezani Yaakub, Mohammad Mahyuddin Khalid*

Abstract: This study reviews twenty-eight users of Islamic equity screening in Malaysia based on the most recent information collected in 2012. Except for the Securities Commission and two index providers, the rest of the users are mutual fund companies. Our review indicates that, with few exceptions, the majority of the local screening users are following the benchmarks set by the Securities Commission of Malaysia, in which only industry screening is applied to separate Shariah compliant from non-compliant companies. A few users, however, employ a two-tier quantitative approach in addition to the qualitative screening. The qualitative screening removes companies whose main businesses are Shariah non-compliant. Companies with mixed activities are then subject to quantitative screenings in which non-compliant contributions are measured against applicable benchmarks. The Securities Commission is scheduled to have in place a two-tier quantitative screening method which is more in line with international practices by the end of 2013.

Introduction

Screening companies determine if certain investments are consistent with the Shariah principle requiring Muslim investors to invest only in Shariah-compliant firms and thereby confirm their permissibility for investors. However, given the modern day interdependence and linkages of business transactions, it is almost impossible to find a company that fully complies with the principles of the Shariah. A degree of tolerance therefore has to be exercised that allows Muslim investors to invest in companies with mixed activities, provided the Shariah non-compliant contribution to profit does not exceed a certain acceptable percentage. A team of international Shariah scholars has developed a screening methodology that paved the way for investors to own shares in public companies back in 1987 (Mian, 2008). These scholars presented a set of Shariah screening criteria and ruled that Muslim investors can purchase shares of companies that fulfil these criteria.

These screening criteria have been widely adopted, albeit with modifications, by Islamic financial markets around the globe. Basically the criteria consist of two levels, the business activity screen and financial ratio screen. For the business
activity screen, a company must derive up to 95 percent of its revenue or profit from Shariah-compliant activities. This means that there is a 5 percent tolerance level in the total revenue or profit that may be derived from non-permissible sources, such as alcohol, tobacco, pork-related products, non-permissible entertainment, weapons and defence as well as conventional financial interest-bearing services. For the financial ratio screen, a company would be accepted as Shariah–compliant if it meets the following criteria: total non-Shariah compliant debt should be less than 33 percent of equity; account receivables should not be more than 49 percent of total assets; and interest income should not be more than 5 percent of total income (Mian, 2008). However, the practice around the world seems to be inconsistent, as documented by Khatkatay and Nisar (2006), Derigs and Marzban (2008), Ho et al. (2011), and Ho et al. (2012).

The Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions Sharia-compliant Standards (AAOIFI, 2010) aims to introduce a higher degree of harmonisation of Islamic finance practices across major Islamic finance markets in order to facilitate further expansion of the industry. The AAOIFI standards consist of a two-stage screening process of qualitative and quantitative screens. The qualitative screen is similar to that used by others: companies have to stay within what is lawful according to Shariah business activities. The quantitative screens used have total debt and interest-bearing deposits being less than 30 percent of market capitalisation, and income generated from prohibited components less than 5 percent of total income. AAOIFI also excludes those involved in the issuance of conventional bonds, trading of futures, options and swaps contracts.

With different countries adopting their own standards, there is a lack of consistency for a universally acceptable compliance method and this may hamper growth in global Islamic investments. The different Shariah screening methodologies adopted by the Islamic financial industry also connote a lack of standardisation of the practices in the industry. There is therefore a need for Shariah scholars and industry players to consider greater standardisation of their screening methodologies to further the Islamic financial industry. Despite the controversies and uncertainties surrounding the issues of screening for Shariah-compliant companies, there is surprisingly very little analytical and empirical research in this area.

This paper aims to add to the much needed literature in this field. The aim of this paper is to review and analyse the Shariah-compliant screening methods currently practiced in Malaysia. Firstly, we discuss the current screening practices of the Malaysian Securities Commission. The Securities Commission is entrusted with the role of regulator of the local capital market. Since its establishment in 1993, it has been heavily involved in paving the way towards facilitating the development
of Malaysia to be an international Islamic financial hub. Secondly, we present and analyse the qualitative and quantitative screening procedures as practiced by local financial institutions. This paper contributes to existing literature by documenting and analysing screening practices applied by Malaysian Islamic financial institutions. Since Malaysia is considered one of the major financial hubs for Islamic finance, it is important to share its practices with others, for greater understanding and harmonisation of practices at the international level.

Section two of the paper provides a review of existing literature on Shariah screening. The data collection and data profile are explained in Section three of the paper. Section four contains the presentation and discussion of the screening process used by local institutions and Section five summarises and concludes this paper.

**Review of Literature**

While there seems to be a reasonably strong consensus regarding what business activities are allowed in Shariah, controversy arises regarding companies with mixed activities. These include companies whose core activities are lawful but who out of necessity are also involved in unlawful transactions. As widely noted, it is extremely rare to find companies that are 100 percent Shariah-compliant in all their investing and financing activities. A more practical approach would be to develop filters that weed out companies whose Shariah non-compliant activities constitute a percentage beyond an acceptable benchmark.

It is common knowledge that certain business activities are prohibited in Islam. There is also consensus among all Islamic jurisdictions to prohibit business operations which involve giving and taking of interest; gambling; the production, distribution, promotion and sale of non-halal goods or services such as alcoholic beverages and pork; or immoral entertainment facilities such as prostitution, pubs, massage parlours and discos. Moreover, companies dealing with *gharar* that could lead to excessive speculation activities such as conventional insurance as explained by Derigs and Marzban (2008) are also considered as non-Shariah compliant. In addition, Naughton and Naughton (2000) and Iqbal and Mirakhor (2007) concluded that short selling, speculation and margin trading activities are not permissible in Islam, and this poses many challenges in structuring contemporary Islamic financial instruments and system. Khatkhatay and Nisar (2006) pointed out that Shariah-compatible investment is judged according to the investment structure and the nature of the contracting parties. Shariah prohibits interest-related investments, monetary obligation (debt, currency, liquid assets) and future rights (uncertainty).

Khatkhatay and Nisar (2006) compared and analysed screening criteria used by three organisations: Dow-Jones Islamic Index (US), Securities Commission (Malaysia) and Meezan Islamic Fund (Pakistan). The authors noted that among
the three, Dow-Jones Islamic Index has the most comprehensive industry criteria in addition to a comprehensive set of financial criteria. Meezan also applied both industry and financial criteria while the Securities Commission of Malaysia, according to the authors, has the most liberal screening criteria. The Securities Commission does not apply any financial criteria but instead operates on a four-tier industry screening to exclude companies involved in various forms of non-Shariah compliant activities. It seems that the Securities Commission is taking the approach of prioritising the Shariah prohibition of these activities; those that are strongly and clearly prohibited have the lowest tolerance level and those that are subject to much uncertainty have a more liberal benchmark. Khatkhay and Nisar proposed that screen users not take into account percentages of non-permissible income, but instead exclude all companies whose businesses are not 100 percent Shariah-compliant.

Derigs and Marzban (2008) provided a comparative study of screening practices on Shariah compliant stocks which have been adopted by nine groups of international users. The authors noted that all the users surveyed invariably use a two-tier screening process. First is an industry screen in which some users exclude companies with any level of involvement in non-Shariah compliant activities while others exclude only those whose primary activities are non-Shariah compliant. Upon passing the industry screening, companies are subject to quantitative screenings that are divided into four categories: liquidity ratio, interest ratio, debt ratio and non-permissible ratio. Derigs and Marzban’s (2008) main conclusion is that there are inconsistencies in the method of classification used by different groups, such that some stocks that are deemed permissible by one group may be non-permissible by other groups. The authors called for a more standardised screening framework across international users. Other studies, such as Shaikh (2010), Shariah Capital (2009) and Sengupta (2012), also found differences in Shariah compliant criteria acceptable to different Islamic investors.

In two recent studies, Ho et al. (2011) and Ho et al. (2012) reviewed the screening methods of equities among international Islamic finance users objectives. Regulators such as the Securities Commission of Malaysia are more flexible; this approach is needed to rapidly develop the Islamic capital market in the country. Index providers, on the other hand, are concerned with the “purity” of the index in order to provide an accurate Islamic performance benchmark; hence they would apply a relatively strict screening method. Private asset managers catering to Middle Eastern investors would be more stringent in their interest screening as interest is a major concern for their clients. The authors also noted that, with only a few exceptions, most users employed quantitative screens for non-permissible income, followed by financial ratio screens. In general three financial ratios,
namely debt ratio, liquidity ratio and interest to income ratio, are tested.

Although the above studies mention the use of financial ratios by various users, there is much uncertainty and inconsistency in the specification of the ratios as well as in the setting of the benchmarks. First, some of the users use percentages based on the market value of equities or total market capitalisation, which is market-based, while others were based on total assets, which is accounting-based. The use of both denominators has its merits and demerits, and it seems neither measure has a definite superiority over the other. Secondly, the setting of benchmarks is a matter of judgement by the Shariah jurists. There is no clear guidance on the cut-off points from the Shariah sources. Tolerance levels are set by Shariah advisors based on indirect inferences of the Quran and Hadith. It is therefore not surprising that there exists a great deal of variation in the benchmarks practiced by different users.

**Data Profile**

This study provides a fairly comprehensive compilation of Shariah screening methods of twenty-eight participants in the Islamic financial market in Malaysia, consisting of a market regulator, two Shariah index providers and twenty-five mutual fund management companies. The mutual fund companies are in turn affiliated with investment houses (13 companies), banks (nine companies) and insurance companies (three companies). Data used for this study consist of information on the screening methods applied by users that are collected from their respective websites. The information was collected during 2012. The list of users is presented in Table 1.

Table 1 shows the compiled list that includes the Securities Commission and two Islamic index providers in addition to the twenty-five mutual fund companies. The index providers are FBM EMAS Shariah Index and FBM Hijrah Shariah Index. The mutual fund companies are affiliated with banks, insurance companies and investment houses. The banking institutions reviewed include Affin, Alliance, AmBank, Bank Islam, BSN, CIMB, Hong Leong, Public and RHB. These are the major banks in the country that provide not only banking services but also Islamic investment products. The insurance companies are ING, Prudential and MAA. They provide long term investment opportunities and manage them in accordance with Shariah principles. The thirteen investment houses are Amanah Raya, Apex, ECM Libra, Hwang DBS, Inter-Pacific, Kenanga, MIDF Amanah, OSK-UOB, Pacific, PMB, PNB, Pheim and TA. They provide an important function by pooling savings in long term investments which provide higher returns not only for investors within the country but for a large number of funds invested either regionally or globally.
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Permodalan Nasional Berhad</td>
<td>✓</td>
<td>Malaysia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Pheim Unit Trusts</td>
<td>✓</td>
<td>Malaysia, Asia excluding</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Prudential Corporation Asia</td>
<td>✓</td>
<td>Malaysia, Asia excluding</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>*</td>
<td></td>
<td>Japan, Greater China</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>TA Securities Holdings</td>
<td>✓</td>
<td>Asia including Japan,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Brazil, Russia, India and</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>China.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total 1 2 25 9 13 3

Note: * Has more than one Shariah advisor.
The Shariah screening process is generally carried out by in-house Shariah boards—international or local Shariah advisors which provide these institutions with Shariah related recommendations. These Shariah advisors may be profit-oriented companies that provide Shariah compliant consulting and related services and therefore help to screen global assets based on demand. Similar to the other profit-oriented institutions, some institutions also possess their own Shariah boards and thereby apply their own screening methods. They also provide financial services by managing their own funds and those of their clients and screen selected global assets. Institutions with their own in-house Shariah boards include AmBank, Bank Islam, CIMB, RHB, Apex, MIDF Amanah and PNB. Those who do not have an in-house Shariah board have to consult independent Shariah advisors in order to comply with the regulatory requirements. Independent Shariah advisors include IBFIM, Amanie, Al-Rajhi, FTSE, Khalij, ZI Shariah Advisory or the Securities Commission of Malaysia. It should also be noted that some users, for example AmBank and Prudential, use more than one Shariah advisors.

Findings and Discussions

The Securities Commission’s Screen

In 1995, with the establishment of its Shariah Advisory Council, the Securities Commission of Malaysia began to classify listed securities as Shariah-compliant or Shariah non-compliant. The screen used was basically the industry screen; that is, whether or not the business of the company is permissible by Shariah. If the main activity is not Shariah-compliant, the firm would be excluded. However, if the main activity is Shariah-compliant but there are elements of Shariah non-compliant activities, the company would be subjected to the filter tests, where the percentage contribution of non-permissible activities to total revenue or net profit would be measured against the appropriate benchmarks. The types of non-permissible activities and their respective benchmarks are shown in Table 2.

With the rapid development in the Islamic financial market domestically as well as globally, the Securities Commission has decided to upgrade its screening procedure so that it is more in line with international practices and is also closer to the requirements of the Shariah. The new screening criteria, which are to be fully implemented by the end of 2013, will consist of a qualitative industry screen and two-tier quantitative screens (Securities Commission, 2013). The Securities Commission stated that “in view of the current development and sophistication of the Islamic finance industry, the screening methodology has now been revised by adopting a two-tier approach to the quantitative assessment which applies the business activity benchmarks and the newly introduced financial ratio
benchmarks while at the same time maintaining the qualitative assessment” (Securities Commission, 2013). For ease of making comparisons, the old and new screening methods are summarised in Table 2.

Table 2 shows that the old screening method has four industry benchmarks. The contribution of Shariah non-compliant activities to the overall revenue or profits before taxes is measured against these benchmarks. There is no financial ratio screen used in the old method. As can be seen by the description of the categories, there exist considerable subjectivity and uncertainties in the classification of activities that is left to the discretion of the Shariah Advisory Council. In the new method, the number of industry benchmarks is reduced from four to only two, which are 5 percent and 20 percent. The 5 percent benchmark is for activities (a) and (b) in the old screen (see Table 2), while the 20 percent benchmark is for activities (c) and (d) in the old screen.

**Table 2** Comparison of the Old and New Equity Screening Methods of the Malaysian Securities Commission

<table>
<thead>
<tr>
<th>Business Activity Benchmark</th>
<th>Old Benchmark</th>
<th>New Benchmark*</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5%</td>
<td>5%</td>
<td>a. Conventional banking; conventional insurance; gambling; liquor and liquor-related activities; pork and pork-related activities; non-halal food and beverages; Shariah non-compliant entertainment; and other activities deemed non-compliant according to Shariah.</td>
</tr>
<tr>
<td></td>
<td>10%</td>
<td>20%</td>
<td>b. Interest income from conventional accounts and instruments; tobacco and tobacco-related activities; and other activities deemed non-compliant according to Shariah.</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>20%</td>
<td>c. Rental received from Shariah non-compliant activities; and other activities deemed non-compliant according to Shariah.</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td>20%</td>
<td>d. Hotel and resort operations; share trading; stock-broking business; and other activities deemed non-compliant according to Shariah.</td>
</tr>
</tbody>
</table>
| Financial ratio Benchmark   | None          | 33%            | 1. Non-compliant cash deposit over total assets  
2. Non-compliant debt over total assets |

Note: *The new screen is applicable as of November 2013.
In addition, the Securities Commission also proposes to screen financial ratios for the first time. Two ratios would be used: (1) cash over total assets and (2) debt over total assets. For the cash ratio, only cash placed in conventional accounts and instruments is included, whereas cash placed in Islamic accounts and instruments is excluded from the calculation. Likewise for the debt ratio, only interest-bearing debts are included in the calculation of the ratios, whereas Islamic debt and sukuk are excluded. Both ratios use balance sheet items and are measured against the same benchmark of 33 percent. It is obvious that these ratios are aimed at measuring the extent of non-compliance in the non-Islamic financial transactions of the company. The benchmark of 33 percent probably has its root in the well-known Hadith of the Prophet that limits donation to one-third of one’s wealth (Obaidullah, 2005). This benchmark is also used in the screening standards of developed markets such as the DJ, FTSE, S&P and MSCI (Derigs and Marzban, 2008). However, the Securities Commission’s definition of cash and total debt includes only the non-compliant component and is considered more appropriate than others that use total debt and total cash whether they are Islamic or not.

There are two positive observations in the new method. First, it is simpler than the old method because a lesser number of benchmarks is used in the industry screen. This should pave the way for a quicker and more economical calculation process. It would also expedite the extraction of relevant information from the companies. Secondly, the idea of using a financial ratio has gained momentum in the international market, and this is included in the new screening method. The financial ratios are aimed at measuring the extent to which the financial management of companies complies with the Shariah principles. Again, with only two ratios to calculate, this would expedite the calculation and classification of companies.

On the negative side, the new screening method is somewhat more restrictive, and this may result in the exclusion of companies that were previously classified as Shariah-compliant by the old standards. This possibility has been alluded to by Abdul-Rahman et al. (2010), who found a drastic reduction in the Shariah-compliant universe when the DJIS screens were applied to the local listed stocks. The upshot of this is that, in the short run, local investors may have fewer companies listed in their Shariah-compliant universe. In the long run, however, it is expected that companies will respond positively to these benchmarks and adjust their operations accordingly in order to qualify for the coveted Shariah-compliant status. One implication of this limitation in the local Shariah-compliant investment field is that local investors may have to look for international diversification of their portfolios.
Qualitative Screen

All twenty-eight institutions included in this review employ a two-stage screening process. The first process is the industry screen. This is a qualitative screening based on whether the main business activity of the company is Shariah-compliant or non-compliant. Companies that pass the industry screen are then subject to quantitative screening. Shariah non-compliant businesses may be classified into five categories based on the nature of the business: *riba* and *gharar*; non-*halal* products; gambling and gaming; immoral activities; and other impermissible activities. This study compiled all prohibited activities as stated by each institution and their respective Shariah advisor or board. In general we find that there is a high degree of agreement among all institutions regarding non-permissible business activities. This is hardly surprising because these prohibitions have clear Shariah rulings on them. The only difference among the users is in the detailed specification of these activities.

We analyse the qualitative information provided by the users in Table 3. For users with multiple Shariah advisors, there are variations among the advisors in the specification of non-compliant activities. Table 3 tabulates the frequency each item is mentioned by the advisors. The information may be summarised as follows:

In terms of *riba* and *gharar* activities, the main activities mentioned are conventional financial services, which are *riba*-based banking and insurance. Many users also include stock-broking or share trading in non-Shariah stocks in this category.

Because non-*halal* products are very clearly defined, there is no variation in the screening by the users. Basically any form of business activity associated with liquor or pork is included.

Gambling and gaming businesses in their various forms are clearly prohibited in Islam and therefore there is no variation in the screen used.

Regarding immoral activities, the most frequently mentioned is “non-permissible entertainment” and pornography. A few users specifically mentioned music, hospitality services, movies and recreations as not permissible in Shariah.

Other impermissible businesses include tobacco products, weapons and defence product manufacturing.

In summary, there is definitely a clear list of activities that are Shariah non-compliant and the majority of institutions have a comprehensive list of them. Companies whose main activities are prohibited by Shariah are deemed Shariah non-compliant and would be rejected, while those that are not involved in any of the prohibited activities are deemed to be Shariah-compliant. This leaves companies with mixed activities that would be subjected to further tests.
Table 3  Shariah Non-Compliant Business Activities: Frequency Distribution

<table>
<thead>
<tr>
<th>Business Activity</th>
<th>Frequency</th>
<th>Percentage (%)*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Riba and Gharar</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Conventional financial services</td>
<td>25</td>
<td>75.53</td>
</tr>
<tr>
<td>Conventional banking</td>
<td>7</td>
<td>20.59</td>
</tr>
<tr>
<td>Conventional insurance</td>
<td>16</td>
<td>47.06</td>
</tr>
<tr>
<td>Stock broking in non-compliant stocks</td>
<td>12</td>
<td>35.29</td>
</tr>
<tr>
<td>Riba-based financial activities</td>
<td>8</td>
<td>23.53</td>
</tr>
<tr>
<td>Others</td>
<td>2</td>
<td>5.88</td>
</tr>
<tr>
<td><strong>Non-halal products</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-halal products</td>
<td>29</td>
<td>70.59</td>
</tr>
<tr>
<td>Liquor and related products</td>
<td>24</td>
<td>64.71</td>
</tr>
<tr>
<td>Pork and related products</td>
<td>22</td>
<td>41.18</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Gambling and gaming</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gambling, casinos, lottery</td>
<td>34</td>
<td>100.00</td>
</tr>
<tr>
<td>Gaming</td>
<td>20</td>
<td>58.82</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Immoral activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-permissible entertainment</td>
<td>30</td>
<td>88.24</td>
</tr>
<tr>
<td>Pornography</td>
<td>24</td>
<td>70.59</td>
</tr>
<tr>
<td>Music</td>
<td>6</td>
<td>17.65</td>
</tr>
<tr>
<td>Hospitality, hotels, resorts</td>
<td>5</td>
<td>14.71</td>
</tr>
<tr>
<td>Cinemas, movies</td>
<td>5</td>
<td>14.71</td>
</tr>
<tr>
<td>Recreation</td>
<td>4</td>
<td>11.76</td>
</tr>
<tr>
<td>Others</td>
<td>3</td>
<td>8.82</td>
</tr>
<tr>
<td><strong>Other Impermissible</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tobacco and related activities and products</td>
<td>32</td>
<td>94.12</td>
</tr>
<tr>
<td>Weaponry and defense</td>
<td>21</td>
<td>61.76</td>
</tr>
<tr>
<td>Other non-permissible activities</td>
<td>32</td>
<td>94.12</td>
</tr>
</tbody>
</table>

*The percentages are based on 34 Shariah Advisors of the 25 users.
Quantitative Screening

Companies with a mixture of Shariah and non-Shariah compliant activities are subject to quantitative screening to test the extent of non-Shariah contribution to the business. Quantitative screening may be subdivided into two categories: non-permissible business percentage and financial ratios.

Non-Permissible Income Screening

At this stage, non-permissible activities identified from the initial business screening are further quantified to check if their level is acceptable by the respective institutions. Table 4 shows the benchmark used by the institutions to test for the contribution of the non-Shariah activities. It can be seen from the table that the Securities Commission operates a four-tier benchmark of non-permissible income: the clearly prohibited activities have a very restrictive benchmark of 5 percent, followed by umum balwa (commonly practiced forms of business) activities with a 10 percent benchmark, mixed rental payment, 20 percent and maslahah (public interest) activities, 25 percent. Recall that these are exactly the same classifications as presented in Table 2 earlier. It is also clear from the table that, with few exceptions, every institution applies the classification of the Securities Commission. This is to be expected as it is a regulatory requirement that all Islamic mutual fund companies comply with the Securities Commission’s classification.

It is interesting to note that twelve of the twenty-five mutual funds have overseas investments (see Table 1) and the screening of these overseas investments is beyond the Securities Commission regulation. Table 4 shows that even those investing overseas do not apply their own screening, except for one user, AmBank, which may be considered a special case in that it has five different Shariah advisors with differences in their screening methods: one advisor follows the Securities Commission’s classification; two advisors have a flat 5 percent screen for all types of non-compliant contributions; and two advisors do not have any quantitative screening at all, which means that a company involved in any form of non-compliant activities, regardless of the amount, would be excluded.

It is further noted that the benchmarks operate on two denominators: total revenue and profit before tax. There are two tests for each benchmark: the first is the gross contribution from the non-compliant sector divided by the gross revenue of the firm. The second is net contribution before tax of the sector, divided by total profit before tax of the firm. Violation of either of these tests would result in the company being dropped from further consideration. Companies that fail the non-permissible income screening are deemed to be Shariah non-compliant, while those that pass the test are further subjected to financial ratio-tests.
Table 4  Benchmark for Non-permissible Income

<table>
<thead>
<tr>
<th>USERS</th>
<th>Clearly prohibited x% TR and PBT</th>
<th>Umum balwa x% TR and PBT</th>
<th>Mixed rental payment x% TR and PBT</th>
<th>Maslahah x% TR and PBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Securities Commission (SC)</td>
<td>5%</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>2</td>
<td>FBM EMAS Shariah Index</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>FBM Hijrah Shariah Index</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Affin</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Alliance</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>AmBank</td>
<td>&lt; 5%</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>7</td>
<td>Bank Islam</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>BSN</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>CIMB</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Hong Leong</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Public</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>RHB</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Amanah Raya</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Apex</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>ECM Libra</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>HwangDBS</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>ING</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Inter-Pacific</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Kenanga</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>MAA</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>MIDF Amanah</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>OSK-UOB</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Pacific</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>PMB</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>PNB</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Pheim</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Prudential</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>TA</td>
<td>SC</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: SC indicates that the institution simply follows the classification of the Security Commission.
Financial Ratio Screen

Use of financial ratios is basically confined to screening of companies’ non-Shariah operations. It is vital to understand that Shariah strongly prohibits *riba* or interest in any form of business or financial transaction. Conventional borrowing and lending, which is interest-based, is therefore not Shariah-compliant. Many scholars are of the view that it is necessary to screen non-compliant financial operations of the companies by looking at selected financial ratios. Previous studies classified financial ratios screening into three types: debt, liquidity and interest. Debt screening is to weed out companies involved in excessive borrowing, while liquidity screening is aimed at assessing the amount of cash and liquid assets. Interest screening is of course to filter the amount of interest income to total income. The interest screen is not included here because interest income will have already been screened either in the qualitative stage or in the non-permissible income stage. Table 5 reports the results of the twenty-eight screen users.

Our compilation of results of the screen users reveals only four users of debt ratio screening – FBM Hijrah Shariah Index, AmBank, CIMB and Prudential. All other users seem to follow the Securities Commission in not having any financial ratio screening. AmBank alone employs five different Shariah advisors with each specifying its own debt ratio screen. The debt ratio benchmark is either 30 or 33 percent, while the denominator used is either total assets or market capitalisation value of equity. Readers interested in exploring the justification for the benchmarks as well as the denominators should refer to previous studies such as Khatkatay and Nisar (2006) and Derigs and Marzban (2008).

Liquidity measures applied by the users and their Shariah advisors consist of three types: accounts receivables, receivables plus cash and cash plus conventional deposits. Similar to debt screening, only four users (eight advisors) apply liquidity screening. Since the Securities Commission of Malaysia has not imposed any official restrictions on liquidity, those institutions that follow the Securities Commission regulation have not set any limit on liquidity. Shariah boards of Amanie, AmBank, Al-Rajhi and CIMB apply a 33 to 49 percent benchmark to total receivables over total assets or market value of equity. FTSE as the Shariah advisor for the FBM Hijrah Shariah Index is the only board that applies receivables plus cash of 50 percent limit over total assets. For cash plus conventional deposits, the limit varies between 30 percent and 33 percent of total assets or market value of equity.
### Table 5 Financial Ratio Screen

<table>
<thead>
<tr>
<th>User</th>
<th>Shariah Advisor</th>
<th>Debt Screen</th>
<th>Liquidity Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total Debt</td>
<td>Receivables</td>
</tr>
<tr>
<td>Securities Commission</td>
<td>SAC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FBM EMAS Shariah Index</td>
<td>Securities Commission</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FBM Hijrah Shariah Index</td>
<td>FTSE, SC</td>
<td>33% TA</td>
<td>50% TA</td>
</tr>
<tr>
<td>Affin</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alliance</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AmBank</td>
<td>Amanie Advisors Sdn. Bhd.</td>
<td>33% MVEq</td>
<td>49% MVEq</td>
</tr>
<tr>
<td></td>
<td>Khalij Islamic (BVI) Limited</td>
<td>30% MCap</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Shariah Advisory Board</td>
<td>33% AvMCap</td>
<td>45% AvMCap</td>
</tr>
<tr>
<td></td>
<td>Shariah Supervisory Board</td>
<td>33% AvMCap</td>
<td>33% AvMCap</td>
</tr>
<tr>
<td></td>
<td>Al Rajhi Banking &amp; Investment Corp (M) Bhd</td>
<td>30% MCap</td>
<td>45% AvMCap</td>
</tr>
<tr>
<td>Bank Islam</td>
<td>Shariah Panel, SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSN</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CIMB</td>
<td>CIMB Islamic Bank Berhad</td>
<td>30% AvMCap</td>
<td>45% TA</td>
</tr>
<tr>
<td>Hong Leong</td>
<td>Amanie Advisors, SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>ZI Shariah Advisory Services</td>
<td></td>
<td></td>
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<td>RHB</td>
<td>RHB Islamic Bank Berhad</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amanah Raya</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apex</td>
<td>Shariah Committee, SC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ECM Libra</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HwangDBS</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ING</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inter-Pacific</td>
<td>Amanie Advisors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenanga</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MAA</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MIDF Amanah</td>
<td>MIDF Shariah Committee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OSK-UOB</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pacific</td>
<td>BIMB Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PMB</td>
<td>BIMB Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PNB</td>
<td>Shariah Committee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pheim</td>
<td>Amanie Advisors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prudential</td>
<td>Amanie Advisors</td>
<td>33% AvMCap</td>
<td>45% MCap</td>
</tr>
<tr>
<td>TA</td>
<td>IBFIM</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: *IBS = Interest bearing securities.
It should be mentioned that the use of a financial ratio is still subject to much debate, both in the ratio specification as well as in the critical cut-off point. For example, should we include all debts or just conventional debts in calculating the debt ratio? Filtering the involvement of companies in interest-based financing has merit in the sense that this is a clearly prohibited transaction, but there is no clear Shariah ruling on companies operating on high leverage if the debts are Shariah-compliant. Secondly, it may be understandable to screen for cash placed in conventional money-market instruments and other short-term deposits, not as a measure of liquidity per se, but rather as an additional measure of Shariah non-compliance in financial management. This is indeed the position taken by the Securities Commission in its new screening methodology. However, there is an alternative view as explained by Khatkatay and Nisar (2006) and Shaikh (2010), that Islam does not allow income to be derived from liquid assets. According to this view the market value of liquid assets is equal to the residual of the market value of equity after netting out fixed assets and external financing. Some Islamic scholars have stated that there should be a limit to this market value of liquid assets. Flaws to this approach have been pointed out by Khatkatay and Nisar (2006).

Summary and Conclusion

This study reviews twenty-eight equity screen users in the Malaysian Islamic capital market. The objective of this review is to document the various screening processes and to draw out common rules and practices. The users are mainly mutual fund managers affiliated with various financial institutions such as investment houses, banks and insurance companies. The comprehensive data also include the Securities Commission and two major Shariah index providers. Information on the screening practices is obtained from the official sites of the respective users and their financial advisors during 2012.

The foremost screen provider in the Malaysian Islamic capital market is the Securities Commission, the capital market regulator, which began to screen for Shariah-compliant securities in 1995. The Securities Commission, with the overriding objective to develop the Islamic capital market, employs a more liberal screening process that allows more securities to be classified as Shariah-compliant. The screen applied is the industry screen that filters companies based on the percentage of the Shariah non-compliant component in the companies’ income. Nevertheless, the Securities Commission has announced that it would begin to apply the industry as well as financial ratio screens beginning in November 2013, a move that is seen as more in line with international practices.
Reviewing the practices of the rest of local screen users, it is found that the majority of these users follow the practice of the Securities Commission. We also found that all users apply both qualitative and some form of quantitative screening processes. The qualitative screen filters companies that are clearly Shariah non-compliant based on their main business activities. Those passing the qualitative screen are then subjected to non-permissible income screening, which is the first part of the quantitative screening. In this stage the percentage contribution of various non-permissible incomes is measured against their respective benchmarks. Those passing this stage are further tested by financial ratio screening. Two ratios are basically applied in the financial ratio screening – debt ratio and cash ratio – and these are measured against pre-determined benchmarks. Most users apply either a 30 percent or 33 percent benchmark based on either total assets or equity market values.

Policy Recommendations

• From a policy standpoint, the Securities Commission needs to strike a balance in its role between regulating and developing the Islamic capital market. A strict screening standard would have the effect of reducing the universe of Islamic securities and thus curtail the development and growth of the Islamic capital market. On the other hand, too liberal screening processes may jeopardise the local market in the eyes of international Islamic investors.

• The move to use financial ratios in addition to the simplification of the current non-permissible income screening may be considered as the right combination to move forward.

• Shariah screening would result in only a subset of the entire market being available to Islamic investors, putting them at a disadvantage from the perspective of an efficient portfolio.

• It is hoped that more securities would be encouraged to be Shariah-compliant in the future and in the meantime investors should aggressively screen international securities to expand their investment universe in order to achieve equitable returns.

• Debt is a worrying problem and a major driver of financial crises. Hence the limits on debt-based trade and finance should be carefully observed. This recommendation stands for both Islamic and conventional finance.

• Furthermore, regulatory authorities and government should reconsider the tax incentives given to debt-based financing. At present debt- and credit-based financing is preferred to asset-backed transactions simply because of the tax advantages for debt, which make it more appealing. These incentives should be reconsidered.
References


Notes

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1. Our attempts to obtain information from other investment institutions such as EPF, KWAP, LTAT, Takaful and Tabung Haji have not been successful. Therefore we are unable to include them in our analysis.
FROM GOLDSMITHS TO MODERN BANKING
A Frank Look at the Money-Creation Process and its Relevance to Islamic Banking

Yusuf Jha

Abstract: This paper discusses the role interest has played in the modern financial system, highlighting the money creation process in particular and the key questions that arise within Islamic Finance as a result. The paper contends that the legalisation of interest built the foundations for much of our modern day financial architecture with the modus operandi of commercial banking being its central element. As a result, money today is mainly created as interest-bearing debt with a host of associated consequences. Among these are an artificial economy of scarcity, endemic debt pressure, constant inflation, wealth polarisation, an ever present risk of default, and the environmentally irreconcilable paradigm of perpetual growth. Consequentially the interest-based modern financial system has seemingly set the world on a path necessitating an incessant demand to privatise, commoditise, and monetise ever increasing amounts of the earth’s resources, causing us to live in an age where finance\(^1\), energy\(^2\), health care\(^3\), and the ecosystem\(^4\) are reportedly headed towards imminent collapse. The question for Islamic finance practitioners is whether their discipline as currently practiced is actually providing a solution towards tackling these crises, or whether it is instead normalising the problems within an “Islamic” framework.

Introduction

The history of modern banking can be traced back to the societal tolerance accorded to interest/usury in Western Europe in the seventeenth century and the effect on one group in particular, the goldsmiths. Goldsmiths were originally depositaries for gold or commodity money, who kept gold deposits safe from the public in return for receipts promising payments and redemption to the bearers of those receipts. In what was eventually to become the antecedent of today’s financial system, sixteenth-century goldsmith bankers, upon discovering that their receipts had in fact become de facto currency and that the proportion of receipts redeemed was far less than those issued, subsequently began issuing and lending amounts exceeding the total amount of gold they actually kept.

Crucially, instead of printing receipts to spend on their own consumption, they chose instead to lend them (at interest), whereby they would still be in control of the newly created money, thus allowing them to destroy the money upon repayment (and keep the interest). The key to all of this was the interest, which they could keep as a valid profit. Thus we see that the newfound legality
of interest was a key lever in promoting the goldsmiths to the fore as a class of the financial elite.

The pointer to their commercial success lay in the question as to where the interest would come from. As the goldsmiths’ money came into existence as interest-bearing debt, the money to be repaid was always more than that which had existed. What this meant was that (unless the economy was perpetually growing) such interest could only be repaid at someone else’s expense. The goldsmiths had thus instituted a zero-sum game in their own favour. This was arguably the greatest business idea ever invented. The business model of creating fictional money as interest-bearing debt, destroying the created money before subsequently keeping the interest, still exists today in what we have come to know as commercial banking, more aptly described as “institutionalised usury” (Rowbotham, 1998, 26).

<table>
<thead>
<tr>
<th>STEP 1: MAKING INTEREST PERMISSIBLE</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Whom:</em> In early 16th century, primarily Christian Reformists in Western Europe, such as Luther and Calvin</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>STEP 2: BIRTH OF MODERN BANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Whom:</em> In 16th century, goldsmiths who kept gold deposits and issued receipts in exchange to be redeemed later</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>STEP 3: CREATION OF FIRST CENTRAL BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Whom:</em> In 1694, banks in England lent King William $1.2 million at interest to fight his War of Succession</td>
</tr>
</tbody>
</table>

Figure 1: Showing the key steps that resulted in modern banking, the “institutionalisation of interest”

Present day commercial banks employ a money creation process that is simpler still. Unlike the goldsmiths of old, most of modern money is created “ex nihilo” by simply making an accounting entry in a bank’s ledger, i.e., by simply entering digits on a screen.
Strange to believe but true, as former Harvard Business School lecturer and award winning author David. C. Korten notes, “When a loan is issued, the bank’s accountant enters two numbers in the bank’s accounting records: she records the borrower’s promise to repay the loan as an asset, and the money the bank puts into the borrower’s account as a liability... With the accountant’s entries, the bank created new money from nothing in the amount of the loan principal and caused the amount of money in the economy as a whole to increase” (2010, 37). In similar fashion, Sir Mervyn King, the Governor of the Bank of England, says, “When banks extend loans to their customers, they create money by crediting their customers’ accounts.” Likewise, Martin Wolf, the chief economics editor for the Financial Times, says, “The essence of the contemporary monetary system is creation of money, out of nothing, by private banks’ often foolish lending.”

And this is only natural, for as Ryan-Collins and others (2011, 4) demonstrate, “Banks do not need to wait for a customer to deposit money before they can make a new loan to someone else. In fact, it is exactly the opposite; the making of a loan creates a new deposit in the customer’s account.”

But clearly this differs from what most people assume. Popular thought has always been that banks actually lend from money acquired, that they perform the function of financial intermediaries by taking money from savers and lending this money out to borrowers. The chairman of the Financial Services Authority (UK), Lord Adair Turner, articulately corrects this misconception: “The banking system can thus create credit and create spending power – a reality not well captured by many apparently common sense descriptions of the functions which banks perform... ; in fact they don’t just allocate pre-existing savings, collectively they create both credit and the deposit money which appears to finance that credit.”

Today due to the institutionalisation of interest and the advent of digital money, roughly 97 percent of modern money comes into existence as interest-bearing debt; i.e., it “comes into being only when someone promises to pay back even more of it.” As a result, it follows that either some of these loans must end up in default, or that the supply of money must continually grow. In practice, fiscal policy seems to be a balancing act between these two extremes. On the one hand, there is the need to continually grow so as to prevent the first option and on the other hand there is a cap on the alternative option, i.e., growing too much, for when money is created, “in amounts exceeding the ability of the economy to create new goods and services, the result is inflation” (Eisenstein, 2007, 269). Thus today the entire global economy is trapped in a trajectory of seeking “non-inflationary economic growth—an increase in the production of goods and services ... [and] the relentless conversion of life into money” (Eisenstein, 269).
How exactly does this happen?

The key to understanding how banks create money is to recognise the different types of money in existence.

In essence, there are at present three types of money:

3. Commercial bank money – bank deposits created when commercial banks lend money, thereby crediting credit borrowers’ deposit accounts.

While the state creates the first two types of money, the money that actually circulates in the general economy is only of types 1 and 3. Of these, physical cash generally accounts for less than 3 percent of the total stock of money in the economy. Commercial bank money (exclusively created by commercial banks), credit and coexistent deposits, makes up the remaining 97 percent of the money supply.

What is commercial bank money?

Perhaps the simplest way to explain commercial bank money is to recognise that the system allows an extension of a liability from a bank, effectively an IOU, as an accounting entry, to be treated as money.

As Ryan-Collins and others state, “An IOU from a friend is not acceptable at the tax office or in the local shop, an IOU from a bank most definitely is.” (2011, 3) The result is that “banks create new money whenever they extend credit, buy existing assets or make payments on their own account, which mostly involves expanding their assets, and that their ability to do this is only very weakly linked to the amount of reserves they hold at the central bank” (3).

There is nothing controversial about this statement, for standard economic theory recognises this concept, as it is not uncommon to study the money multiplier effect in economic text books. In fact many Central Bank documents themselves usually state this; a Chicago Federal Reserve Bank paper explicitly states that the “actual process of money creation takes place primarily in banks” (Modern Money Mechanics, 1994, 3). Likewise a recent Bank of England paper says, “By far the largest role in creating broad money is played by the banking sector... When banks make loans they create additional deposits for those that have borrowed the money.” In fact the definition of broad money itself is defined by the Deputy Governor for Financial Stability in the Bank of England as an accounting entry; Paul Tucker says, “[Banks] can lend simply by expanding the two sides of their balance sheet simultaneously, creating (broad) money.”

All of these quotations and more testify to the fact that the creation of money...
in the UK and across the world has effectively been privatised in the hands of commercial banks. In other words commercial banks effectively create almost all of the money in the world as debt when they lend. This has a wide range of rarely discussed consequences and effects upon the economy and society, which this paper hopes to discuss. But before that we intend to focus on the money multiplier theory, which though instructive, is not entirely accurate.

**What is the money multiplier theory?**

The standard money multiplier theory states that the amount of money that can be created is limited by a centrally agreed reserve ratio, thus implying an implicit cap on or control of the amount of money created by the private banks. This theory is widely taught in economics and banking courses across the globe. Despite its wide acceptance, the theory has its limitations and may lead to wrong assumptions with regard to banking and the money creation process, something we will seek to clarify and discuss later.

In broad terms the theory argues that an agreed reserve ratio will control the amount of money that can be created. For example, a 10 percent reserve ratio will only allow for a 90 percent increase. This is because as a Chicago Federal Reserve document states, “Since only $10 must be held against the new $100 in deposits, $90 is excess reserves and can give rise to $900 of additional deposits” (Modern Money Mechanics, 16).

The figure below illustrates how this happens. Using an initial deposit of $100 as an example, this figure shows how theoretically the various reserve requirements can lead to the different amounts of money creation.

![Diagram showing money creation with varying reserve ratios](image)

**Figure 2: Showing monetary expansion with varying reserve ratios (Open Source)**
In order to further illustrate the money creation process, let us take a scenario whereby a bank receives a deposit of £100,000 in cash. As a result of using the principle of double entry book-keeping, both its assets and the total of its liabilities to its customers would rise by the same amount.

We then take a bank’s liability-to-cash-reserve ratio as being 10:1. This would mean that the bank can now lend out 90 percent of whatever deposit it has received, thereby creating further deposits throughout the banking system in the process show below. The key to the money creation process is that this 90 percent is not taken from existing money (in this case £100,000), for if that were to happen, no extra money would be created. Rather, this money is created out of nothing, as mentioned, simply as an accounting entry (Korten, 37). This means that if each bank across an economy takes in a deposit and creates new loans to the degree of 90 percent of whatever deposit it had received (while keeping the existing money), then assuming the money circulates ad infinitum in a closed economy, we would have a scenario of money creation similar to the table below:

<table>
<thead>
<tr>
<th>Bank Account (in same of a different bank)</th>
<th>Deposit in GBP</th>
<th>Loan in GBP</th>
<th>Cash Reserve Requirement</th>
<th>Cash Reserves in GBP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100,000</td>
<td>90,000</td>
<td>10%</td>
<td>10,000</td>
</tr>
<tr>
<td>2</td>
<td>90,000</td>
<td>81,000</td>
<td>10%</td>
<td>9,000</td>
</tr>
<tr>
<td>3</td>
<td>81,000</td>
<td>72,900</td>
<td>10%</td>
<td>8,100</td>
</tr>
<tr>
<td>4</td>
<td>72,900</td>
<td>65,610</td>
<td>10%</td>
<td>7,290</td>
</tr>
<tr>
<td>5</td>
<td>65,610</td>
<td>59,049</td>
<td>10%</td>
<td>6,561</td>
</tr>
<tr>
<td>6</td>
<td>59,049</td>
<td>53,144</td>
<td>10%</td>
<td>5,905</td>
</tr>
<tr>
<td>7</td>
<td>53,144</td>
<td>47,830</td>
<td>10%</td>
<td>5,314</td>
</tr>
<tr>
<td>8</td>
<td>47,830</td>
<td>43,047</td>
<td>10%</td>
<td>4,783</td>
</tr>
<tr>
<td>9</td>
<td>43,047</td>
<td>38,742</td>
<td>10%</td>
<td>4,305</td>
</tr>
<tr>
<td>10</td>
<td>38,742</td>
<td>34,868</td>
<td>10%</td>
<td>3,874</td>
</tr>
<tr>
<td>11</td>
<td>34,868</td>
<td>31,381</td>
<td>10%</td>
<td>3,487</td>
</tr>
<tr>
<td>12</td>
<td>31,381</td>
<td>28,243</td>
<td>10%</td>
<td>3,138</td>
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<td>13</td>
<td>28,243</td>
<td>25,419</td>
<td>10%</td>
<td>2,824</td>
</tr>
<tr>
<td>14</td>
<td>25,419</td>
<td>22,877</td>
<td>10%</td>
<td>2,542</td>
</tr>
<tr>
<td>15</td>
<td>22,877</td>
<td>20,589</td>
<td>10%</td>
<td>2,288</td>
</tr>
<tr>
<td>16</td>
<td>20,589</td>
<td>18,530</td>
<td>10%</td>
<td>2,059</td>
</tr>
<tr>
<td>17</td>
<td>18,530</td>
<td>16,677</td>
<td>10%</td>
<td>1,853</td>
</tr>
<tr>
<td>18</td>
<td>16,677</td>
<td>15,009</td>
<td>10%</td>
<td>1,668</td>
</tr>
<tr>
<td>19</td>
<td>15,009</td>
<td>13,509</td>
<td>10%</td>
<td>1,501</td>
</tr>
<tr>
<td>20</td>
<td>13,509</td>
<td>12,158</td>
<td>10%</td>
<td>1,351</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>N</td>
<td>1,000,000</td>
<td>900,000</td>
<td>10%</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Figure 3: Showing monetary expansion in tabular format
As the table above shows, with an initial £100,000 and a 10 percent reserve ratio, £900,000 can be created out of nothing. In effect, with a 10 percent reserve requirement, the banking system as a whole has the capacity to create 90 percent extra money based on the initial deposit.

In formulaic terms, the money multiplier is expressed as: 

$$m = \frac{1}{R}$$

Where $m$, the money multiplier is the inverse of the reserve requirement, $R$.

Is the money multiplier theory entirely accurate?

While the money multiplier as standard economic discourse recognises the fact that banks create money out of nothing from an initial deposit, it is still not entirely accurate. For inherent in the money multiplier theory is the assumption that central banks and reserve ratios actually control the money expansion process. This is not true, at least not in the case of most Western countries, with the UK being a prime example.

For the UK specifically, following deregulation in 1981 of domestic and international finance, banks choose their own reserve targets rather than have them determined by a balance sheet ratio of any kind. Such changes are in keeping with today’s world of globalised capital flows and banking services which has seen a shift away from domestic regulation and ratios to an international regime of banking regulation with policy developed by the Basel Committee on Banking Supervision (commonly referred to as the Basel Accord). With the Basel Committee itself being a private body of central banks and regulators linked to the Bank for International Settlement (BIS), the Basel Accord rules are not formally binding through any national regulators but instead are targets specified by multilateral regulatory authorities (such as the EU in Brussels) that pertain to the solvency assurance of banks (their capital adequacy specifically). While the recent banking crisis has demonstrated that previous Basel Accord ratios (I and II) have all been circumvented by the use of derivatives, off-balance sheet Special Purpose Vehicles (SPVs), and a range of innovative capital instruments, the latest round of revised Basel Accord rules (Basel III) already seems to indicate a similar direction with the introduction of perpetual Tier 1 capital notes. All of this has led several observers to consider the Basel committee itself to be strongly influenced by the goals of the largest banks in industrialised countries, which is a conflict of interest. The upshot is that with no local regulatory ratios and with global regulatory standards such as the Basel Accord (I, II and recently III) being both loosely applied and easily circumvented, there are effectively no limits on credit expansion for banks and no limits barring the possibility of the banks not receiving the newly created credit back. Banks would then have to take the losses from the defaulted loans on their balance sheets, which explains their reluctance to lend in difficult times.
In short, it seems banks lend first and look for reserves later, as the economist James Galbraith notes: “If anyone believes that reserves are key to lending, they deeply misunderstand what banks do.”

He quotes the late economist Hyman Minsky who writes, “Banks don’t lend reserves, and they don’t need reserves in order to lend. Banks create money by lending. They need a client willing to borrow, a project worth lending to, and collateral to protect against risk. If these are lacking, no amount of reserves will turn the trick. And especially not when the government is willing to pay interest on their reserves: the truest form of welfare, income for doing nothing.”

How is it relevant that banks create money out of nothing?

Today, given the nature of money, our entire financial system survives on debt. Debt is how money comes into existence and indebting others is how banks make profit. Thus banks need to produce more and more debt and we need to take on more of it to simply survive; ironically the more debt we take on, the more in turn to survive we need. This pressure of debt-based systemic growth ensures that soon as growth slows, debt rises faster than income and the intensifying debt pressure fuels increasingly desperate attempts to extract more money from somewhere (other people, nature, etc.). Politically, these efforts translate into the very policies encouraging growth that could be said to be collectively destroying the planet itself.

The money-creation process and the imperative of perpetual growth it introduces have today brought about a series of crises and challenges. Below are just some of the features (among others) that are impacting the global economy:

1. Artificial scarcity. As Bernard Lieter says, “For a bank-debt-based fiat currency system to function at all, scarcity must be artificially and systematically introduced and maintained” (2001, 47). We are meant to compete with each other and “rationally” maximise our self-interest in order to operate and survive within the system, thus systematically destroying community ties and communal links. This loss of community occurs because “the current money system obliges us to incur debt collectively, and to compete with others in the community, just to obtain the means to perform exchanges between us” (Lietar, 52). Is it any wonder that the assumption of scarcity is one of the two central axioms of economics, with the second principle being that people naturally seek to maximise their rational self-interest. On reflection, the two axioms may be interrelated, perhaps even mirror-images. As Eisenstein says, “Greed makes sense in a context of scarcity.” Such greed systemically introduced by the financial system has resulted in an epidemic of mental illness and emotional distress that has gripped much of the modern world.
2. Trade distortion:\textsuperscript{22} Another by-product of the money-creation process is its effect on the nature of trade itself. As a result of ever-expanding debt, the parameters of trade are distorted. Such distortion is at the level of market prices as supply and demand change through inherent inflation, with property prices a case in point.\textsuperscript{23} Alongside such systemic price distortion, is polarisation in wealth accumulation, which in turn leads to monopolistic lines of trade in both the supply and distribution chain. In modern times, nowhere is this more evident than in the Wal-Mart phenomenon.\textsuperscript{24} Another aspect of the distortion of trade is the financialisation of capital itself as an ever-increasing money supply entails an eventual cannibalisation of money itself, causing both the trading of capital on the foreign exchange markets and trading on positions on capital in the financial derivatives markets to become the bulk of what is considered trade today. Collectively, today’s foreign exchange (forex) and financial derivatives markets dwarf anything else on our planet. In 2010, the volume of foreign exchange transactions reached US$ four trillion per day, whereas one day’s exports or imports of all goods and services in the world amounted to about 2 percent of that figure. It is worth reflecting on this figure, for as Lietar and others go on to say, this means that “98 percent of transactions on these markets are purely speculative” (12). With regard to derivatives, Korten writes: “The total notional amount of over-the-counter derivatives still outstanding totalled an eye-popping $604.6 trillion in June 2009, compared with an estimated 2009 gross world product of $58 trillion” (118).\textsuperscript{25} In effect, as Lietar and others similarly state, this was over eight times the entire world’s annual GDP in same year. Is it any wonder that those writers state that the nature of our money supply has today caused global trade to be akin to a global casino.

3. Inherent booms and bust: The focus of trade on capital itself and its further divestiture into derivatives (options, futures, swaps, etc.) have led us to a situation wherein “waves of credit” as described by Lietar are more like a “financial tsunami” than waves in a calm sea. This volatility and the consequent repercussions create financial instability. According to the London based think tank, International Financial Services London (IFSL): “During the financial crash of 2008, the global total of asset-backed securities issued and sold to investors fell by 79 percent to $441 billion, as overleveraged borrowers, banks and investors exited the market.”\textsuperscript{26} All of this speculation has seemingly come at a cost; as Lietar noted: “According to the IMF, between 1970 and 2010 there were 145 banking crises, 208 monetary crashes and 72 sovereign-debt crises—in other words, a staggering total of 425 systemic crises, an average of more than 10 per year! These crises have hit more than three-quarters of the 180 countries that are members of the IMF, many of them being
hit several times” (12). These results too are systemic: within the logic of the money creation dynamic, a boom and bust is a reboot mechanism to further concentrate capital.

4. The privatisation and patenting of life itself: Eisenstein writes, “The imperative of perpetual growth implicit in interest is what drives the relentless conversion of life, world, and spirit into money. And yet ... this entire process is considered rational in traditional (neoclassical) economic theory ... [wherein] the very definition of a ‘good’ is anything exchanged for money” (272). Today, through perpetual growth, forms of natural capital that were hardly recognised have become property, as multilateral agreements such as the International Property Rights (TRIPS) aim to force developing countries to extend property rights to indigenous seeds and plant varieties. Corporate property rights to individual plant genes have already been granted, thereby potentially impacting agricultural practices that two-thirds of the world rely upon for their livelihoods. Likewise, indigenous cultural and local knowledge is increasingly sought to be patented while viable treatments and cures are denied to the needy on the basis of such patents. When six corporations own 70 percent of patents on staple food crops, when the electromagnetic spectrum sequences of genetic DNA, and even the earth’s capacity to absorb industrial waste are privatised, something has definitely gone wrong with the world and how we see property. These issues too are linked to the nature of our money supply.

5. Wealth polarisation: As world debt increases because of the nature of the money supply, the corporate interests served by the debt allow for the rich to get richer. Over the last decade, more and more wealth has been concentrated in fewer and fewer hands. When the top three richest individuals in the world own more wealth than the combined GDPs of the 48 poorest countries in the world, when of the world’s largest 100 economic entities, 51 are corporations and 49 are countries, when the world’s richest 2 percent own 51 percent of the world’s assets while the poorest 50 percent own only 1 percent of its assets, we have a problem. Such wealth polarisation is systemic to the money creation process, for even in America, purportedly the world’s richest nation state, fewer than 7,500 individuals collectively control “almost 75 percent of the nation’s industrial (nonfinancial) assets, almost two-thirds of all its banking assets and more than 75 percent of all insurance assets.” These effects are most manifest in the developing world. Today the average European cow is richer than 75 percent of Africans. In fact, according to the World Bank, 95 percent of all people in developing countries, which means about 80 percent of all human beings, are living on less than $10 a day. Such uneven wealth redistribution is systemic and is tied to the nature of the interest-based money creation process as Dr Margrit Kennedy (1995) and others explain.
6. Ecological destruction: The pressure to perpetually grow and pay off debt is what makes the clearance of rainforest for the growing of monoculture (mostly palm oil) plantations sound economic sense. As Eisenstein writes, “This is how the destruction of a forest to create 100,000 board feet of lumber is, preposterously, counted as an increase in wealth. The forest no longer contributes to soil stability, oxygen production, climate stability, biodiversity protection, and so on, but those losses are not included in the price of a plank of lumber.” The demands of perpetual growth have also contributed to a gradual exhaustion of the remaining supplies of accessible petroleum, destruction of the world’s fisheries and rain forests and an increasing poisoning of the air and water. With every summer getting hotter and every winter getting milder, with a continual incremental increase in the melting of Arctic ice (with some predictions that it will be almost free of ice within the next fifty years) and with the result that the sun is warming our oceans, there is a good deal to be concerned about. With estimates stating that more than a million species worldwide are likely to be driven to extinction by 2050, with half of the world’s tropical and temperate forests now gone, with an estimated 90 percent of the large predator fish now gone, with more than one significant scientist saying on record that this may be the last century for the human race, we have more than a problem! And this problem is linked to the money supply as testified to by a figure as mainstream as the former administrator of the United Nations Development Program, James Gustave Speth, who when writing about impending environmental doom asks what he calls the big question, namely, “How can the operating instructions for the modern world economy be changed so that economic activity both protects and restores the natural world?” Perhaps the best way to answer his question is to look at the roots of the system, the nature of bank money coming into existence itself as interest-based debt.

The above effects and more are indicative of the money creation process and its demand for perpetual economic growth. In fact, today our very societies and the very institutions that engage in commerce are premised on the logic of having to ensure the perpetual growth of capital.

Armor, Hansman and Kraakman state that the five core structural characteristics of the business corporation are: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralised management under a board structure, and (5) shared ownership by contributors of capital (2009, 7). In their paper they state, “These characteristics have strongly complementary qualities for many firms. Together, they make the corporation uniquely attractive for organising productive activity (namely, the maximisation of capital)” (7).
The logic of maximising capital (at all costs and at the expense of a lot besides) has been described by former Harvard University Business School Professor David Korten as one that destroys life. He writes: “The publicly traded, limited liability corporation is more accurately described as a pool of money with special legal rights and protections dedicated to self-reproduction. The People, including the CEO and directors, can be dismissed without recourse. Only the money, which the corporate officers are legally bound to serve, has rights. In theory it is the shareholders whom management serves, however, since most shares are held in trust by various institutional investors, the real shareholders are generally invisible even to the corporate officers. Management’s real focus is on the money, not the shareholders. In effect they are hired by money to nurture its growth and reproduction even at the expense of life.”

The logic of money maximising its own growth even at the expense of life is ultimately the logic of interest-based money and the institutions and regulation it has founded. The problem is that it was within these institutions and regulation that Islamic Finance sought to emerge.

Was that a proper direction to take? By doing so and having Citibank and Goldman Sachs as the prime owners of “Islamic” assets today, have Islamic banks contributed to this process of systemic global destruction, or have they proposed a solution to this process?

**What is the role of Islamic banks in the money creation process?**

Saleh Kamel, founder of the Dallah al-Baraka group, in his acceptance speech for the Islamic Development Bank prize in Islamic Banking, 1996, said:

I tell you, truthfully and without pretence ... that we went beyond choosing the “bank” label [in “Islamic Banking”], to the point of adopting its central essence ... Consequently, we failed to give our financial institutions any characteristics beyond simple financial intermediation. This is accomplished through Islamic banks’ favourite investment modes that are essentially a hybrid between loans and investment; which hybrid carries most of the characteristics of usurious loans.

For the most part Islamic banks (as currently existing) in their regulation, operational expectations, operational dynamics and organisational structures appear to be entirely the same as commercial banks (Asutay, 2007; Siddiqi, 1999). In practice, the only place they seem ostensibly different is at the transactional level (as they do not extend usurious loans), so it is instructive to analyse the impact this has had, if any, on the money creation process.

First, Islamic banks, just like their conventional counterparts, effectively create bank credit as money out of nothing, i.e., ex nihilo. This they do whenever they enter into a financing transaction. This money in keeping with standard
bank credit comes into existence on the back of financing documents wherein an accounting entry as a liability to the customer from the Islamic bank appears as digital money in the customer’s bank account. Up to this stage the process is remarkably similar to that of conventional banking apart from one difference: when an Islamic bank introduces newly created bank credit as a liability, it does this to finance an asset (or service) and hence could be said to create money that is linked to the asset.

This (money creation linked to an asset) represents a crucial demarcation for some Islamic scholars in Islamic Finance, for while scholars such as Mufti Taqi Usmani accept the inherent expansionary elements of bank credit money through its fractional reserve nature and its subsequent contribution to monetary debasement and inflation (Usmani, 2001), they have not been so forthcoming with regard to Islamic banks. As Mufti Taqi notes, the problem of “artificial money supply ... multiplied without creating real asset in the same quantity” can be solved via Islamic Banking because it is “backed by asset, [therefore] it [money supply] is always matched with corresponding goods and services” (Usmani, 2005, 21-22).

In effect, the claim is that even though Islamic banks create money out of nothing (like their conventional counterparts), they create it relative to the sale/financing of an asset and hence the credit or money creation by Islamic banks is non-inflationary and will not lead to a debasement of the currency and other related social evils. The logic is that despite Islamic banks’ operating on the same reserve basis and money creation paradigm as conventional banks, an increase in the money supply brought by Islamic banks would occur only when an asset is in existence and hence is non-inflationary. With the additional caveat that the Islamic Bank first has to take ownership of the assets to finance it (be it constructive or otherwise) before selling it on, then all the money creation would theoretically be backed by real assets/real economy.

Arguably, what Mufti Taqi and other scholars who support this argument have stated is the equivalent of the ‘Real Bills Doctrine’ (RBD), a theory that assumes that “inflationary over issue is impossible provided money is issued on loans made to finance real transactions” (Humphrey, 1982, 4). Before analysing the effectiveness of RBD as a theory, it is important to note that by claiming credit expansion in Islamic banks to be non-inflationary and equivalent to RBD, Islamic scholars are essentially making an economic argument. The question as to whether money can actually be created out of nothing as a debt still remains a valid Shariah question to ask, and will be dealt with later.

The RBD theory was initially proposed by bankers themselves, arguably with spurious motives. They sought to justify the credit creation by commercial banks on the basis that such new credit was going towards productive activities,
and hence, they argued, it wasn’t inflationary. It is important to mention that this theory has generally been held in ill repute and is considered discredited by economists since the 1950s, mainly on the basis that all monetary creation from commercial banking is inherently inflationary due to the introduction of a future greater debt, namely, the interest. It is the interest that drives forward an inflation spiral due to the fact that the amount of money being paid back to the banks is always greater than the current money supply. The only way such a spiral can be stopped would be for the money created genuinely to go towards productive purposes with no cost of capital. Let us see how Islamic banks fare in this regard.

In the context of Islamic Banking (as currently practiced), there are three key issues about the credit creation process that show a parallel to that of commercial banks:

1. **The asset ownership Islamic banks assume is incidental.** Credit creation on the back of a “sale” for Islamic banks is a means to facilitate the creation of debt money. This often means there is a single asset with multiple exchanges, as in the case of Banking Tawarruq. Likewise, when a piece of land, a vehicle, or machinery, etc., is “purchased” many times over simply for seeking the services of a financial intermediary, each step involves the creation of credit for the same asset or commodity. This means that such a sale is not a productive one but an incidental one to facilitate debt. Issuing newly created money to an existing stock of goods is not the same as producing more goods as such bank credit does not fund production but instead creates nothing but credit expansion, entirely similar to its conventional counterpart.

2. **Credit comes into existence with a corresponding cost of credit.** When Islamic banks create credit on the back of a sale, this newly created money has the banks crediting themselves in return for the corresponding amount of money plus the profit (with the profit being inevitably benchmarked to the prevalent interest rate, namely, the cost of credit). What this means is that by adopting the paradigm of money only coming into existence as interest-bearing debt, Islamic banks though seeking to justify their profits (as linked to sales), continually perpetuate the problem of there being insufficient money in existence to repay the debts created by the banking system itself. This means that Islamic banks continue the perpetual growth paradigm with the same logic and ill effects created by the conventional commercial banks as discussed earlier.

3. **Credit creation in Islamic banks causes an inflationary spiral.** As Islamic banks continually benchmark their profit differential to LIBOR, EBOR, etc., they produce and perpetuate a continual rather than merely a one-time rise in money and prices. The Interbank interest-based benchmark is designed to be always profitable when compared to production costs (so as to stimulate borrowing), but the increased cycle of borrowing needs more lending, greater
monetary expansion, and still higher prices, and so continues ad infinitum in a cumulative inflationary spiral. Interest always leads to inflation unless more and more goods are bought and sold. By perpetuating the same differential between the money to be paid back and that existing in the economy, Islamic banks place the same pressures of inflation, increased privatisation, and wealth polarisation as those of normal commercial banks by their credit expansion.

In short, economically speaking, there is very little difference between the effects caused by the credit expansion of commercial banks and those caused by Islamic banks. If one bears in mind that such credit expansion in general (as discussed earlier) can be linked to artificial scarcity, trade distortion, inherent booms and bust, wealth polarisation and ecological destruction, this is distressing indeed.

It is sad that Islamic banks have yet to review their essential nature in this regard, that instead of consistently operating within the same system as commercial banks, i.e. by maintaining Statutory Liquidity and Cash Reserve Requirements, they do not seek to charter their own institutions and regulation. For now, it is empirically evident that Islamic banks function economically the same as conventional banks, as the data on their balance sheets cannot be differentiated from those of their conventional counterparts. In a report to State Bank of Pakistan, a consolidated balance sheet of an Islamic bank showed that the total cash was Rs. 15.2 billion vs. total deposits of Rs. 83.7 billion and the total liabilities of Rs. 102.3 billion (Ahmad & Baloch, 2007). What this showed was that Islamic banks expand credit-based money and generate a money multiplier effect, exactly like their conventional counterparts. If this is the case, then Islamic banks, far from removing the evils of conventional banking, are actually perpetuating the debt-based system. This would be a far cry from what Mufti Taqi and other scholars perceived Islamic financing to be when he said, “The original concept of Islamic financing is undoubtedly in favour of equity participation rather than creation of debts, because it is only equity participation that brings an equitable and balanced distribution of wealth in the society. Debt-ridden economy, on the other hand, tends to concentrate wealth in the hands of the rich, and creates a bubble economy which fuels inflation and brings many other social and economic evils” (Usmani, 2008).

What about the Shariah permissibility of the money creation process itself?

The aforementioned discussion was focused on the economic effects of Islamic banks and the result of their continuing with the paradigm of money creation of their conventional counterparts. Although money creation in Islamic banks is coupled with the sale of an asset or provision of a service, the analysis shows that Islamic banks currently perpetuate many of the social, environmental and
economic problems of their conventional equivalents, due to the fact that such money creation is embedded within the dynamics of an interest-based paradigm. Although this fact alone may necessitate significant Shariah consideration, questions still remain as to the issue of money creation from nothing as a debt. Thus it would be instructive to see prevalent Islamic opinion on this matter.

When looking at the issue of money creation and fractional reserve banking, the Islamic Fiqh Academy (IFA) in its Resolution No.86/3/95 stated that “Call deposits (current accounts) whether at Islamic banks or interest-based banks, are considered as loans, from a Shariah perspective, since the bank taking delivery of these deposits is answerable for their safety and bound Shariah wise to returning them on call. The ruling applicable to the loan is no way affected by the Bank’s [the borrowers’] solvency or otherwise.”

Hence, the logical argument proposed by IFA was that just as it is seemingly legally permissible in Islamic law for a borrower to further lend, invest or otherwise utilise borrowed money as long as he remains obligated to the original lender in an on-account format (lit: Tahta al Hisaab), such that he is able to repay on demand, it should similarly likewise be fine for financial institutions to operate on such a basis, provided they remain similarly obligated. The argument supposedly continues that just as the measures a borrower takes to mitigate the possibility of his not being able to pay on demand are subject to his ability, with no stipulation existing in Islamic Law concerning the degree of solvency needed to be maintained, similar flexibility should be extended to financial institutions. Hence, the argument of the impossibility of banks actually meeting every lender’s demand because of the money simply not existing is not deemed to carry weight, as the support provided by the “lender of last resort”, namely the Central Bank, is seen as sufficient to offset such a risk.

Though it may be argued that theoretically this resolution makes sense, others may state that it is reductionist and legally formalistic in that there are still significant Shariah concerns that are inadequately answered. Some of these concerns are the following:

1. What the IFA statement seems to ignore in this resolution is that commercial bank money is not money in a traditional Fiqhi sense at all, but is instead promissory debt that uniquely functions as money within an economy founded on such promissory debt. Does the Shariah have any precedent for sanctioning a promissory debt, effectively as an IOU, to function as money?
2. What is the Shariah justification for the creation of purchasing power out of nothing which then allows for the ownership transfer of assets in an economy? This is especially important given that ownership principles in Islam are associated with legitimate risks and work.
3. Given that the money creation process proliferates debt and causes wealth polarisation, trade distortion and ecological destruction, are Islamic banks allowed to perpetuate the current paradigm?

4. Can money created by a bank as a liability be used to fund investment ventures, given that traditionally debt cannot be used to finance investment ventures such as Musharaka and Mudaraba?

5. Is it permissible in Islam for the money creation process to be effectively privatised for the benefits of a portion of the financial elite, as is the case with commercial banking?

Conclusion

In recent times the pressure group Positive Money in the UK has campaigned against what it considers the undemocratic nature of the banking system, as its founder, Ben Dyson, states: “Simply ‘getting banks lending again’ won’t help when the public are already saddled under a mountain of debt. What we need is more money, not more debt. This is impossible while all money is created by banks when people go into debt... The power to create money is far too dangerous to leave in the hands of the banks who caused the crisis. Taking this power away from them is our best hope of both ending the current crisis, and preventing the next one.”

For the purposes of this paper, we hoped to illustrate that the privatisation of the world’s money supply and its creation, for the commercial gains of an increasingly financially privileged minority, is an outcome of the story of interest and its central institution, the commercial bank. Islamic banks by co-opting this institution and seeking to “Islamicise” it may have gone down a wrong route (in regard to their originally stated motives).

What may be better and more just is for Islamic banks to join the various movements in the world that are seeking to amend the underlying structures of banks themselves, thereby seeking to bring forth a new narrative with regard to commerce and money, one that is more just and equitable. To many, the need for a new narrative has become an imperative as we are currently at the threshold of a series of crises caused by the financial system and the perpetual growth of the money it requires to survive. We just can’t continue growing; the growth has long become oppressive. Is it merely a coincidence that among the meanings of Riba is “oppressive growth”?

Today, we have reached an impasse in our ability to grow. We have reached an impasse in our ability to convert nature into money. As Eisenstein says, “There is little more we can convert. Technological progress and refinements to industrial methods will not help us take more fish from the seas – the fish are mostly gone. It will not help us increase the timber harvest – the forests are already stressed to capacity. It will not allow us to pump more oil – the reserves are drying up.
We cannot expand the service sector – there are hardly any things we do for each other that we don’t pay for already. There is no more room for economic growth as we have known it; that is, no more room for the conversion of life and the world into money.”  

Crisis heralds a chance for a new narrative, one previously inconceivable but presently feasible. As we continue to scramble towards applying new and not so new fixes to further prop up this interest-based system at an ever greater cost to alleviate the very problems caused by it, hope emerges in initiatives that challenge the structural dynamics of interest and the institutions it brings about. “Bailout” packages raised from public money given to the very banks that have caused the crisis have run their course. In their place is an emerging mass movement determined to reclaim the freedom of people for themselves. Islamic banks too need to make a decision in this regard. They need to answer the perennial question, where then are you headed? with regard to the money creation process.

As things stand, Islamic banks allow for Muslims and others who want to be a part of this collapsing, oppressive system to partake “Islamically”, but with this system itself headed towards imminent collapse, for how long can this continue? Would it not be better for Islamic banks to redesign themselves into community oriented institutions, for them to partake in and contribute to the movements of ecological awareness, localism, green design, community currencies, ecology-based economics, gift economics, negative interest currencies, public co-operative interest-free banking, community land trusts, gold dinar, and open community markets that are all currently seeking to challenge the hegemonic nature of the interest-based financial system. Would it not be better for them to aid and abet B2B and p2P financing schemes which reconnect people to people and form communities, at the expense of the current interest-based model that destroys community in favour of anonymous, impersonal financial institutions which have been described as psychopathic in their relentless pursuit of profit at all costs?  

Is it not time that Islamic finance itself undergo a reformation from within, from practitioners and academics who expect that the word Islamic entails a holistic analysis (by which they mean an analysis of structures, means and ends, direction, etc.), and not a reductionist one (myopically focused on transactions divorced from context)? Is it not time to rise above the slumber that has entered Islamic banking from a lack of direction? Is it not time to move beyond interest and the institutions and social settings it has brought about? Is it not time to propose a new mechanism for the supply of money, to create a supportive financial environment that decreases our reliance on debt and increases our sense of community?

Is it not time to save the world before it’s too late? So “where then are you going?” [Qur'an 81:26].
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Notes

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1. The fragility of the global financial system is illustrated by impending hyperinflation, currency collapse, and depression waiting for the day when the American dollar can no longer be sustained.

2. Peak Oil and the dependency of all aspects of our economic infrastructure and food supply on fossil fuels are a significant challenge when one considers the argument that no conventionally recognised alternative energy source can possibly be expected to replace oil and gas any time soon.

3. Recent times have seen an epidemic rise of autoimmune diseases, heavy metal poisoning and electromagnetic, chemical, and genetic pollution. These factors, aligned with the degeneration of the modern diet and the toxicity and impotence of most pharmaceutical drugs are a significant cause for concern.

4. Climate change, global warming, desertification, coral bleaching, tree death, topsoil erosion, habitat destruction, irreversible loss of biodiversity, toxic and radioactive waste, PCBs in every living cell,
swaths of disappearing rainforests, dead rivers, lakes and seas, increasing slag heaps and quarry pits all point to the fact that the planet the next generation will inherit will be very different to one we currently live on. This has caused environmentalists like Bill McKibben to coin a new name for the planet to come: Eaarth <http://www.billmckibben.com/eaarth/factsandfigures.html>.

5. Sir Mervyn King, Speech to the South Wales Chamber of Commerce at The Millennium Centre, Cardiff, 23 October 2012.


11. For more quotes along these lines, see <http://www.positivemoney.org/how-banks-create-money/proof-that-banks-create-money/>. 


13. The secretariat of the Basel Committee of Banking Supervision is located at the Bank of International Bank of Settlements (BIS) in Basel, Switzerland. Surprisingly, the committee is a private body of central banks and regulators, many of whom may have links to the very banks they seek to regulate.

14. These are effectively interbank investments that due to their perpetual and subordinated nature are considered tier 1 capital for regulatory purposes, <http://www.alenovery.com/SiteCollectionDocuments/Tax Treatment of Additional Tier 1 Capital under Basel III.pdf>.

15. Basel III is the latest in line of global regulatory standards on capital adequacy ratios following on from Basel I and Basel II, both of which were easily circumvented and not effective in limiting banks, <http://www.bis.org/bcbs/basel3.htm>.

16. <www.guardian.co.uk/commentisfree/2012/sep/20/quantitative-easing-not-magic-central-banks>

17. Ibid.

18. This fits into the paradigm of the “Devilish touch” in the definitive verse against interest [Qu’ran, 2:268] as causing those affected to feel “threatened with poverty and urged to immorality”, being an apt definition for the phenomenon of artificial scarcity.


20. Ibid.

21. Renowned psychologist Oliver James, in his bestselling book *Affluenza*, introduces what he refers to as a modern psychological virus primarily sweeping through the English speaking world since the 1970s. The symptoms of those suffering from this “virus”, he lists as being obsessive, with envious, greed-driven tendencies, with twice as much of a likelihood to be suffering from anxiety, depression and other addictions than people in other nations. In his subsequent book entitled *The Selfish Capitalist*, he argues that the epidemic of mental illness and emotional distress that has primarily gripped English speaking nations is primarily due to policies that have aided the usurious world, policies he refers to as “selfish capitalism”. As the Qu’ran says: “Those who consume interest cannot stand except as one who stands being touched by a Devilish touch into insanity” [Qu’ran, 2:275].

22. As the Qu’ran says: “They say, ‘Trade is [just] like interest.’ But God has permitted trade and forbidden interest.”

23. Since the beginning of the 1960s the average house price in the UK has increased by 273 percent in real terms (i.e., even after allowing for retail price inflation). As indicated by the UK Positive Money website, this price distortion reflects more the banks’ continual need to lend and the subsequent capacity to borrow than any market dynamics in and of itself <http://www.positivemoney.org.uk/consequences/house-prices/>.

24. See <http://www.neweconomics.org/publications/will-wal-mart-eat-britain>._Wal-Mart ranks as the 33rd largest economy in the world, having greater purchasing power than most nations. It was China’s fifth largest trading partner, ahead of the UK, Russia and Germany. The company captures one of
every five dollars spent on food, sells more clothing, furniture, toys, jewellery, music CDs, DVDs, magazines, books than any other retailer and accounts for nearly one-third of the entire US market for many household staples. As a result its power extends all the way from farms and factory floors to publishing houses all across the globe. No other company on earth exerts as much power and control over how and where goods are produced. The domination of multinational corporations like Wal-Mart can be directly attributable to an interest-based paradigm that gives power and wealth to those that already have the most.

26. <www.ifsl.org.uk>
29. See <http://www.inmotionmagazine.com/global/vshiva4_int.html> wherein the environmental activist Vandana Shiva writes: “If you want to have one tool for imperialistic control, it’s patent law under the WTO agreement . . . . With the broadening of patents to life forms, patents do not just regulate technology; they regulate life.”
31. See the story of the man who stood up to the plaintiffs of 39 pharmaceutical corporations who sued the South African government for its effort to import and produce cheaper generic HIV/AIDS drugs, which the corporations alleged violates their patent rights under international trade law <http://www.time.com/time/nation/article/0,8599,106995,00.html>.
35. “Pollution credits and similar schemes seek to convert the earth’s absorptive capacity into property.” (Eisenstein)
38. As noted by political scientist Thomas Dye in Who’s Running America.
39. In 2005, World Bank chief economist Nicholas Stern estimated that on average each European cow receives $2.50 a day in government livestock and dairy subsidies while 75 percent of African people live on less than $2 dollars a day.
40. Dr Margrit Kennedy states that interest structurally redistributes wealth from the large majority to a small minority. For further details see <http://www.zoupic.com/tag/wealth-distribution/>.
42. See Al Gore, An Inconvenient Truth.
43. Sir Martin Rees, arguably Britain’s most distinguished theoretical astrophysicist, holds that there is a 50:50 estimate that this will be humanity’s last century, <http://www.amazon.co.uk/exec/obidos/ASIN/0434008095/guardianunlim-21>. Also see James Lovelock, originator of the Gaia theory, who expects “about 80%” of the world’s population to be wiped out by 2100, <http://www.guardian.co.uk/theguardian/2008/mar/01/scienceofclimatechange.climatechange>.
45. <http://livingeconomiesforum.org/ii-pathology>. David Korten is one of the foremost authors against corporations and globalisation; a former Harvard Business School professor and a development economist, he is a strong advocate for a people-driven economy, one that is for Main street as opposed to Wall Street, one that in his words puts real wealth over phantom wealth (2010).
November 2012).

49. Ibid.

50. Ibid.


52. For example, see the work of Dr Adi Setia in Malaysia, who has been striving to set up a local community finance co-operative in Kuala Lumpur in place of Islamic banking, along these lines:
   a. Islamic Community Investment Corporation, focusing solely on Mudaraba and Musharaka.
   b. Islamic Community Depository Corporation, focusing solely on Wadi’a providing safety deposit, storing and warehousing services for a fee.
   c. Islamic Community Payment (or Clearing) System, focusing on hawalalah and payment clearing and netting off services, that can offer debit cards and checking services.
   d. A waqf based takaful system to spread local community risk.

For more information on Dr Adi’s ideas, see <http://www.uaekhutba.com/images/stories/docs/IGE.pdf>. Also see the inspiring work of Dr Amjad Saqib and his organisation Akhuwat in Pakistan (http://www.akhuwat.org.pk/) and their efforts in eradicating poverty using Prophetic principles to create the world’s first fully interest-free microfinance institution. See an interview with Akhuwat: <http://www.ethicainstitute.com/ethica_interviews_akhuwat_the_worlds_first_completely_interest_free_microfinance_program.aspx>.
ISLAM, CAPITALISM AND UNDERDEVELOPMENT
Timur Kuran and Murat Çizakça
on the Great Divergence

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Abstract: The debate over the causes of the Muslim world lagging behind the ascent of Western Europe and failing to evolve adequate institutional and financial tools to counter the challenges of Modernity is of keen interest to economic historians. Works addressing this complex issue by two leading Turkish scholars, Professors Timur Kuran and Murat Çizakça, provide a focus for discussion of this debate and are here summarized and the authors’ divergent theses contrasted. At the heart of the debate is the question whether Islamic religious and legal structures inadvertently or directly hindered Muslim societies in the Middle East over the past several centuries from modernising their economic and financial systems. Furthermore, is there a viable alternative form of capitalism found in Islam? Several critical responses or contrasting views (M. Shahid Ebrahim, et al., 2012) are briefly presented, along with the implications for Islamic economics.

Introduction

Islamic finance, banking and economics have blossomed into a major set of disciplines over the past three decades and now attract the serious attention of non-Islamic entities and institutions worldwide. Dramatic changes occurring in the world economy are bringing social, political and economic dispossession in Europe and North America. The real estate and derivative bubbles which induced the Great Recession in 2008 have been replaced by bond, stock and currency bubbles. Ongoing debt monetisation to the amount of US$1 trillion annually by the U.S. Federal Reserve threatens the US dollar’s role as the world’s reserve currency. The capitalist-inspired ethic of endless affluence and heedless waste threatens to overwhelm nature’s capital (our natural resources). The capacity of Earth’s ecosystem to absorb waste is being exhausted, reducing the ability of Earth to support life. Some informed observers view our present reality as the crisis of free-market capitalism forcing globalisation into its destructive endgame.²

We are also witnessing a shifting of wealth to the East, with the rise of Asian middle classes offering tremendous potential for profits to be captured by transnational global corporations. Shariah-conscious marketing is expanding rapidly in all sectors, while a distinctive Halal “lifestyle” is promoted. Several Muslim observers share the conviction that an authentic form of Islamic capitalism has always been an historical reality, which may offer a potentially
viable alternative to the current world economic system led by an elite oligarchy of powerful private interests. Ideally, such an Islamic–motivated alternative might serve as a necessary corrective to the excesses of self-serving private interests controlling the prevailing financialised form of capitalism. This worldwide system operates with an instrumental rationality marked by calculation and efficiency, reducing all relationships to those of self-interested means and ends, transforming by its Midas touch even the personal relationship of trust and mutual cognisance that formerly animated commercial exchanges in the historical past.

Could an Islamic alternative offer a more ethically directed and risk-averse economic theory for sustainable human development in the 21st century? If markets are not organically embedded in society to serve an equitable social purpose for the well-being and dignity of all, they become monopolised by private interests tending to inequity, insecurity and conflict (fasād). However, to institute a fresh economic model informed by authentic Islamic principles and practices would require multiple reforms in political and educational systems, wise and informed leadership, cultural awareness invigorating civic society and a genuinely creative engagement with the timeless values and higher aims of Islam’s rich legal and ethical legacy. Most observers agree that these conditions have not yet been achieved within Muslim society, which does not mean that they can never be achieved.

The Great Divergence

Industrialisation dramatically changed the European economy and allowed it to attain much higher levels of wealth and productivity than other world regions. Our current world economic system represents the latest form of marketisation spread by industrial capitalism over the past several centuries through the various European colonial projects. Why did Europe alone among the great civilisations of the world achieve such a profound transformation in output and productivity by the nineteenth century? The notion of a European miracle projects a self-serving exceptionalism: since the Early Modern period Europe rose to dominance ahead of the Islamic and Chinese civilisations by forming a progressive capitalist society and economy, which was supported by the industrial revolution. It attained complete domination of world trade and politics through expansive imperialism, remaining unrivalled until the mid-twentieth century.

Closely related to this Eurocentric vision is the idea of the “Great Divergence” (a term first coined by Samuel Huntington): the rising disparity in wages, prices and economic development between Western Europe and Asia during the period 1500–1800, and more emphatically during the nineteenth and twentieth centuries. This divergence signalled the era of socio-economic dominance of Western European civilisation, an historic shift wherein European societies
outstripped Asian societies during the modern era in every field of endeavour by means of their superior technology and scientific applications, innovative mercantile enterprises, evolved financial structures and institutions and a dynamic individualistic commercial spirit. A unique aspect was the growth of accounting procedures, an impersonal financial infrastructure, banking and insurance institutions, and large scale business enterprises in key European cities, all vital to the rise of Europe and its dominance over Asia and other continents. Western technology and economic practices did eventually spread to the East, yet differences in application and a distinctive knowledge culture preserved the European lead and accelerated the Great Divergence.4

We present a closer look at the three theses to better comprehend the issues being debated and their complex implications for any presumed Islamic economic alternative. The consistent concern animating all three views is the recognition that institutional conditions hold the key to understanding how the past has shaped the present, and if reworked afresh through informed engagement with Islamic principles, might offer a way forward toward possible resolution. Examining these views may enable one to gain a deeper appreciation of the significance of this long standing debate, which has recently increased in both intensity and urgency due to the growing industry of Islamic banking and finance.

**Timur Kuran: The Long Divergence**

Timur Kuran is Professor of Economics and Political Science at Duke University in North Carolina. He has a sound reputation for his work on the political economy of Muslim societies in the Middle East,5 and he has already advanced many of his basic insights in a series of well-researched articles which attracted wide attention.6 In this detailed wide-ranging work Kuran seeks to demonstrate that the institutional roots of economic underdevelopment in the Middle East by the nineteenth century are bound up with the larger question of why the modern economy emerged in northwestern Europe and not the eastern Mediterranean. Middle East is here defined to include the Arab countries, Iran, Turkey and the Balkans, though he understandably focuses especially on the Ottoman regions.

Kuran rejects common explanations for the “long divergence”: why the Middle East remained economically retarded and was late in adopting key institutions of the modern economy originating in Western Europe. Conventional Western wisdom until very recently has been, he explains, that “Islam opposes innovation ... so Muslim social structures resisted adaptation and advancement” (ix). In contrast, Muslim apologists assert it was the pernicious effect of colonial exploitation which induced deep stagnation and spread ignorance and poverty. Kuran correctly dismisses this as a self-serving distortion. “In lamenting the demise of traditional institutions, the Islamist interpretation ... asserts that
traditional Muslim institutions performed ideally until inferior European institutions took their place. It thus overlooks that useful institutions might become dysfunctional as the global economy evolves” (37). Rather, the colonial period brought fundamental transformation, rising literacy and education, and enrichment at unprecedented rates. Kuran notes:

The Middle East fell behind the West because it was late in adopting key institutions of the modern economy. These include laws, regulations, and organizational forms that enabled economic activities now taken for granted in all but the most impoverished parts of the globe: the mobilization of productive resources on a huge scale within long-lasting private enterprises and the provision of social services through durable entities capable of transformation. Well into the nineteenth century, the private sectors of the Middle East were composed of atomistic enterprises that did not outlive their founders. When individuals pooled resources in profit-making enterprises, their cooperation was meant to be temporary, often no more than a few months. By that time, most of the now-advanced countries had developed institutions essential to the mass mobilization of savings, the lengthening of individual planning horizons, and the exploitation of new technologies. Therein lies a key reason why the Middle East fell behind in living standards and why it succumbed to foreign domination. In a nutshell, that is the thesis of this book. (5)

By the eighteenth century “the Middle East’s economic infrastructure would become dysfunctional” and “the region would need to transplant from abroad an entire institutional complex” (279). Kuran focuses upon what he identifies to be significant inefficiencies which cumulatively were mutually reinforcing and blocked the required institutional transformations essential for global competitiveness. Chief among these institutions which eventually became dysfunctional in the modern period are frozen *waqf* assets; the adverse effects of Shariah laws of inheritance and polygyny on contract partnership law and on the flexibility or long-term continuity of business partnerships; atomistic financial markets; and courts inhospitable to impersonal mercantile exchange. All these were rooted in medieval Islamic institutions, and their effects mutually combined to delay the economic modernisation of Islam, which only occurred because of the active interference and penetration of European trade and business in areas of the Ottoman Empire through the fiscal impact of the notorious Capitulations granted by the Sultans to European powers and their agents.

**Implications.** His concluding chapter “Did Islam inhibit Economic Development?” (279–302) recapitulates the arguments advanced in this book. Throughout Kuran’s critique of the supposed retarding effect Islam exercised in first deflecting, and then postponing, modern capitalist commercial practices such as joint-stock trading companies as well as corporate institutions such as
banks, thereby hindering these from taking root in Muslim societies, a persistent major theme emerges. This is his insight that Islam’s financial and mercantile ethos privileged the personal nature of social transactions built upon mutual trust, individual cognisance of communal responsibility and sincere expectation of adherence to moral guidelines animated by the salvational value of proper use of wealth and higher aims of economic activity for human welfare and divine approval (see esp. 34, 63, 248, 293–95). While Kuran emphasises the unintended retarding effect of Islam’s privileging the personal nature of economic transactions centred on trust and mutual cognisance, he is quite clear in asserting that the impersonal modes of exchange animating corporate identity developed and spread by Europe are preferable and necessary for the modern economy to succeed (see esp. 63–4, 89–92, 209–210, 238–46, 251–53). The clear implication is that key economic institutions of modern capitalism remain the privileged mode for both financial and social transactions and should necessarily be embraced in order for Muslim societies to fully experience the current mode of modernity being promoted by private-sector-driven market capitalism with its debt-based financial structure and monetisation. Professor Kuran never recognises this in an explicit manner. With his comparative institutional focus and broad historical perspective, Kuran appears to ignore the wider social and environmental costs and hidden “externalities” of market behaviour flowing from the European innovation of defining impersonal corporations as fictional legal persons acting as rational economic agents.

The universal validity of global market capitalism, which penetrated all continents through the agency of the European colonial enterprise, is never questioned. The subsequent marketisation of human life has entailed severe consequences in wasteful planetary resource depletion and ecological degradation, uprooting of traditional faith values with an impaired sense of the sacred, and subservience to the controlling profit-interests of transnational financial cliques serving only themselves. Are these baneful effects merely to be deemed (to use Kuran’s term) as “unintended secondary consequences”? For Professor Kuran the impersonal exchange at the heart of the market economy appears as an unavoidable reality if not an unquestioned benefit. He fails to address the question whether Islamic historical and institutional experience might offer a possible alternative to institutions of modern consumer capitalism; e.g., whether the primacy of social transactions for ethically ordered economic life, or of private endowments offering social services, might be desirable goods which could be revived or recast in more adequate forms for contemporary needs and conditions.
Murat Çizakça: Islamic Capitalism and Finance

Murat Çizakça is Professor of Comparative Economic History and Islamic Finance at the Global University of Islamic Finance (INCEIF) in Kuala Lumpur. Professor Çizakça is widely respected for meticulous research into the Ottoman Archives and comparative economic institutional studies between the Islamic world and Europe and has published a major study of the *Awqāf* institution.8 Professor Çizakça expressly aims to equip Muslim financial engineers with enough knowledge of past Islamic experience and institutions to aid them in their current and future tasks of building an authentic system, so his book is both analytic and prescriptive. His colleague at INCEIF, Professor Abbas Mirakhor,9 states in his caption on the back cover of Çizakça’s book: “It is all at once an exploration in analytic history and a complete text of Islamic finance theory and application. It is also one of the most succinct renditions of evolution of Islamic finance embedded in a comprehensive account of particularities of economies as diverse as Malaysia and Turkey.” Çizakça provides an informed overview of the economic systems currently emerging in Islamic societies through case studies of enterprises in these two countries (Part IV: “Islamic Capitalism and Finance Today”, 99–226), which puts flesh on the bones of his historical and theoretical review. However, for our purpose we shall concentrate on Parts I–III (3–95) which give an historical and analytical exposé of the financial institutions and mechanisms in the classical Islamic period, for the reason that Çizakça’s treatment is directly relevant for comparison with Kur’an’s thesis summarised above. This is not to deny the value and importance of Parts IV and V, which treat very significant issues at the heart of contemporary Muslim finance.

In his Introduction (xiv–xxiv), Çizakça explains his chosen term “Islamic capitalism” to denote “the economic system practised by the Islamic world from the seventh century to roughly the middle of the thirteenth century”, given that “the three most important rules crucial to economic development identified by the Western new institutional economics – property rights protection, enforcement of contracts and good governance – constitute the essential principles of the classical age of Islamic capitalism as well” (xiv). Çizakça insists that the Islamic capitalism existing during the first seven centuries of Islam “was an economic system derived basically from the Qur’an and Prophetic tradition”. The main reasons he invokes to defend using this phrase are that the Prophet and leading Companions were merchants, that “the bulk of the Islamic jurisprudence was written down by men, most of whom were merchants,” and that “great Islamic philosophers also had firm opinions about markets” since “most of them had been appointed as *muhtesibs*, officials in charge of markets, and earned their living as such” and therefore “had a profound understanding of the way markets actually
functioned” (xiv–xv). Among such great philosophers Çizakça names al-Shatibi, al-Ghazali, and Ibn Khaldun. He further stresses the well-known prominence of commercial and trading metaphors in the religious topoi of the Qur’an and Islam, and that the original Islamic economic system “favours merchants, property rights, free trade and market economy,” as well as ownership of the factors of production by private persons, profit making and capital accumulation. An added factor (which Çizakça discusses later) is the bimetallic monetisation of commerce which Islam established and internationalised. He argues that this type of economic system is in fact “pre-industrial, commercial capitalism”:

Because an economic system which favours merchants, and respects property rights and free trade, applies the principles of market economy and market wage rate and treats interference in the markets as transgression and sinful would be considered capitalist, I have no qualms about calling this Islamic economic system as such. … [T]he West should not have a monopoly over this term, particularly because many important principles, institutions, even laws, of the medieval Western European economy, which formed the nucleus of the modern Western capitalism later, have been borrowed from the Islamic world. … The capitalism that I am referring to here is pre-industrial, commercial capitalism. It naturally differs from the industrial capitalism referred to by Adam Smith and Karl Marx. (xv–xvi)

**Shariah Values.** In Part I “Value Systems Behind Institutions” (3–25) Professor Çizakça describes the two contrasting approaches to Islamic economics and finance:

- the dominant “Shariah compliant approach” based on conventional banking borrowed from the West which now prevails; and
- a potential truly “Shariah based” value system drawn from a profound historical understanding of Islamic financial institutions and how they operated over centuries.

This second approach requires “modifying these historical instruments or designing completely new ones,” because “[i]f Islamic finance is to emerge as the heart of a viable alternative capitalist system, it must progress from being Shariah compliant to being Shariah based” (3). Çizakça emphasises that this progression demands Islamic practitioners “try to understand and apply the substantive spirit of Islamic law … by understanding the economic functions served by classical legal provisions and principles” or of “the way the substantive spirit of Islamic law has been applied throughout history.” Çizakça therefore proposes that “a grand synthesis of legal/economic thought combined with historical application leading to a study of institutional evolution emerges as conditio sine qua non for the Shariah based approach” in order to grasp and apply the substantive spirit of Islamic law (4). Without such a challenging and ambitious synthesis,
Islamic finance cannot develop its own authentic Islamic instruments. Çizakça is realistic and blunt, yet at the same time optimistic, when he clarifies that what currently passes for Islamic finance in truth largely mimics conventional Euro-American finance:

So far, Muslims have been free-riding on financial theories and instruments developed by the West. Unless Islamic finance develops its own genuinely Islamic financial instruments, it cannot achieve the dynamism of a system that provides the security, liquidity and diversity needed for a globally accepted financial system, which would be a genuine alternative to the present debt–interest-based international system. … The essence of the approach is the realization that there is a substantial difference between the Western homo-economicus, the rational man, who has discarded all religious and ethical teachings and acts purely to maximize his profit, and the homo-Islamicus, the Muslim person, who also tries to maximize his profits but does so subject to the laws and ethics of Islam. (5)

So Çizakça accepts that in the modern era Muslims took over and applied financial theories and instruments from Western Europe and disregarded their “own genuinely Islamic financial instruments” sourced in and arising from “the substantive spirit of Islamic law”. Kuran’s thesis that Islamic law contributed indirectly to the inadequacy of classical financial and economic instruments or institutions in the modern era, thereby leading to Muslims adopting European models, may possibly not contradict Çizakça’s discussion.

Çizakça outlines his understanding of the principles of Islamic capitalism being rooted in fundamental Islamic creedal axioms including tawhid, prophecy, human dependence on Allah as Creator and the task of a mid-most community. He sketches the implications of these axioms for the main features of Islamic capitalism: interest prohibition, profit taking and market exchange. Çizakça maintains these creedal axioms “lead to powerful auto-control, contract fulfilment and a reduction of transaction costs” (11), emphasising that Islam’s classical economic system was based on voluntary self-control augmented by an informal mode of distributive justice. Regarding the issue of redistributive justice, Çizakça observes:

It has been argued that in comparison to Western economic thought which, from Rawls to Sen and Nozik, requires comprehensive government intervention on a continuous basis, in an Islamic society the state’s role is one of administrator, supervisor and protector of the society. In such a society, it is the members of the society themselves, governed by their personal beliefs, who ensure that social justice prevails. It is argued further that in such a society poverty would be eradicated. If it is not, the mere existence of the phenomenon [of widespread poverty] constitutes prima facie evidence of non-compliance with the rules of Islam. (21)
While no upper limit was imposed by jurists on private wealth accumulation, nevertheless massive wealth circulating forever among a few was considered a serious transgression. Islam ideally expects Muslims to redistribute privately accumulated wealth through voluntary means to ensure a justly balanced society. Furthermore, with regard to curbing inequalities through taxation, he states: “The problem of disincentives caused by taxation is not relevant for Islamic capitalism. This is because Muslims are expected to notice income inequalities and act upon them voluntarily by paying zakat, sadaqa and establishing waqfs …” (14). On profit taking Çizakça observes: “Generating profits by hurting others, or by violating the basic principles of Islam, is considered as transgression. Consequently, a Muslim business man is obliged to control himself and to see to it that his profits are earned through halal transactions” (12). The ideal for market activity is to observe self-regulation and rule-compliance, while capital accumulation is “subject to ethical and voluntary self-controls and redistribution of wealth” (18).

This strongly suggests that the entrenched and widespread poverty in many contemporary Muslim majority societies reflects a failure to adhere to and implement basic Islamic principles. Çizakça’s emphasis upon the voluntary self-controlled market ideal that minimises state interference appears to reinforce the crucial idea of the personal nature of financial and mercantile transactions in the classical Islamic system. He provides descriptions of how a Muslim would behave as a worker, an employer, a merchant, a consumer, and a saver, when he is properly imbued with these values (21–22). For example, the consumer would avoid conspicuous consumption, aware that God dislikes extravagance or squandering of resources: “while property ownership in respected, waste and extravagance are discouraged” (14). Wealth accumulated lawfully should not encourage extravagant indulgence nor a miserly lifestyle, and rational choice inevitably leads to charitable sharing and philanthropy. With this snapshot of the basic values of Islamic economics, Çizakça moves on to provide an historically grounded overview of the institutions which emerged out of these values and translated values into practice.

Islam imposes limitations on disposing of property, whereby individuals have the obligation not to waste, squander or destroy, or to use property for selfish extravagance or unlawful purposes such as bribery and nepotism. “Property rights over natural resources are placed in trust of either the state or the society in the form of commons” (14). The Islamic system teaches the duty of sharing the product or the income derived from it or the wealth obtained from its sale. Such income or wealth is cleansed from the rights others have in them through payment of zakat, since the Qur’an recognises the rights of the poor in each person’s income. The characteristic hallmarks of the Islamic economic system
are described by Çizakça to consist of partnership, legitimate ethical profit and sharing of risk and gain.

**Democracy and Capitalism.** Does Çizakça overly idealise the ongoing relevance and utility of the “substantive spirit of Islamic law” for creating new institutional forms to forge a new Islamic economic system which may operate globally? He points to the importance of the *maqāṣid al-Sharī‘ah* for providing the propitious political framework within which Islamic capitalism and its financial institutions may flourish. In his final chapter (“Democracy and the modern Islamic capitalism”, 276–292) Çizakça argues that the five traditional components of the Higher Aims of Islamic law require being explicitly extended to embrace a sixth fundamental axiom, namely democracy. He stresses that Islam possesses an inherent preference for democracy evidenced by the prohibition of interest, the primary motive of which “is to lead Muslims to an economic system characterised by a spirit of sharing.” He continues,

Risks, profits and losses must be shared in a true spirit of partnership. Indeed, partnership and contract/covenant are considered to be at the very heart of Islam. … There is therefore no doubt that the Islamic political system must also be characterised by partnership, sharing and brotherhood. Obviously, what is to be shared here is political power. … In short, if we deduce from the interest prohibition that profits, losses and risks must be shared in Islamic finance, by analogy, *qiyas*, we deduce further that power too must be shared in an Islamic political system. Democracy is, therefore, perfectly harmonious with Islam because it is the institutionalisation of the idea of power sharing. (287)

The historical experience of Muslim polity dominated by authoritarian rulers and dynasties does not reflect the original intent of Islam in Çizakça’s view but rather the impact of Byzantine and Sasanid imperial example, which captured the state structure in early Islamic centuries. There is much to say in favour of this argument proffered by Cizakça regarding the need for a democratic political environment conducive to the emergence of a properly Islamic economic system in the modern world. Nevertheless, his extending the condition of representative or democratic power-sharing in Muslim polities as the needed precondition for truly manifesting a genuine Islamic economic system embedded in properly conceived institutions will only make some of us despair, given the depressing reality in so many Muslim-majority societies.

**Implications.** Çizakça’s call for erecting a “grand synthesis of legal/economic thought” by means of historical scrutiny and conscientious modern financial engineering is ambitiously far-reaching, yet it has the virtue of not being self-deluded concerning the true nature of current economic practices of Islamic banking and financial institutions. Certainly he provides many relevant examples
and insights which suggest that such a synthesis may be possible. He urges Islamic economic theory to develop “its own genuinely Islamic financial instruments”, apparently the task to be accomplished by those Muslim financial engineers for whose benefit he seems to have written his book. Are these creative individuals who shall engineer the new Islamic capitalism the investment brokers, wealthy bankers, and scholar–entrepreneurs who labour in the enterprise of Islamic banking and finance? Are they the teachers and professors of Islamic economics in universities, institutes or think-tanks, or officials in ministries of certain governments, or the well-paid contemporary Muslim jurists (fuqahā’) serving on the Shariah-compliant boards of banks, investment firms and large corporations? All theory and institutional practice must weather the reality of their human exemplars, the persons who understand and apply ideas and practices. This has always been the weak point in grand systems intended to benefit humanity and promote the well-being of society: the shortcomings and distortions or deflections perpetrated by individuals for numerous self-serving reasons or in response to unavoidable forces and conditions.

It might be that such individuals who are heavily involved in the banking and financial industries, which as Çizakça explicitly states are “free-riding on financial theories and instruments developed by the West,” or who work in the modern enterprise of higher education, which effectively serves those industries, could exemplify the homo-Islamicus whom Çizakça holds up as the ideal model. Perhaps Çizakça is demanding too much of such individuals: to master thoroughly the intricacies of juristic financial instruments and institutions (a vast 1400 years tradition), to become versed in the historical applications of this Islamic legal tradition, and to comprehend well the nature and functions of this original Islamic capitalism in contrast to that of conventional capitalism. Only then may the Muslim geniuses serving as financial engineers create their own authentic modern form of Islamic capitalism.

The Long Divergence and Islamic Capitalism. Professor Çizakça has replied to Kuran’s thesis in some detail in his article “Was Shariah Indeed the Culprit?” (see above), while Çizakça’s book implicitly builds a coherent vision of what a genuinely Islamic financial system or Shariah based synthesis might actually look like, namely his vision of authentic Islamic capitalism. Çizakça states in his review of Kuran’s Long Divergence (the MESA Bulletin, Fall 2011) that it is “a most informative book and may make contemporary Muslims wonder whether a forthcoming second codification of Islamic law should heed some of the warnings of the author”. Although Kuran and Çizakça may appear to differ on the primary cause of the Great Divergence and whether Muslim jurists were inadvertently constrained in the possibility of evolving more adequate forms of hallowed institutions to address evolving needs, it would be inaccurate
to view them as in essential disagreement regarding the inadequacy of many of the financial instruments and legal structures which the jurists had evolved in the past. Both of these learned economic scholars converge on the need for fresh creative thinking to meet present and future requirements for forging more adequate institutional vehicles embodying an Islamic economic system.

Nevertheless, Kuran’s goal is almost exclusively descriptive, comparative and analytical within a broad historical perspective. While Çizakça also provides a broad historical overview with less comparative material, he includes many more topics than Kuran (taxation, sukūk, takāful, maqāṣid al-sharīʿah, democracy, the gold dinar, venture capital). Furthermore Çizakça concentrates on modern practices and enterprises in some detail and reviews the experience of the JOHOR Corporation, of Tabung Haji, and of Permodalan Nasional Berhad (all three in Malaysia) as possible institutional models for an Islamic capitalism. His primary goal is prescriptive, namely to encourage the contemporary practitioners and theorists of Islamic economics to re-evaluate their understanding of the historical legacy of Islam’s juridical experience, to deepen their grasp of essential principles and techniques, and to attempt to forge creative responses to the urgent requirements facing their society and institutions. One also detects an unmistakably sincere tone of faith-conviction in Çizakça’s work (with his abundant citations of Qur’an and Hadith), which is entirely lacking in Kuran’s more abstractly neutral book. Perhaps this reflects the reality of the differing environments in which the two live and work.

Therefore it is plausible to understand these two scholars as working on the same task but from varying perspectives and goals. Kuran seeks to uncover the institutional shortcomings which hindered Muslims from responding more effectively and with greater authenticity to the challenges forced upon them by an aggressively expansive and commercially more sophisticated European penetration of Muslim markets, facilitated by the indigenous non-Muslim agents whom they employed and relied upon. His real concern is comparative and historical, but this does not imply that Kuran is not concerned with conveying a prescriptive lesson as well. By pointing to specific shortcomings and inadequacies in the inherited instruments and institutions, he clearly implies that if the Muslim jurists had been more alive to the social and economic realities of their community and more concerned with the welfare of merchants, artisans and workers who were adversely impacted by European penetration and activities, then perhaps a different, more adequate response could have been evoked. Both of these scholars concur that for Islamic societies to succeed and flourish in today’s global economic environment, important adjustments or transformations need to be accomplished in the rich legal and social legacy of homo-Islamicus. Interestingly though, neither of them dwells overly on the shortcomings of the
jurists as a class or their institutionalised incapacity to evolve fresh forms of tried and true financial instruments. This is precisely what the authors of our third text undertake to do.

**M. Shahid Ebrahim et al., and Perennial Underdevelopment**

The first three authors of this forthcoming joint research paper teach at Bangor University in the UK and the fourth at Leeds University. Although a relatively short article, it summarises a great deal of information and succeeds in presenting a coherent thesis concisely argued. Both its comprehensive nature and ample documentation, as well as the care taken to address the key issues involved in the debate we are examining, encouraged us to include a brief appreciation of the arguments it advances. The authors begin by paying attention to the current discussion in academic literature concerning the weight which religious beliefs may play in shaping economic life. They then attempt to arrive at some sort of resolution of the debate over the Great Divergence by reviewing chief points in Kuran’s works and the reservations raised by his critics and respondents. Kuran sees specific Shariah structures as impediments, while his critics may view them as facilitators. Ebrahim et al. are generally receptive and positive about Kuran’s thesis and appear to agree with his thesis in the main, even as specific points are questioned or depreciated. (For example, Kuran’s argument about the role of primogeniture in Europe and his conclusions about inheritance laws are questioned or undermined).

In Section 3.2 the authors review several contrasting theories as to whether Islam hinders growth, including A. Malik’s argument that European commercial success was “aided by a combination of commerce, coercion and colonization”. Given the historical conditions of long-distance trade, overseas expansion and European inter-state rivalry, commercial enterprises in Europe invented new organisational forms and financing instruments which led ultimately to the appearance of corporate entities which were impersonal and long-lived, separated ownership and control and mobilised long term capital through joint stock companies. Malik views such legal and corporate innovations partly as a response to the exigencies of war-making states and overseas commercial competition. He also lays responsibility for Muslim degeneration upon the fiscal policies of the Ottoman Empire, which stifled private initiatives. The authors synthesise these views by affirming that “there is no absolute evidence that Islam hinders growth.”

However, the authors do not concede that the shortcomings or hindrances were solely institutional and insist strongly that the real responsibility must be laid at the door of the jurists themselves and the rigid uncreative mindset which they exhibited (see esp. Section 4, “Rationalising the Perennial Underdevelopment of
the Muslim World”, 12–30). This constitutes the thrust of their main argument, which revolves around “the criticality of ijtihad”. The cultivation and effective implementation of such “individual-reasoning-exertion” became stifled over time within Sunni Islam, and therefore “the possibility of developing and evolving new theoretical and hermeneutical frameworks became virtually impossible” (13). They succinctly review the main modes of reasoning techniques practiced by jurists, as well as the circumvention of the prohibition against interest through ruses. As modernity brought about more complex market structures, the long term consequences were devastating. This has resulted in the general incoherence of so-called Islamic banking and finance: “To date, there is still no clear formulation by the jurists of the economic rationale behind the core Islamic injunctions related to financial matters, which led to the apparent disconnect in the present practice of Islamic banking and finance” (16).

The authors then offer a very short allusion to the theological inadequacy of Sunni orthodoxy (Ash’arī kalām), which privileged a determinist creed where human rationality was downplayed and reason or natural law was subordinated to divine revelation. In several paragraphs the authors characterise Ash’arite theological dogma as failing to produce a viable ethical basis for a rationally-grounded non-revealed legal framework. Extrapolating from this (rather inadequate) snapshot of Ash’arite theological dogma, the authors reach the conclusion that “no system of ethics has been worked out by its theologians and jurists that may serve as a foundation for natural law or human positive law” (17), and thus a gap between theory and practice has arisen. Furthermore they assert that “customary law had no official locus standi in jurisprudence.” They next apply the implications of their conclusions to the manner in which jurists worked out their understanding of the various financial instruments in contract law, characterising certain aspects of juridical practice (e.g. banking murāba‘ah in the form of a tawarruq loan) as a “violation of the Sharī‘ah” (20). The authors conclude that “the current practice of Islamic banking, which is based on implementing medieval (and often inefficient) Islamic financial instruments, is nothing less than the failure of the religious establishment to engage in ijtihād” (20).

They trace this failure back to the orthodox theological dogma of Sunni Islam which discouraged a fully independent rational basis for law and creed. The rudiments of Islamic financial terminology “have remained a static edifice, as its formulators did not keep pace with the changing intellectual environment” (22). Thus, “the monopoly that the jurists have enjoyed on formulating, interpreting and articulating the religion has had a detrimental effect in the recent history of Muslim communities, especially in the field of economics.” Islamic law became stagnant and closed-minded, which “contributed to the inability of the society as a whole to grasp their situation in a rapidly changing environment” (24). The
authors conclude that the “long divergence” is due to the “lack of understanding of the economic aspect of injunctions like that of ribā, which basically enjoins property rights and co-operation”. They continue:

This deficiency in understanding the crucial injunction led the Muslim world to: (i) give in to autocratic rule for centuries without resisting it; (ii) eschew the development of independent judiciary to protect the property rights of the masses; and (iii) avoid the development of institutions for their economic advancement” (25).

Such sweeping conclusions along with harsh or dismissive portrayals of the negative impact of Sunni legal and theological thinking and institutional functions may strike many informed thinkers as unjustified and overly simplistic. The far-ranging judgement the authors pass upon the disappointing consequences of Ash’arite theological dogma, based on skimpy references or on the competence and motives of jurists, is difficult to accept without reservations. Attributing authoritarian abuse and medieval despotic governance to juridical misunderstanding of fundamental Shariah injunctions also appears to be a giant leap or over-simplification. Perhaps when individuals trained in Western disciplines of economics and financing trespass into the domains of Islamic religious disciplines of kalām and fiqh, simplifying characterisations or facile conclusions are to be expected. Scholars trained in these classical Islamic disciplines with competence in the vast body of Arabic literature may find the portrait offered by these authors a caricature. This factor appears operative to some degree with all contemporary economists working in the field of Islamic finance and banking. Not being trained in classical Muslim jurisprudence nor familiar with the interpretive tradition recorded over centuries, these economists tend to rely on the works of other specialists who display competence in these fields (e.g., scholars such as Professor M. Hashim Kamali), exploiting the results of their research for the needs of contemporary business and commerce. On the other hand, there are very few reputable faqīhs with solid traditional expertise who also are competent in contemporary economics and finance.

Conclusion

In attempting to assess the persuasiveness, or possible lack of convincing considerations, which our authors have advanced to explain Muslim backwardness, it is good to bear in mind wider issues of context and intent. The debate over why Muslim societies (note: we do not say Islam) were unprepared economically and politically and were at a clear institutional and conceptual disadvantage when confronting European penetration of African and Asian lands, should not be confined to one specific domain of human activity and thought. Economic and financial institutions are among the most important factors.
contributing to the underdevelopment of Muslims and their incapacity to counter European success and exploitation. Yet to focus overwhelmingly upon the legal and juridical mechanisms and conceptions to explain economic reality may be shortsighted. Whether the mindset of the jurists induced by creedal dogma is the culprit as Ebrahim et al. would have us accept, or specific historical components of the Shariah as Kuran suggests, human economic activity occurs in a multi-dimensional environment where religious values, geographic and political constraints and social norms and expectations all play roles. Çizakça concludes his work with a plea for democracy to be re-integrated within Islamic polities, which he argues is the most essential precondition for achieving a genuine Islamic economic system. The authors of *Perennial Underdevelopment* echo this concern by highlighting the disregard of Islamic values in the political arena. This is moving in the right direction, since integrating these complementary dimensions of human life into our economic and financial horizon is productive of civilisational renewal.

We should also make due allowance for the variety of levels of discourse and conceptualisation Muslim societies experienced in the past and in the present. As Kuran observed, “The missing element is the role of public discourse in keeping individuals from questioning, even noticing, social inefficiencies.” This hints at a crucial factor behind why the Muslims themselves were not able to evaluate, correctly understand and analyse their own condition when confronted by Europe, and why they were slow in projecting an intelligent response. The thesis of “Perennial Underdevelopment”, of a stagnant class of jurists, strikes us as unfair, as if only the jurists can think and propose solutions to society’s problems. Actually, the officials and civic society leaders and merchants and intellectuals all should play their part in the overall arousing of an adequate response. The Tunisian thinker Hichem Djait remarks in his insightful study *Europe and Islam: Cultures and Modernity*,

What Muslim countries lack today is precisely the sort of organic intellectualism once embodied in the ‘ulama of the classical and post-classical epoch. For the most part the modern world has resisted this approach, undoubtedly owing to the intellectualization of politics and the politicization of intellectual life. … [T]he organic intellectual school could be defined by its power of integration, by the link it forges between past and future history, between the social ideal and the social reality—not a group of ideologues defending a given political order but interpreters of a civilization in process.

Finally we revert to the notion of capitalism itself. We pointed out that Kuran appears to accept the necessity and benefit of the impersonal mode of market transaction evolved by Europe. He asserts that the emergence of profit-oriented
businesses organised as Corporations was a distinct European innovation, without any Islamic model. In the contemporary capitalist market society where social transactions are marketised, the motive behind the production of food is not to feed people, housing is not made to give them shelter, clothing is not made to keep them warm, and health care is not offered primarily to keep people healthy. All of these things, which should be viewed as basic rights, become nothing other than commodities, to be bought and sold, with which to make a profit. Çizakça’s observation that Muslims felt no need to construct an impersonal corporate entity until confronted by Europe has some validity, once we understand the ethos and socio-religious dynamic which guided and shaped Islamic societies. Here we may cite Professor Çizakça:

The Western system has become an inverted pyramid of huge debt piled upon a narrow production base. This growth in debt has nearly severed the relationship between finance and production. ... An Islamic financial system can address this problem by its fundamental operating principle of a close link between finance and production and because of its requirement of risk sharing. But to the extent that Islamic finance emulates the West, it loses its ability to do so. (5)

The fact that prominent Muslim entrepreneurs today spout confidently about corporate *waqf* and Islamic capitalism should give one added impetus to critically reconsider the vaunted virtues of the financialised mode of impersonal exchange animating capitalist consumption with all of its consequences. As Raj Patel demonstrates in *The Value of Nothing*, the way profit-driven corporations value the world brings systematic distortion in valuation when such negative externalities are not paid, being in reality a form of “theft from those who bear the cost of their behavior” in which “wealthier consumers share the spoils of the theft.” Perhaps the most striking consequence of our contemporary mode of capitalist exchange is the excessively gross waste of natural resources and its blatant disregard of economy of scale and frugal husbanding of planetary resources.

Such inequities are inherent in the modern corporative enterprise animating marketised society wherein the social bonds of exchange fall under the shadow of profit, while the rules and the very culture of exchange are dictated by the power and greed of corporations and the bankers who finance them. To use Max Weber’s term, such marketisation reflects the dominant mode of rationalisation inherent in the capitalist market. Increasingly one finds that acute observers of the excesses of consumer market society are searching for alternative ways of thinking about and valuing social transactions of exchange, as well as of the social benefit or wellbeing derived from such transactions, by means of restraining profit-driven markets. Does the classical Islamic model of exchange...
where personal bonds of trust shaped the moral boundaries of social transactions have any relevance for humanity in the future?

**Policy Recommendations**

- For centuries in the past, Muslim scholars and scientists were thought to be leaders of innovative ideas and made significant contributions to Western science. This could not have occurred if Islam itself had been a source of backwardness for Muslims. There is no definitive proof for Kuran’s somewhat surprising claims that have little precedent in mainstream scholarship. Muslim thinkers should certainly forge ahead with making fresh contributions to Islamic disciplines, including the burgeoning IBF sector.
- If there is a case for Islam’s renaissance and renewal, it must surely be inspired by Islam’s own resources and a renewal from within. During the colonial period and now since the onset of globalisation, Western ideas and institutions have admittedly been somewhat overwhelming for older traditions but not so for Islam. A keen awareness of this factor is necessary for innovative scholarship.
- Muslim scholars and researchers should adopt ideas and institutions that are conducive to the development of their communities while ensuring that all adaptations remain compatible with Islamic principles.
- There is evidently much imitation and superficial adaptation of conventional ideas and products in IBF, often at the expense of innovative thinking and *ijtihad*, which have yet to become an engaging reality of IBF.
- IBF should utilise equity instruments and participatory forms of financing such as common shares and sukuk on a wider scale. Risk sharing and participatory finance, which are foundational to IBF, have hitherto remained marginal and merit renewed attention.
- Innovation in science and technology needs to be more vigorously promoted and generously funded. This would also require that universities and other centers of higher learning are granted greater autonomy and that they put in place substantial incentives for the attainment of excellence.
- Training programmes for Shariah scholars and advisors should integrate professional know-how and practice of IBF with foundational knowledge of Shariah.
- IBF has come under criticism for its adherence to the *fiqih* rules on contracts and transactions, often in total disregard of the higher goals and purposes, or *maqasid*, of Shariah, which should now be an integral part of the teaching and training of Shariah advisors.
- A more rigorous system of monitoring and periodic self-assessment of the successful implementation of the above measures needs to be established and consistently pursued.
References

The following works are the primary focus of this study and are referred to throughout the text; all other references are fully cited in the notes.


Notes

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1. Paul Craig Roberts, The Failure of Laissez Faire Capitalism and Economic Dissolution of the West (Atwell Publishing, 2012). He asserts (p. 92) that: “The rhetoric of Free Markets is unmasked as an extractive asset-stripping operation by publicly supported private banks and the governments they control. Self-serving private interests co-opt and assimilate the government, resulting in an oligarchy of crony capitalism.” Proponents of Ecological Economics (notably Herman Daly) lend support to this view. Free unregulated markets are not natural, but were created by government coercion in the service of private interests. This was examined by John Gray, False Dawn: The Delusions of Global Capitalism (London: Granta Books, 1998; & New York: The New Press, 1998; 3rd ed. Granta, 2002); see also David Harvey, A Brief History of Neoliberalism (NY: Oxford University Press, 2007).


4. He previously published Islam and Mammon: The Economic Predicaments of Islamism (Princeton University Press, 2005), in which he examined Islamic banking and economics in its contemporary cultural and political context, portraying it as an ‘invented tradition’, and discussed the reasons for the failure of Islamic culture and tradition to achieve wealth and prosperity for its population.


6. In modern economics, “externalities” denote the broader social costs of production and consumption not reflected in prices nor paid for by corporations, but which nevertheless have to be paid for by the rest of society. A well known example is the beef in McDonald’s hamburgers sold in the United States (550 million Big Macs annually), which is fattened on corn which is highly government-subsidised has a high carbon or greenhouse gas energy footprint, and costs taxpayers through social subsidies to low-wage fast-food employees, as well as public health costs for treating diet-related disease induced by excessive fatty meat consumption.


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8. Professor Mirakhor formerly served as Executive Director of IMF and is due to publish a major work on Islam and Development: the Institutional Framework, which Professor Çizakça often refers to in his book.

9. These three scholars were all outstanding jurists, and while al-Ghazālī and Ibn Khaldūn also studied falsafah, they were not generally viewed as philosophers – the exception being al-Ghazālī, who was known to the Latins in Europe as a philosopher (Algazel) because of the accident of certain of his works treating philosophy being translated into Latin and Hebrew. As far as we are aware, no Muslim philosopher ever served as a muḥtasib market supervisor, although several famous philosophers worked as viziers or bureaucratic state administrators, including Avicenna. It appears the word philosopher is employed here by Çizakça in the loose contemporary sense of “systematic thinker”.

10. Nevertheless Çizakça recognises that “in reality, it is difficult to establish a clear cut separation between the two approaches … because an originally Shariah based instrument can eventually be misused as a tool to borrow conventional methods” (p. 8, n.1).

11. It is well known that the majority of modern institutions of Islamic higher education in Muslim societies have adopted the business model of organisation and focus strongly on business and commercial studies, IT and media, and prepare their graduates for employment in the prevailing economic system. In several countries universities are now incorporated as business entities.


14. Blaming the jurists is like washing our hands of responsibility; this also reflects a widespread tendency among Muslims today to privilege the Shariah discourse and legal tradition above all other intellectual and spiritual endeavours in Islam. It is true, however that jurists often encourage this perception, for their own status and self-image.


16. To better appreciate the full dimensions of the “blowback” (unforeseen consequences) of the impersonal mode of exchange at the heart of the contemporary capitalist economy, consult the illuminating work by Zygmunt Bauman, Work, Consumerism and the New Poor (New York: Open University Press, 2003); also Neal Lawson, All Consuming (London: Penguin Books, 2009).


19. See especially the recent report by the Institute of Mechanical Engineers: “Global Food: Waste Not, Want Not” (London, January 2013), which documents that current practices are wasting 30% to 50% of all food produced and reviews the exploitation of land and water, showing that huge amounts of water are used to grow crops which are never eaten.

20. Weber understood rationalisation as the process where an increasing number of social actions become based on considerations of teleological efficiency or calculation, rather than on motivations derived from morality, emotion, custom or tradition. Weber correctly perceived this mode of rationalisation to be a central aspect of Western modernity: as a behaviour of the capitalist market, of rational administration in the state and bureaucracy, of the extension of modern science, and of the expansion of modern technology. To the degree that everyday life was affected by these procedures of cultural and societal rationalisation, traditional forms of life, which in the early modern period were differentiated primarily according to a person’s trade, were dissolved. Today Weber’s notion is generally termed “instrumental rationality” as well as “commodification”.

21. We are grateful to Professor Mohammad Hashim Kamali (Chairman & CEO, IAIS) for kindly sharing this paper with us and also lending his copy of M. Çizakça’s book, as well as to Professor M. Shahid Ebrahim of Bangor Business School, Bangor University (UK) for generously providing us with the latest version of his and his colleagues’ draft paper and permitting us to cite from their work. We gladly thank the staff of the Knowledge Management Centre at INCEIF in Kuala Lumpur for their assistance in accessing articles consulted for our study and express gratitude to brother Hissam Kamal Hassan for exchanging ideas and providing materials.
THE ISLAMIC FINANCIAL SERVICES ACT, 2013
Malaysia’s Model Framework for Shariah-compliance and Stability

Sheila Ainon Yussof

Abstract: Malaysia is said to have created legal history by introducing the world’s first comprehensive legal framework for its Islamic Finance Industry through the pro-active approach of its central regulator (Central Bank of Malaysia, or the CBM) and government-driven Economic Transformation (ETP) Policy. This piece of legislation was crafted by regulators, policy makers and legal drafters to enforce Shariah compliance in a move towards greater financial stability. Factors such as changing demographics and increased growth of Shariah-conscious consumers worldwide, the increasing complexity of financial products, enlightened public policy goals to alleviate poverty, improve equity and enhance growth, as well as increasing global interconnectivity, have driven the regulators to beef up Shariah compliance surveillance. Punitive measures provided under this Act are designed to act as a deterrent to would-be Shariah non-compliance offenders; and at the stroke of a pen the new law has created a new breed of corporate criminals. The recently gazetted Islamic Financial Services Act 2013 (and its conventional counterpart the Financial Services Act 2013) is regarded by many as a “landmark law” for the multifaceted regulatory objectives it has to fulfil to ensure financial stability. This paper embarks on an impact analysis of the IFSA 2013 from the Shariah-compliance and governance-perspective to examine whether the new law has overcome the constraints or limitations of the Malaysian Shariah Governance Framework (SGF 2011) to ensure effective Shariah governance, as highlighted by the author’s earlier studies on Shariah audit1 and her critical appraisal of the Bank’s Shariah governance framework, the SGF 2011.2 Reference is made to the specific section, Part IV, on “Shariah Requirements” of the IFSA 2013, to see whether the prevailing concerns regarding the accountability, independence and objectivity of the SC have been given due consideration. It will also assess the adequacy of protection accorded to consumers through the expanded avenues for consumer redress as provided under this Act to strengthen the level of confidence in the Islamic financial system.

Introduction
The Islamic Finance Industry in Malaysia is “government-driven”, where regulators are described as being backed by political will; it is centrally regulated and adopts a proactive approach in its supervisory and oversight role. The most prominent feature in its Shariah governance set-up is the Shariah Advisory Council (SAC). Positioned in the hierarchy of Shariah supervision and oversight, the SAC as the main accessory for the two central regulatory bodies (the Central
Bank of Malaysia and the Securities Commission of Malaysia) is given the mandate to standardise Shariah practices within their jurisdictions. It also acts as the final arbiter of any disputes on points of law or Islamic jurisprudence and is by mandate resorted to by the civil courts of Malaysia before they come to a decision on Islamic Finance issues.

Malaysia is not the only country that is concerned about greater compliance with Shariah and effective governance and the pressing need to have Shariah-compliant legal and regulatory mechanisms to ensure that IFIs comply with Shariah. Other countries are still drawing from the experiences of their counterparts, tweaking existing models before developing their own unique model in their persistent effort to manage risks of non-compliance with Shariah. In comparison with Malaysia’s GCC neighbours, the Shariah governance model of Bahrain, Kuwait, UAE, Qatar and Oman is based on a “minimalist approach”, in which the regulatory authorities expect IFIs to have a proper Shariah governance system without specifying the requirements in detail. Oman as a new entrant in the Islamic Finance Industry is reported to be opting for the decentralised approach rather than the centralised Malaysian model to ensure Shariah compliance. In this Sultanate, there will be no single, commonly accepted Shariah board overseeing the industry and no creation of a centralised Shariah supervisory board like the SAC of Malaysia. The Central Bank of Oman requires that each bank establish its own Shariah board and stricter rules will be imposed on the choice of Islamic financial modes to manage liquidity and other facilitative transactions, as well as on the “fit and proper” qualifications of their Shariah supervisory board, where the competency and maturity of Shariah scholars are measured by how well-grounded they are in Shariah and finance and how committed they are in performing their role through regular attendance at meetings. The minimum years of experience was set at ten years before Shariah scholars can serve on any Shariah supervisory board in Oman. Dubai has recently switched over to a centralised Shariah board after seeing the benefits of legal and regulatory clarity offered by centralised governance. The Malaysian Shariah governance model, although displaying some semblance of uniformity, is still in need of fine tuning, “as no system can be perfect” (Sheila Aion Yussof and Abdullah Masoud Alharthy, 2013). Saudi Arabia is the only GCC country that adopts a “passive approach” where the existing Shariah governance system as practiced by IFIs is not with any legal and supervisory requirements but rather is a voluntary initiative with indirect influence from the market. Generally, in all these countries the AAOIFI standards will be used for effective management of Shariah compliance. AAOIFI, a standard setting body focusing on accounting and auditing, is based in Bahrain and GCC central bankers and regulators--particularly within Bahrain--have naturally endorsed their support for AAOIFI
standards, although in many cases, there has been a resistance to making the standards mandatory across borders (several countries’ regulators require compliance with AAOIFI standards, but others do not).\textsuperscript{10} Other governance standards are offered by international standard setters like the Malaysian-based Islamic Financial Service Boards (IFSB), which provide guidelines on effective governance and consumer protection in the Takaful industry under the IAIS-IFSB\textsuperscript{11} collaborative effort (the Insurance Core Principles). Recently, there has been a shift towards making the IFSB standards mandatory which may mark the failure by AAOIFI to broaden its mandate beyond accounting and auditing standards (primarily adopting the international standards for Islamic financial institutions). AAOIFI was considering expanding its role to include investigating breaches of Shariah-compliance by member institutions, but the effort appears to have “fizzled out”, overshadowed to a certain extent by the IFSA 2013 and IFSB standards\textsuperscript{12}.

There is greater awareness now (with numerous examples given in the GCC of failed transactions or Sukuk-securitisation which circumvented Shariah for commercial pursuits) that to ignore the implications or risks of non-compliance with Shariah is to be exposed to other contagions such as operational and systemic risks which make the industry vulnerable to financial instability. To ensure the continued safety and soundness of financial institutions and to promote overall financial and payment systems stability, the Bank as a central regulator has to undertake a yearly assessment of risks and challenges faced by the financial system and to review the strength of its regulatory and supervisory measures. Malaysia undergoes this annual assessment under the Financial Sector Assessment Program (FSAP) conducted by the International Monetary Fund and World Bank. And as a result of the Financial Stability and Payment Systems Report 2012, “the Islamic Financial Services Act (IFSA) 2013 and its conventional counterpart the Financial Services Act (FSA) 2013 were enacted to reinforce the Bank’s mandate to safeguard financial stability and strengthen the foundations for a regulatory and supervisory framework that is effective, transparent and that can contribute towards an efficient financial system that is resilient to future stresses. The new laws also strengthen the oversight on the market conduct of financial service providers, promote effective oversight of payment systems and payment instruments, and support preconditions for the development of the financial sector.”

The IFSA 2013

The Islamic Financial Services Act 2013 was enacted to reinforce the CBM’s mandate to safeguard financial stability as well as to statutorily monitor and
enforce Shariah compliance. The Bank is given the locus standi to initiate civil actions in court against financial institutions. The Act empowers the Bank with wider responsibilities to expand its early intervention role in addressing emerging problems in financial institutions. It represents a modernisation of Malaysia’s financial sector laws to make it financially inclusive with international financial systems. Rifaat Abdel Karim, a former IFSB secretary general, gives a glowing commendation to the new legislation, that “when it comes into force, it will be a landmark law, and perhaps the only omnibus Islamic finance legislation in the world.” Other positive comments about the Act are that it has elevated the country’s status to become the world’s most important Islamic finance centre, internationally known for its continued and resolute focus on developing Islamic financial services and products, a sound regulatory infrastructure with strong global integration, and skilled talent in managing and innovating Shariah compliant products. A contrary opinion is however held by a former central banker who was CBM’s Project Advisor for IFSA 2013, that the new legislation has not made dramatic changes to the Shariah governance system within Malaysia (Gopal Sundram, 2013). What it does is to formalise the Shariah regulatory system for Shariah compliance within the overall regulatory system in relation to oversight on the process of determining Shariah compliance, and specifically to oversight of the operational details associated with products. This raises the question why it was not steered towards the changes as expected when the project advisor was charged with the responsibility to make a difference? Could it be that the Bank will leave it to the Shariah scholars and Shariah Committee members to determine the arrangements through a separate body, or as recommended by the present author in another study, a council to govern the role and responsibilities of the Shariah board like the Bar Council for the legal profession, as an independent body, which cannot and should not therefore be created by statute?

The IFSA 2013 has consolidated the Islamic Banking Act 1983 and the Takaful Act 1984. The new Act was gazetted on 22 March 2013. At first glance, the new Act provides a comprehensive regulation and supervision of Islamic financial institutions, payment systems and other relevant entities. It also covers the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah. Some of the key features of the new legislation referred to in this paper include:

- Greater transparency and accountability of the CBM in carrying out its principal object to safeguard financial stability through a more risk-focused and integrated approach to the regulation of financial institutions;
- A comprehensive or end-to-end Shariah-compliant legal framework with respect to regulation and supervision (from licensing to winding-up);
- Strengthened business conduct and consumer protection requirements to promote consumer confidence in the use of financial services and products;
- Strengthened provisions for effective enforcement and supervisory intervention through imposition of higher penalties to act as a credible deterrent; locus standi given to CBM to initiate civil actions in court against financial institutions. CBM can also issue directions of compliance or accept legally enforceable undertakings that commit financial institutions to take specific actions to address identified risks.

**Past Research on Constraints to Effective Shariah Governance**

It was only recently in 2011 that the CBM introduced the Shariah Governance Framework to ensure effective Shariah governance for Islamic Banking and Takaful industries. The principle-based directives given by CBM were viewed, however, to be inadequate to deter IFIs from committing consistent acts of Shariah non-compliances, which were either the result of a greater focus given to commercial viability by IFIs in order to remain competitive or the limited understanding of the macro socio-economic impact of Shariah non-compliances.

Various research projects undertaken by academicians and research analysts have exposed the areas where IFIs have failed to undertake end-to-end compliance to the Shariah throughout its operations. This was due mainly to weak internal controls and inadequate or ineffective audit at the implementation stage by IFIs (Abdul Rahim, 2008), or, from a risk-focused approach, the scant attention given to the level of risks that Islamic financial institutions, markets and products pose to the overall financial system (Zeti Akhtar Aziz, 2012). The dangers of Shariah non-compliances were also highlighted as a risk that can have contagion effects such as systemic risks which can lead to financial instability. There were rampant practices of form over substance compliance by IFIs due to the replication of conventional products, which exhibited the Shariah features only in form, but in substance only mimicked conventional practices, rather than reflecting Shariah objectives, or *maqasid al-Shariah*.

**Strengthened Provisions for Effective Enforcement and Supervisory Intervention under the IFSA 2013**

Effective enforcement is achieved mainly through enactment of civil and criminal penalties for Islamic Financial Institutions for non-compliance to Shariah. It is shown in this section that the new Act has provisions for both civil and criminal penalties for Shariah non-compliance by an Islamic financial institution. Under the new legal framework, Islamic financial institutions will be deterred from committing statutory offenses, as the punishment (if convicted), will be
imprisonment for a term not exceeding eight (8) years or being liable to a fine not exceeding RM25 million ringgit or to both [Clause 28(5) IFSA 2013].

Legislating punitive measures was recommended in an earlier paper to deter unethical practices and persistent violations of Islamic laws and regulations by IFIs in Malaysia (Sheila Ainon Yussof & Abdullah Masoud Alharthy, 2013). The issue raised here is the severity of the punishment. The regulators and legal drafters of the IFSA have viewed non-compliances not to the same degree as suggested by the above study, where it should be persistent non-compliances and not first-time offenders, as the classical rule for any crime is that the punishment must fit the crime. It is suggested here that the regulator rely on two consecutive Shariah audit reports showing consistent deviations by IFIs before meting out severe punishment.

However, if one takes the position of the regulators, it is submitted here that the strict provision under Section 28 is designed to support the principal regulatory objectives of the Act, which is aimed at promoting financial stability and compliance with Shariah. It requires IFIs to ensure at all times that their aims, operations, business, affairs and activities are in compliance with Shariah [Clause 28 (1) of the IFSA]. The term “institution” in this section refers to an authorized person (directors, controllers or officers) or operator of a designated payment system. The severity of the punishment is an indication of the regulator’s seriousness in managing Shariah non-compliance risk as it can lead to systemic risk and financial instability.

The present writer however views this as an onerous duty which could create a backlash and hamper the growth and development of the Islamic Finance Industry as potential entrants to the industry may fear being made a criminal. The law as it is now states that any person, including a financial institution or its directors, controllers or officers, is considered to have committed a criminal offence if he contravenes the requirements under Clause 28 of IFSA, and this may reduce the number of experts wanting to serve the Islamic Finance Industry as directors, chief executive officers and auditors.

The other area that needs further clarification is related to the procedural mechanism under Section 28 (3), where in the event that an institution becomes aware that it has failed to abide by this statutory requirement of complying with the Shariah or the advice of its Shariah Committee (SC) or ruling of the Shariah Advisory Council (SAC), the institution shall do the following:

- Immediately notify the Bank (CBM) and its SC of the fact of non-compliance;
- Immediately cease continuing with the business activity which is the cause of the non-compliance, and
- Submit a plan for rectification of the non-compliance to the regulator (CBM) within 30 days.
The circumstances in which an institution becomes aware of the offending situations are not outlined here. How does an institution discover the fact of non-compliances? Will it be through the Shariah Committee or internal audit reports? Will the discovery of non-compliances be fully reported? Are there governance arrangements and mechanisms within the IFIs that can erode the independence and objectivity of internal control reports and the SC reports? Can the new legal framework accommodate the role of whistleblower? Can information on non-compliances be suppressed by IFIs since the SC members are remunerated by the IFIs and not by a public or professional body?

It is not intended here to cast aspersions on the role of Shariah scholars, but under principles of good governance, there must be a separation of powers between IFIs and the Shariah Committee to prevent conflict of interest. This would require that the SC members be remunerated by a public body and not by IFIs. Furthermore, if it is the Shariah body that has designed the Shariah-compliant manual and the oversight procedures, it must not at the same time review its efficacy or compliancy; otherwise it amounts to “self-review” and the erosion of independence.

As Section 28 (3) requires the institution to immediately notify CBM of not complying with the Shariah, the advice of its SC, or the ruling of the SAC, perhaps it is time to consider the setting up of a Central Compensation Fund where it is the CBM who will remunerate the SC and SAC members directly.

There is a need to overhaul the Shariah governance system relating to Shariah advisory, so that independence can be further strengthened through a separate professional body to govern Shariah advisors or SC members similar to the Bar Council that governs the legal profession. It can be called the Governing Council for Shariah Advisors, to be made a public body under the supervision of the Central Bank (Sheila Aion Yussof & Abdullah Masoud Alharthy, 2013); or as an independent regulatory body for the SC (not governed by the CBM) known as an “Association of Shariah Advisors”, where the Central Bank and IFIs can seek their services (Akram Laldin, 2012).

Civil and Criminal Penalties for SC Members for not complying with Shariah Standards set by CBM

The questions that were posed in an earlier research (Sheila Aion Yussof & Abdullah Masoud Alharthy, 2013) requires further reflection here: Can the SC be sued for not reasonably foreseeing harm to customers when it approves based on the legality of transactions for commercial reasons and not on the basis of applying the objectives of the Shariah which requires protection of consumers or looking after their welfare for social reasons or the public good? Or will they be immune from liability suits based on the justification that Shariah advisors individually, or Shariah Committee members collectively, cannot be sued if they
made the wrong decisions on Shariah compliance because they have religious immunity in exercising collective *ijtihad*?

The above questions have been answered to a certain extent by section 29 (6) of the IFSA: “*Any person* who fails to comply with any standards specified under subsection (1), commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.” The persons here include “every institution, its director, chief executive officer, senior officer or *member of a Shariah committee*” (emphasis added). Section 29 (1) gives power to the CBM to specify standards on Shariah matters with consultation of the SAC.

It appears that the institution, its director, chief executive officer, senior officer, can be caught under two IFSA sections: Section 28 (3) for not complying with Shariah, the advice of the SC or the ruling of the SAC; and Section 29 (6) for not complying with the Shariah standards as prescribed by the CBM. The institution and its officers will be walking a tight rope, trying to balance business goals and strict statutory requirements of Shariah compliance. Will this also be reflected in their KPIs (Key Performance Indicators)?

Furthermore, the law as it is described in the Act does not specifically link the potential of jail terms to compliance with the SAC, which may also err in its advice to CBM on the Shariah standards, ultimately affecting the legal positions of the consumers in Islamic financial transactions. Under the new law, any affected customer would have a right of civil redress against the financial institutions. But it is not clear whether the SAC can be accountable for giving wrong advice to the CBM, where the effect of the Shariah approved Islamic financial product was unjust enrichment of the financiers to the detriment of customers.

**Contract-Based Regulatory Framework for Islamic Finance under the IFSA**

The IFSA has established a strong legal foundation for the evolution of a contract-based regulatory framework (See Diagram 1). The legislation contains provisions that enable CBM to specify regulatory requirements that promote and are consistent with Shariah contract-based operational frameworks. As the principles of Shariah will be enforced within this framework from end–to-end, it will ensure a comprehensive Shariah governance and compliance in the Islamic financial sector and facilitate reducing the legal and operational risks in the conduct of Islamic financial transactions. The holistic governance approach will redress the lopsided or imbalanced monitoring and oversight of Shariah compliance management, at the product development and implementation stages by IFIs, and preclude the form over substance compliance, as highlighted by earlier research.
In this regard, CBM is now empowered under S 29 of IFSA to specify “Shariah Standards” for key Islamic contracts in consultation with the Bank’s Shariah Advisory Council. The standards will define the essential features of the contract which will promote certainty and enhance public confidence in Islamic financial transactions. The Shariah standard on Mudarabah was issued in October 2012, while Shariah standards on murabahah, musharakah, ijarah, wadi’ah and istisna are expected to follow in 2013 and 2014. The well-defined Shariah parameters should also incorporate the ethical standards or maqasid benchmarks. It should address the possible harm to consumers when Islamic financing modes are viewed from the legality and not the maqasid aspects. At this juncture, the Shariah standards are still to be determined by CBM. An earlier study had put forth the recommendation as a public policy requirement that any Shariah decision on product development must take into consideration both the legal and maqasid impacts for the public good and a sustainable development of the Islamic Finance Industry in Malaysia.

CBM is also empowered to issue guidance or Operational Standards on Shariah matters to address sound practice principles and the Bank’s expectations for effective risk management, governance, disclosures and appropriate legal and accounting treatments for key Islamic contracts that are necessary to ensure compliance with Shariah under different Islamic contracts (See Diagram 1).

Diagram 1  Contract-Based Regulatory Framework

<table>
<thead>
<tr>
<th>Shariah Standards</th>
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<tbody>
<tr>
<td>Compliance with fundamental requirements of respective Shariah contracts</td>
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<tr>
<th>Operational Standards</th>
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<tr>
<td>Strengthened risk management, governance, transparency and disclosure, market conduct and other operational aspects of applying Shariah standards</td>
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<tr>
<th>Oversight Functions</th>
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<tr>
<td>Codification of the role of the Shariah Committee and Board of Directors of financial institutions in ensuring Shariah compliance</td>
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<tr>
<th>Resolution</th>
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<tr>
<td>Priority of payment reflective of underlying Shariah contracts</td>
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For End-to-End Shariah Compliance under the Islamic Financial Services Act 2013
To achieve greater alignment with Shariah, the Act clearly defines the scope of assets and liabilities in Islamic Banking based on the underlying contractual features. For instance, on the liability side, the use of principal-guaranteed Shariah contracts such as *qard*, *wadi’ah* and *tawarruq* in deposit-taking is clearly distinguished from principal non-guaranteed Shariah contracts for investment such as *mudarabah* and *wakalah*. On the asset side, the scope of financing activities similarly draws on the distinctive features of Islamic contracts to include equity and partnership financing contracts such as *musharakah mutanaqisah*, lease-based financing contracts such as *ijarah muntahia bittamleek*, and fee-based activities under *wakalah* contracts. The new legal framework will ensure that the laws are reflective of the “true nature” of Shariah contracts (Zeti Akhtar Aziz, 2012).

Does the “true nature” of Shariah contracts also mean that all Islamic contracts must now reflect both the contractual requirements of an Islamic contract and the *maqasid* of the contracts? Is there now a conscious steering by the regulator to ensure that the Shariah objectives of justice, equity and fair play must be followed to protect consumers and other stakeholders? This is apparent in the significant change made by the IFSA for Takaful industry, in which legal effect is given to the segregation of ownership of funds between the Takaful participants and the shareholders to ensure true conformity with Shariah in Takaful operations; and the greater emphasis on fiduciary relationship between Takaful operators and Takaful participants as stipulated in *mudarabah* or *wakalah* contracts employed in Takaful business where Takaful funds must be managed on behalf of and in the best interests of Takaful participants. But one thing that will be assured by the IFSA is that with greater clarity on the legal and prudential requirements underpinned by Shariah principles in its regulatory architecture, it will enable participants in the Islamic financial system to align their practices and expectations accordingly with Shari ‘ah when undertaking Islamic financial business and transactions (Zeti Akhtar Aziz, 2012).¹⁶

Another significant feature of the IFSA is in the provision of a strong legal foundation for the dissolution of IFIs. Thus under Resolution (Diagram 1), in the event of say, a winding-up or dissolution of an Islamic bank or Takaful operator, the priority of payment should be reflective of underlying Shariah contracts and be in line with distinctive elements of the relevant Islamic contracts: for instance, payments to Islamic depositors are prioritised in a manner that is consistent with the guaranteed nature of contracts employed in Islamic deposit products. Assets managed on behalf of investors (Investment Account Holders) are legally ring-fenced from the assets of the Islamic banks to reflect the prohibition of any co-mingling of profits and losses attributed to the investment account with other funds. Likewise for Takaful business, assets of Takaful funds and shareholder funds are separated and utilised to meet the respective liabilities and these
obligations differ in priority based on the specific contracts underlying the Takaful business model.

Now that IFIs are geared by the contract-based regulatory framework toward ensuring authenticity in its Islamic financial products, it should also move IFIs towards a Shariah-based operating environment. Innovations should be contractually engineered on the basis of Islamic contract principles and features, and not as currently practiced, through a financial engineering of Islamic contracts to mimic the nature of conventional instruments. This could mean a new focus for innovation from the fount of Shariah instead of replicating conventional contracts that have caused harm to consumers from the transfer of risk to the latter.

Islamic Finance has a diverse spectrum of Shariah contracts in financial transactions that provide for different risk and return profiles. Complying strictly with the (legal) specificities of the contract will preserve the sanctity and validity of Islamic financial transactions, but what should be further considered are the ethical and social implications of the contract. Islamic contracts and instruments must reflect the true nature of their contractual form and substance to not only distinguish themselves from their conventional counterparts but also to ensure systems and financial stability.

However, with the power given to CBM under the new law to address non-compliance with Shariah and operational standards one would expect greater supervisory intervention to require prompt corrective actions. Enforcement is greatly assisted by a comprehensive penalty framework that provides a credible deterrent.

**Market Conduct and Avenues for Consumer Redress**

Specific provisions in the IFSA have significantly strengthened the preconditions for an effective regulatory and supervisory regime for business conduct and consumer protection. The CBM has been given wider power to specify standards on business conduct which go toward ethically conscious behaviour.

To this end the new legislation provides explicit and expanded powers for CBM to set and enforce business conduct standards on Financial Service Providers (FSP) in the following areas:

- Disclosure requirements
- Fairness of contract terms
- Financial promotion
- Provision of advice and complaints handling.

The legislation also identifies prohibited conduct that is inherently unfair to consumers, enhances the legal protection provided to consumers in relation to dealings with Takaful (and insurance) companies and intermediaries and provides for the evolution of avenues for consumer redress.
To complete the end-to-end compliance, and at the dispute settlement stage, there must be a dispute resolution mechanism that can assure customers of the enforceability of Islamic finance contracts in any jurisdiction, as Shariah law must be the governing law to settle disputes that involve Islamic law and ethics (Sheila Ainon Yussof, 2013). Before the Act was introduced, aggrieved customers of IFIs sought justice or redress through civil courts, which referred to the central Shariah advisory (the SAC) for Shariah reference, before making decisions. Under the new law, any affected customer has the right of civil redress against the financial institutions. With the introduction of the IFSA, industry players and investors will find legal certainty when seeking recourse following disputes or disagreements on certain points of law. This will instil more confidence among current and potential investors in Shariah compliant products and services. It will also increase cross-border dealings when there is certainty of the law on dispute settlement and payment systems.

The avenues for consumer redress have now been widened by the IFSA. Thus in addition to litigation and arbitration and financial mediation the CBM is now empowered to approve financial ombudsman schemes, which is another alternative dispute resolution mechanism aimed at ensuring effective and fair handling of complaints and resolution of disputes. Currently there is no specific mechanism for ADR in Islamic Finance. Conventional finance has the Financial Mediation Bureau. A provision now exists in the IFSA for the establishment of a Financial Ombudsman Scheme (FOS) to arbitrate legal and Shariah disputes and to act as an intermediary between disputing parties. It is not yet clear how the FOS is going to be implemented, as the IFSA does not specify its structure or organization (Hashimah Yaacob, 2013). What is certain however is that all Islamic financial institutions operating in Malaysia will be the members of the FOS.

Legislatively providing the FOS avenue or mechanism under the IFSA to arbitrate legal and Shariah disputes in Islamic finance amounts to an ouster clause, which excludes the power of the court as the final arbiter. This means that parties who agree to seek recourse through the FOS instead of the court system will not be able to bring their cases back to the civil court for redress. At this stage, the kind of scheme that the regulator will implement is not elaborated. The issues whether FOS decisions are binding and recognised by the court or not are still being discussed, as some declare that FOS is not like an arbitrator.

Conclusion and Recommendations
Malaysia is one of the few countries where the regulator is given a mandate to promote Shariah compliance among Islamic financial institutions. Glowing commendations have been given to this important legislation crafted by regulators,
policy makers and legislators, industry players and scholars, as the only omnibus Islamic Finance legislation any country has hitherto initiated. It is a landmark law development for introducing an Islamic financial system which takes holistic and humanistic approaches towards the governance of IFIs, not forgetting the punitive measures to act as a deterrent for institutions that fail to comply with the Shariah in its goals, operations, business, affairs and activities. These features support the principal regulatory objectives of the IFSA 2013 (Section 6), which is to promote financial stability and compliance with Shariah, wherein the CBM is given a wider mandate to foster the following:

- Safety and soundness of Islamic financial institutions;
- Integrity within and the orderly functioning of the Islamic money market and Islamic foreign exchange market;
- Safe, efficient and reliable payment systems and Islamic payment instruments; and
- Fair, responsible and professional business conduct of Islamic financial institutions.

And most important is the effort made to protect the rights and interests of consumers of Islamic financial services and products.

Some of the shortfalls of the new law were underlined in a remark, as earlier quoted, by a former central banker and CBM’s Project Advisor for IFSA 2013, Gopal Sundram, who states that the new legislation has not made dramatic changes to the Shariah governance system within Malaysia. In his view, there is not much specifically outlined in the law that defines the responsibilities of a Shariah board. What it does is to formalise the Shariah regulatory system for Shariah compliance within the overall regulatory system in relation to oversight of the process of determining Shariah compliance, and specifically to oversight of the operational details associated with products.

The author concurs with this observation and recommends the following:

- In using the CBM Shariah Governance Framework (SGF 2011) guidelines, we recommend a restructuring and re-engineering of the Shariah Governance system in terms of the composition and formalisation of Shariah boards under the IFSA as a point of reference. Similarly, appointment and tenure of Shariah Committee members should be revised. There is a need for greater clarity on responsibility, accountability, independence and objectivity to prevent conflict of interest and self-review situations; competency building through a comprehensive training programme to preserve or increase the quality of Shariah advisory; and succession planning to ensure continued leadership in this area.
• A separate professional body should be established to govern Shariah advisors similar to the Bar Council for the legal profession: either as a public body under CBM or as an independent regulatory body not governed by the CBM. This professional body may be known as the Governing Council for Shariah Advisors or Association of Shariah Advisors and will decide on fit and proper qualifications and good governance principles and ensure the quality of Shariah advisory services through talent development as well as the setting up of a Disciplinary Board for Shariah advisors or SC members.

• A Central Compensation Fund should be set up by CBM to remunerate Shariah Committee members directly; or alternatively a standard fee imposed by CBM requiring all IFIs to pay at the same rate for hiring the services of SC members to ensure equitable compensation among SC members, to prevent Shariah arbitrage, and erosion of SC members’ independence.

• A public policy requirement should be made for Shariah Committee’s decisions on product development to be based on a matrix of legality of transactions vis-à-vis maqasid impacts (to achieve social justice or public good). A Product Development Framework must show both the legal effect and ethical impact (socio-economic, environmental, etc.) before the product can be approved or certified as Shariah-compliant, or preferably Shariah-based products.

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Notes

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3. The “standardised” or “harmonised” Shariah concept is a component of institutionalisation of Shariah. Standardisation of Islamic financial contracts has its major benefit in ensuring the enforceability of such contracts in disputes brought before civil courts that are not legally bound by the Shariah. M.A. Laldin (2010) of ISRA defines institutionalisation of Shariah as the process of embedding Shariah concepts within an organisation which in turn governs the behaviour of a set of individuals in the organisation or outside it.

4. Countries in the Gulf Co-operation Council (GCC) consist of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. With the exception of the Sultanate of Oman, all IFIs in the other GCC countries have their own framework of Shariah governance systems, where Zulkifli (2012) classifies the Shariah governance approach under two distinct categories: regulation through legal and supervisory requirements as in the case of Bahrain, Kuwait, UAE and Qatar, or through self-regulation as in the case of Saudi Arabia.


7. Bahrain was the only country in the GCC to establish a National Shariah Advisory Board in the Central Bank of Bahrain to serve and to verify Shariah compliance, but it does not have authority over the IFIs unlike Malaysia, Sudan, Indonesia, Pakistan and Brunei (Zulkifli, 2012). Dubai has now opted for a centralised Shariah supervisory board.

8. Ibid.

9. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is an international standard setter on audit, governance and Shariah standards based in Bahrain, where the standards are not mandatory for IFIs to adopt.


11. The International Association of Insurance Supervisors (IAIS) is a global standard-setting body which exists to promote consistent regulation in the insurance industry. Its Insurance Core Principles, Standards, Guidance and Methodology (ICPs) provide a “globally accepted framework” used in assessing the effectiveness of supervisory regimes in the insurance sector. The ICPs are used by the World Bank and International Monetary Fund to assess international regulatory regimes under the Financial Sector Assessment Programme (FSAP).

12. The endorsement of IFSB standards by an Executive Director at Bahrain Central Bank, Khalid Ahmad represents this shift as he stated that “The moment it (use of IFSB standards) becomes mandatory then it will serve the purpose better” (2013).

13. The Star Online, 6 February 2013. Professor Datuk Dr. Rifaat Ahmed Abdel Karim is now the CEO of International Islamic Liquidity Management Corporation (IILM) based in Malaysia. The IILM is an international institution established by Central Banks, monetary authorities and multilateral organisations.
to create and issue short-term Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

14. The Financial Stability and Payment Systems Report 2012 outlines Bank Negara Malaysia’s assessment of risks and challenges faced by the Malaysian financial system and the capacity of the system to sustain its financial intermediation role in the economy. It also reports on the developmental initiatives pursued by the Bank to reinforce the roles of the financial services sector in supporting and contributing to economic growth and the economic transformation process, as well as the regulatory and supervisory measures undertaken by the Bank to ensure continued safety and soundness of financial institutions and promote overall financial and payment systems stability. The publication is intended to promote greater understanding on issues and developments affecting financial stability, including policy directions of the Bank.


16. The Governor of Central Bank of Malaysia in her keynote address at the 8th World Islamic Economic Forum (WIFE) held in Malaysia on 8th December, 2012.

17. A researcher from the International Shariah Research Academy (ISRA) in an interview with The Edge Malaysia.
Debt and Economic Activity

Abdul Karim Abdullah (Leslie Terebessy)*

Abstract: Many nations, rich and poor alike, are reeling under mountains of interest-based debt. What are the effects of large and growing debts on economic activity? It is widely believed that borrowing helps the economy to grow faster. However, a number of recent studies have shown that, beyond a certain threshold, large levels of debt in fact slow down economic activity rather than stimulate it. It appears that in some countries this threshold has already been passed. Others are coming dangerously close to it. Reduced or negative rate of growth makes it harder to repay existing debts. Social unrest has taken place in a number of countries as governments channel increasing amounts of limited tax revenues towards the repayment of debt with interest to creditors. A more effective way to respond to the debt crisis is to adopt bona fide Islamic financing. In such a system there is no room for earning interest income by lending. Active participation in the real sector is required. Participation in real sector activity is rewarded by incentives in the form of profits, rents, and wages.

Introduction

Debt is a condition of obligation by one party to another. It commonly arises from borrowing. Items borrowed typically include real assets or money. When real assets are borrowed, the fee paid for their use is known as rent. When money is borrowed, the fee paid for its use is known as interest. The difference between rent and interest is that the former is paid in return for an item that is in some way useful. Interest, by contrast, is paid for the use of money alone, which in itself is not useful.

Money can be borrowed formally or informally. Formal lending is documented by means of contracts between borrowers and financial institutions. Informal lending such as when friends make interest-free loans to each other is normally not documented. Formal lending invariably takes place at interest.

A loan contract is a legally enforceable agreement between the debtor and the creditor. The creditor permits the borrower to make use of the creditor’s money for a period of time for a fee (interest). The amount of money loaned is known as the principal amount of the loan. The principal has to be returned to the creditor in full on a date that is agreed upon in advance. This date is known as the maturity date of the loan.

People go into debt for various reasons. In some cases, they may be unable to meet their basic needs using their own resources and thus feel compelled to borrow. In most cases, however, people borrow to purchase consumer items such
as automobiles or houses. Others may borrow to take advantage of what may appear to be a promising business opportunity.

In some cases people may be enticed into going into debt without the full knowledge of all the terms and conditions of the loan contract they enter into. Such enticements may take the form of “free” gifts, inexpensive trinkets that have the effect of making potential borrowers more amenable to going into debt.

Loans can be repaid in a single (bullet) payment or they can be amortised. When a loan is amortised, the total amount of repayment is spread evenly over a specified number of repayments. By the time the debtor makes the last payment, the loan will have been fully repaid. The amount of interest, along with the dates on which it has to be paid, is specified in advance.

Unlike payments of profits to investors the amount of interest is determined as a percentage of the loan rather than as a percentage of any profit earned with the help of the loan. Nevertheless, in the case of business loans, all money paid to creditors in the form of interest still has to come from the profits earned by entrepreneurs. In other words, raising funds by way of borrowing at interest reduces the profitability of any business that uses this method of financing. Moreover, when entrepreneurs are unable to earn sufficient profits to make the agreed-upon payments of interest, the money to repay debts will have to come from other sources.

Should a debtor fail to repay any part of the loan as agreed, or should he fail to pay any part of the interest, he will be in default. Default is a breach of the loan contract and may result in court proceedings by the creditor to recover any outstanding amounts due to him from the debtor.

Debtors may be unable to repay for a number of reasons. They may have borrowed too much. Alternatively, personal or business income may fall short of the levels necessary to make repayments. An economic downturn, a drop in the price of exported commodities or an unfavourable change in the foreign exchange rates can also make debts more difficult to repay. Should a debtor be unable to pay, he may default and be driven into bankruptcy.¹

Since the legalisation of lending at interest, indebtedness has become a part of everyday life. Few are able to conceive of life without credit cards, banks, housing mortgages, car loans or student loans. Traditional restraint regarding indebtedness has given way to a culture of debt, if not also to a culture of living beyond one’s means.

The new perspective on debt makes it more socially acceptable to go into and remain in debt. Spend first, and save money to repay debt later.² In the US, prior to the recent 2007 global financial crisis, “the personal saving rate plunged to 1 per cent, and the bottom 80 per cent of Americans were spending, every year, roughly 110 per cent of their income.”³
This contrasts with a more traditional view, according to which one is expected to save money before spending it. The use of savings for the purpose of spending enables the person or institution to stay out of debt. Remaining debt-free in turn is more conducive to safeguarding one’s dignity.

Given the number of personal and business bankruptcies in many countries, including bankruptcies of entire nations (sovereign default), debt-restructurings have become a part of life. What are the effects of indebtedness, in particular on economic growth? What is the evidence of these effects? What can be done to overcome indebtedness? These are among the questions addressed in this paper.

**Rising debt mountains**

While the risks of lending to creditors are often highlighted, the same cannot be said about the risks to debtors. The risk to the lender is that a borrower may fail to repay the debt or a part of it to the lender. The borrower, in contrast, faces the risk of being unable to repay the debt. The pressure to repay debt increases with the amount owed and the interest rate charged.

Borrowers generally go into debt in the expectation that their future income will be enough to pay off any debts with interest. However, this expectation is not always fulfilled. Kenneth Rogoff and Carmen Reinhart write, “What is certainly clear is that again and again, countries, banks, individuals, and firms take on excessive debt in good times without enough awareness of the risks that will follow when the inevitable recession hits.”

Borrowing is risky even when no interest is paid on a loan. There is no guarantee that a borrower will be able to repay his or her loan, as and when agreed upon. Borrowing at interest is riskier, as the borrower has to repay more than what he borrowed. Simple interest increases the total amount owed at a constant rate. Compound interest increases the amount owed at an exponential (accelerating) rate.

The result of adding interest to a loan is that the final amount owed can be several times higher that the original amount borrowed. Over time, debt may grow so large that the debtor may be unable to repay it and default. This can result in becoming trapped in debt, being unable to get out of debt.

Borrowing is even more risky when it takes place at “floating” (or adjustable) rates of interest. The reason is that the borrower does not know in advance what rate he might be obligated to pay. Floating rates move up and down with market forces. This causes a considerable degree of uncertainty. When adjustable rate loans are taken out, borrowers become exposed to “interest rate risk,” or the possibility that interest rates may go up to the point where they will become unable to service their loans. This applies not only to households but also to firms and governments.
Today, indebtedness no longer affects only individuals and business, but even nations and their governments. Entire countries (Greece, Portugal, Spain, Ireland, and others) are teetering on the brink of bankruptcy. Indebtedness poses a threat even in relatively advanced nations. Stephen Cecchetti, M.S. Mohanty and Fabrizio Zampolli write:

High and rising debt is a source of justifiable concern ..., household and corporate, as well as government. Over the past 30 years, summing these three sectors together, the ratio of debt to GDP in advanced economies has risen relentlessly from 167 per cent in 1980 to 314 per cent today, or by an average of more than 5 percentage points of GDP per year over the last three decades. Given current policies and demographics, it is difficult to see this trend reversing any time soon.\(^6\)

In the US total non-financial debt, government, business and consumer, just prior to the Great Depression, was at 300 per cent of GDP.\(^7\) By 2010 it was 360 per cent of GDP. The US national debt currently exceeds $16 trillion, or more than 100 per cent of GDP. In 2012 $432 billion of interest, or nearly 3 per cent of GDP, was paid on the national debt. For the five-year period beginning in 2008 the US taxpayers have paid a total of $2.134 trillion in interest payments on the national debt alone.\(^8\) According to one estimate, by 2016 the US national debt will rise to $20.3 trillion.\(^9\)

Household and corporate debts have likewise reached unprecedented levels. Starting from near zero in the 1950s, by the second half of 2012 household debt in the US reached $12.9 trillion,\(^10\) on which more than $1.1 trillion of interest will have to be paid.\(^11\) Paul Krugman points out:

The root of our current troubles lies in the debt American families ran up during the Bush-era housing bubble. Twenty years ago, the average American household’s debt was 83 per cent of its income; by a decade ago that had crept up to 92 per cent; but by late 2007, debts were 130 per cent of income.\(^12\)

Other developed countries are hardly in a better position.

In advanced economies, during the five years preceding 2007, the ratio of household debt to income rose by an average of 39 percentage points, to 138 per cent. In Denmark, Iceland, Ireland, the Netherlands, and Norway, debt peaked at more than 200 per cent of household income.\(^13\)

Developing nations are not spared large debts either. Beginning in 1964, the government of Nigeria borrowed $17 billion from wealthy creditors. By 2005, and after six years of not borrowing, Nigeria’s debt ballooned to $31 billion, because compound interest and penalties were added to the original debt when Nigeria failed to make promised payments.\(^14\)
Effects of public debt

A high level of public debt has a range of adverse effects. “For individual households and firms, over-borrowing leads to bankruptcy and financial ruin. For a country, too much debt impedes the government’s ability to deliver essential services to its citizens.” Moreover, a high level of debt increases volatility and retards growth: “beyond a certain point, debt becomes dangerous and excessive.”

A study carried out in 2001 showed that in order for the US government to continue servicing its national debt as it has been doing in the past, personal income taxes would have to increase up to 65 per cent by 2013 just to pay the interest charges on the US national debt. Demographic changes in the form of low birth rates and an aging population present an additional challenge to the problem of debt.

For these reasons, governments may find themselves unable to service large and growing debts over the longer term. As total debt rises, additional borrowing becomes more expensive. If lenders begin to have doubts about a government’s ability to repay, as David Greenlaw et al. write, “the government will begin to pay a premium to international lenders as compensation for default or inflation risk. This higher interest rate in turn [will] make fiscal sustainability even harder to achieve, possibly leading to a fiscal crunch – a tipping point in which sovereign interest rates shoot up and a funding crisis ensues.” Cecchetti, Mohanty and Zampoli explain:

As debt levels increase, borrowers’ ability to repay becomes progressively more sensitive to drops in income and sales as well as increases in interest rates. For a given shock, the higher debt, the higher is the probability of defaulting. ... If the downturn is bad enough, defaults, deficient demand and high unemployment might be the grim result. ... In other words, higher nominal debt raises real volatility, increases financial fragility and reduces average growth.

Recessions are typically addressed with countercyclical spending. However, apart from displacing (crowding out) private investment, deficit spending adds to the national debt. Higher taxes necessary to repay debts in turn reduce private spending and further slow down economic growth. In addition, as debt increases, creditors are likely to demand higher rates of interest: Greenlaw et al. continue, “as the ratio of government debt to GDP rises, the government’s borrowing cost … likely rises with it.” In this way excessive borrowing restricts the government’s ability to maintain existing social programs and to finance new ones:

the capacity of the public sector to borrow is not unlimited. When a crisis strikes, the ability of the government to intervene depends on the amount of debt that it has already accumulated. ... Fiscal authorities may become constrained both in their
attempt to engage in traditional countercyclical stabilisation policies and in their role as lender of last resort during a financial crisis. That is, high levels of public debt can limit essential government functions.\textsuperscript{21}

High debts reduce growth in another way. The need to service debt requires the diversion of funds from spending in the real sector towards the repayment of debt. In this way, repayment of debt with interest reduces consumer spending, business investment and government expenditure on essential social services.\textsuperscript{22} In other words, the effects of paying interest on loans are similar to paying taxes. Higher interest rates reduce spending and therefore growth just as higher taxes do.

In the US, the rise in debt during the post war period was accompanied, Hyman P. Minsky writes, by “a significant decline in the growth of consumption”.\textsuperscript{23} Any fall in consumption, or even a decline in its growth, will slow down economic activity, as consumption is by far the largest component of aggregate demand, making up approximately 70 per cent of all spending. Repayment of government debt requires increases in taxes and reductions in social services, which further reduce aggregate demand.\textsuperscript{24}

A recent study of the effects of high levels of debt on economic growth in twenty advanced countries during the post WWII period showed that countries with a level of public debt in excess of 90 per cent had experienced average annual levels of economic growth that were significantly lower than countries with lower levels of public debt. Over the last two hundred years, countries with a debt higher than 90 per cent of GDP grew at an average rate of 1.7 per cent per annum.\textsuperscript{25} By contrast, countries with relatively low levels of public debt (30 per cent of GDP) grew on average at the rate of 3.7 per cent per annum.\textsuperscript{26}

A separate IMF study confirmed that “countries that crossed the 100 per cent threshold [of public debt to GDP] typically experienced lower GDP growth than the advanced economy average.”\textsuperscript{27} A study conducted by the Bank for International Settlements, similarly concluded that “beyond a certain level, debt is bad for growth. For government debt, the number is about 85 per cent of GDP. For corporate debt, the threshold is closer to 90 per cent. And for household debt, we report a threshold of around 85 per cent of GDP.”\textsuperscript{28}

The researchers of another study found “a significant relation between debt loads and borrowing costs”. Even more ominously, they found that interest rates “rise much more quickly at higher debt levels”.\textsuperscript{29} The reason for this is that as debt levels rise in relation to GDP, creditors “demand a higher interest rate in compensation for the possibility of default or inflation.”\textsuperscript{30} This already took place in 2010 “when several European countries suddenly faced rapid increases in borrowing rates on sovereign debt that rendered their current fiscal policies unsustainable.”\textsuperscript{31}
The implication is that a number of countries with high levels of debt would require impossibly high rates of GDP growth because of high levels of interest rates. The creditworthiness of the nation decreases as its debt load increases. As the creditworthiness of countries falls, creditors demand higher rates of interest to compensate for the possibility of default.

In 2012 the average yield on ten-year Greek government bonds was close to 23 per cent per annum. If Greece were to pay a 23 per cent interest rate on its outstanding debt, repaying its debt would become virtually impossible. Greenlaw et al. explain: “The reason is that with debt already at 165 per cent of GDP, 23 per cent interest on this debt would require 31 per cent [growth] ... of GDP each year just to make the interest payments.”

Even a large nation such as the US is not immune from the damaging effects of an increase in interest rates. Should the currently low interest rates on short-term debt, less than 1 per cent, rise to their former levels of approximately 4 per cent to 5 per cent, “debt service costs will skyrocket.”

Another damaging effect of large national debt, as can be seen from history, is political destabilisation. The Ottoman Empire collapsed in part due to the large debts it owed to foreign creditors. The large debts that Germany was saddled with after World War I facilitated the rise of Nazism, with calamitous consequences that manifested themselves in the run up to and during World War II. The need to reduce spending on social services and to increase taxes to raise revenue to repay debt is causing political upheavals in various European nations.

**Effects of debt on currencies**

The 1997 currency crisis was triggered by a speculative run on Asian currencies, by largely unregulated hedge funds. Hedge funds borrow vast amounts of money at interest, and then use this money to influence market prices in their favour by trading on a large scale. By entering a given market on a large scale, they increase the demand for the assets subject to speculation, for example, shares. As the demand for the shares goes up, their prices rise accordingly.

When speculators feel that the shares are unlikely to rise further, they reverse the flow and begin to sell their shares at the higher prices. They make a profit as a result of selling the shares at higher prices than those at which they bought them. Problems to the host countries may arise when their central banks do not have enough foreign exchange reserves (and may be unwilling to borrow from international lenders such as the IMF) to buy back the local currencies now sold by speculators as they attempt to withdraw their funds.

Initially, the entry of large sums of short-term investments into Asian stock markets boosted prices. The subsequent exit from Asian markets of even greater amounts of short-term speculative capital, however, had the reverse effects. A
number of countries ran out of foreign exchange reserves and had to devalue their currencies or borrow from the IMF. In this way, borrowing large sums by hedge funds, and using these funds for speculative purposes, can destabilise and even bankrupt entire countries.

As a result of currency devaluations, the amounts of the loans of the affected nations owed to foreign lenders ballooned.\textsuperscript{35} A number of countries defaulted on loans denominated in foreign currencies. Thailand defaulted in 1997, the Russian Federation in 1998, Brazil in 1999, Turkey in 2000, and Argentina in 2001. The crisis forced either IMF bailouts or the imposition of currency controls and currency devaluations.

**Debt and the 2007 economic crisis**

Ten years later, the recent global financial and economic crisis of 2007 witnessed the deepest contraction in 50 years. Excessive debt (leverage) was again a major factor contributing to the crisis. Surplus funds managed by hedge funds, along with pension funds, and insurance companies played a leading role in this crisis, when they channelled vast sums of money into the US subprime mortgage market by purchasing collateralised debt obligations (CDOs) on a large scale.

Greenlaw et al. observe: “The financial crisis of 2007 to 2008 occurred because we failed to contain the financial system’s creation of private credit and money.”\textsuperscript{36} As a result of excessive lending and low interest rates, an asset bubble developed in the real estate sector. The bubble burst when credit markets froze in August 2007. Asset prices, including the prices of the collateralised debt obligations, collapsed. “The subsequent sharp economic downturn in advanced countries reduced fiscal revenues and led to increased government spending, with the result that government debt has grown dramatically for most developed economies since 2008.”\textsuperscript{37}

The failure of Bear Stearns in the spring of 2008 was followed by the collapse of Lehman Brothers, another leading investment bank, in September 2008, by which time world trade contracted by 20 per cent. GDP of industrialised nations contracted by approximately 5 per cent, the worst contraction since the Great Depression.

Shortly thereafter, the American International Group (AIG) was bailed out using taxpayer funds, along with Freddie Mac and Freddie Mae, two major US government-sponsored mortgage-refinancing institutions. In the UK, Northern Rock and the Royal Bank of Scotland had to be rescued. Northern Rock experienced a run on the bank. A number of financial institutions were likewise deeply in debt.\textsuperscript{38} As a result of the rescues of troubled financial institutions, government debt increased dramatically: “when private borrowing has fiscal backing, default increases public debt.”\textsuperscript{39}
During the five-year period from 2007 to mid-2012 of the recent global financial crisis, more than 4 million families lost their homes while another 3.5 million homes were in foreclosure or behind in payments. In addition, 13.5 million houses were worth less than the mortgages that were taken out to buy them. During the same period, 7.3 million people declared bankruptcy.

The US government tried to keep the economy out of recession by deficit spending. The result is that the US public (government) debt has been growing at an exponential rate. It had grown from $2.4 trillion in 1987 to over $16 trillion by 2012. This does not include an additional $66 trillion of unfunded liabilities, mostly Social Security (pensions) and Medicare.

The danger presented by large and growing debts over the longer term is that a growing proportion of wages, profits and tax revenues has to be diverted from the real sector to repay debt. As a result, progressively less money remains available for spending on consumption, investment and the provision of essential public services. Lower spending in the real sector reduces aggregate demand and slows down economic growth. A reduction in growth in turn reduces government tax revenue and makes it still harder to repay debt. “Without rising GDP, there will be no way to raise the revenues governments need to reduce their exploding debts.”

This can cause a downward spiral. First, taxes need to go up in order to repay debt. Higher taxes, however, reduce consumption and investment. A reduction in consumption and investment spending slows down economic growth. A declining, stagnant or negative growth in turn causes a further decline in government tax revenue. A reduction in tax revenue coupled with the need to make higher interest payments worsens the (budget) deficit and makes it still harder to repay debt. Taxes may have to go up again, and the same cycle repeats itself.

The experience of Japan with utilising loan financing is instructive. In the 1970s, Japan’s Ministry of Finance “trivialized the role of equity markets” and encouraged Japanese corporation to use borrowing rather than risk-sharing (equity) financing for the purpose of investment. Initially the expenditure of borrowed funds stimulated investment and economic activity. Observers spoke of the “Japanese miracle.” Over the longer term, however, the miracle proved elusive. The large-scale expenditure of borrowed funds caused inflation and an asset bubble, especially in the property sector. Two decades later, in 1991, the bubble burst. Then a recession struck.

Now the problems of Japan include “a huge accumulated debt, and a very slow growth rate.” Over the last decade the average rate of growth in Japan has been –1 per cent. Japanese corporations are struggling to free themselves from a mountain of debt incurred in the heyday of borrowing. No end to the recession appears in sight.
In response to the recession, the government of Japan embarked on a policy of deficit spending. In trying to rescue the corporate sector, however, the government of Japan not only did not succeed in ending the recession. Instead, it went deeply into debt itself. Japan’s national debt is now the highest in the world, at 230 per cent of GDP. It stands at 120 per cent of GDP even after reserves of foreign exchange are taken into account. Much of its debt it owes to its own citizens, known for their high propensity to save.

The experience of the Great Depression of 1929-1939 confirmed that over the longer term high debts reduce rather than boost economic growth. Heavy debt loads, crushing interest rates and dramatic collapses in asset prices, all contributed to the Great Depression. Prior to the October Crash of 1929, household debt had been steadily rising, reaching a peak of 53 per cent of household income. Following the crash, between 1929 and 1939, nearly two million homes were lost to foreclosure.

Despite these realities, few signs of alarm about lending at interest are discernible in mainstream discourse on the latest crisis that started in 2007. From time to time one hears calls for more stimulus, as a way of overcoming the current crisis, but seldom, if ever, are fundamental assumptions, such as the utility of interest-based lending, subjected to scrutiny. Were parties with surplus capital forced to invest in the real sector instead of making loans at interest, many of the problems currently being experienced would be overcome.

In the meantime, government efforts are focused on identifying areas where money can be saved to divert more funds towards the repayment of debt rather than on attempts to reform the financial system. Due to a lack of alternative vision, governments solve the problem of debt by more borrowing (rolling over the debt). This does not solve the problem of debt in the long run. True reform will not take place until the thinking about the financial system changes. This requires the adoption of a new paradigm of economic theory to guide practice, one in which there is no room for interest-based financing, one where all financing takes place on the basis of risk sharing, as indeed required by ethical, that is to say interest-free, financing.

**Responses and proposed solutions**

The solution to the problem of large and growing debts, public or private, lies in adopting alternative, interest-free methods of financing, in particular risk sharing. This has already taken place in a number of countries. In Sweden, interest-free financing is available in the form of the JAK banks. In Turkey participatory banking has been introduced.

Financing investment by means other than borrowing at interest would ensure that only actual savings could be invested. This would have a significant
restraining effect on investment and prevent the type of overinvestment that results when financing business activity takes place with borrowed funds. Preventing overinvestment in turn would reduce the likelihood of the development of asset bubbles, the bursting of which invariably signal the beginning of a recession or worse.

Existing debt, whether public or private, should be converted into equity wherever possible. This has indeed been already done in the case of some troubled financial institutions. Bonds are commonly issued with warrants that give the option to creditors to convert their bonds into shares. Instead of making loans to businesses, financial institutions should take equity stakes in the businesses they wish to finance and re-invent themselves as “finance houses”. Their former depositors would have to be informed that as investors they face a degree of risk, depending on the manner in which they choose to participate.51

In this way the interests of the investors (former depositors) will be more fully aligned with the interests of the shareholders. They will also have a stronger incentive to exercise due diligence and ensure that they commit funds only to convincing and credible business enterprises. The law needs to change to enable banks to buy shares in businesses, as is already the case in a number of countries, such as Germany.

An interest-free financial regime will ensure that income can be earned only in exchange for productive activity, in the form of wages, rents or profits. This will ensure that only productive activity and risk taking will be rewarded. It will also ensure that all income will remain within the real sector (the circular flow) and not be withdrawn from it at any stage in the form of repayments of loans.

One way to facilitate the phasing out lending at interest is to encourage retailers to sell goods directly to consumers on an instalment basis. This is already a practice in a number of nations, in the sales of furniture, clothing or automobiles, for example. However, the problem with the current arrangement is that interest charges added to the price of the furniture substantially increase its final price to the consumer.

In order to avoid riba or interest, therefore, it is necessary to ensure that the credit price be the same as the spot price. This means that the sum of all the instalment payments, minus the administrative charge (set by law), must be equal to the cash price of the item.52 This should be done in all markets for consumer goods, including the housing and automobile market.

Direct selling by producers to consumers will increase efficiency by eliminating the need for financial intermediaries. It will do so by eliminating interest expenses paid by buyers, as well as by reducing administrative expenses. The reduced cost of consumer items will stimulate sales, increase production levels and increase levels of employment all at the same time.
Another way to accelerate the phasing out of lending at interest is to encourage firms to raise capital by issuing shares and participatory sukuk rather than by borrowing. The legal environment needs to be restructured to make the issuance of shares and sukuk easier and less complex. Tax breaks that favour lenders need to be transferred to firms raising funds by means of equity and sukuk. The rights of minority shareholders need to be better protected, transparency and accountability need to be enhanced and corporate abuses need to be curtailed.

These measures will result in higher overall production levels and less waste. In principle, in an interest-free economy, real GDP can be expected to rise by the amount currently paid out to all creditors in the form of interest payments, or by approximately 8 per cent of GDP. The reason is that all monies previously paid to lenders would now flow to workers in the form of wages, business people in the form of profit, and owners of real property in the form of rents.

This would be good news to consumers who currently pay higher prices for consumer goods due to the need of business firms to include interest expenses in the cost of final goods and services. It would also be good news to the unemployed. In an interest-free regime, firms that were previously unable to gain access to capital due to the fact that it came at a cost, would now be able to raise it on a risk sharing basis. In other words, they would no longer need to commit themselves to paying pre-determined rewards to the suppliers of capital in the form of interest, irrespective of the performance of the entrepreneurs’ businesses. This would enable firms to access investment capital, hire more workers and thereby boost both employment as well as production levels.

Conclusions and recommendations

The practices the law permits and prohibits significantly impact the long-term well being of society. The tolerance of harmful practices can have only harmful consequences. The harmful consequences of financing at interest, which enables some to “earn” additional wealth without the need to work and even to take risk, are becoming clearer by the day.

The need to channel progressively larger portions of income toward the payment of interest on debt is reducing aggregate demand and slowing down economic growth. An overall reduction in production resulting from reduced spending in addition reduces the standard of living, leaves fewer funds available for research and development and exacerbates recessions. What is worse, swings of business cycles since WWII have been getting more pronounced. Current trends are hardly sustainable.

It is clear that financing by way of lending at interest is neither sustainable nor viable over the longer term. In the series of crises since the Great Depression, each crisis has been more severe than the one that preceded it. The fact that
interest-based financing has been entrenched for centuries need not deter reforms. Slavery was likewise entrenched for centuries until it was abolished. An unjust practice is never sustainable over the longer term. The fact that many nations are facing bankruptcy should add a degree of urgency to the much-needed reform of the financial system.

Deregulation is not a panacea for economic problems. Economic activity, like any activity, needs to be regulated for the benefit of the participants. It needs to be regulated in ways that promote, rather than hinder, an efficient allocation of resources. Incentives need to be in place to reward real contributions to production. Above all, the opportunities for rent seeking in the form of interest income for which no meaningful counter value is given should be eliminated.

In order to achieve a fuller utilisation of resources, it is necessary to ensure that investment funds can be raised only on the basis of risk sharing, where investors take responsibility for the outcome of the enterprises they finance. The opportunity to obtain guaranteed income without work or without taking risk should not be tolerated as a matter of principle in any well-governed society.

- Public education is required to facilitate the conversion of debt-based to asset-backed financing.
- It is necessary to explain the advantages of financing on the basis of risk sharing.
- Economic theory that is not based on interest-based financing needs to be developed.
- Sellers should be legally permitted to sell directly to buyers on an instalment basis, while meeting the condition that the credit price be the same as the spot price in order to avoid interest. This should apply to both the product and resource markets.
- The debts of those unable to repay should be forgiven: if not the principal amounts, at least the interest portions of it.
- Tax breaks currently encouraging borrowing at interest rather than issuing equity have to be transferred to issuers of equity and equity-type instruments such as participatory sukuk.

Notes

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2. The motto of the new culture can be summed up in the slogan, “Enjoy now; pay later.”


5. Inability to repay debt or default is sometimes presented as “debt intolerance”. See Rogoff and Reinhart, This Time is Different, pp. 21-33.

6. This refers only to “nonfinancial” debt, which is owed by governments, businesses and households to financial institutions, but excludes debt owed by financial institutions to each other. Cecchetti, Stephen G., M. S. Mohanty and Fabrizio Zampolli, “The real effects of debt,” Bank for International Settlements, BIS Working Paper No. 352, September 2011, pp. 1, 5 and 7, accessed online on 4 June 2013, <http://www.bis.org/publ/work352.pdf>


11. US Department of Commerce, Bureau of Economic Analysis, accessed online on 21 June 2013; <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=288&ViewSeries=NO&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=1960&LastYear=2008&3Place=N&Update=Update&JavaBox=no#Mid>


22. Government debt is paid off when the central bank buys government issued bonds, which is an equivalent to printing money, also known as quantitative easing. This way of reducing debt, also known as the “monetisation” of debt, however adds to inflation and erodes the purchasing power of currency. Some economists refer it to as a form of “default.” Rogoff and Reinhart, This Time is Different, pp. 6-7.

24. High taxes are destructive of the community, as noted by Ibn Khaldun, among others. “Eventually the
taxes will weigh heavily upon subjects and overburden them ... The assessments increase beyond the
limits of equity ... Finally civilization is destroyed.” Ibn Khaldun, quoted in Alfred Gierer, “Ibn Khaldun
on Solidarity ("Asabiyah") - Modern Science on Cooperativeness and Empathy: a Comparison,”
media/uploads/Talk/Document/ibn per cent20khaldun per cent20per cent20gierer.pdf>

myaccess.library.utoronto.ca/stable/pdfplus/27805061.pdf?acceptTC=true>


32. The yield on Greek government bonds “reached almost 40 per cent at the beginning of March 2012.”


35. “The denomination of debt in foreign currencies implies that a currency depreciation increases the debt
burden, which can lead to financial crises, a collapse in the economy and further exchange rate depreciation.
The possibility of this vicious cycle puts limits on the amount of debt that a country can issue and constrains

36. Turner, Lord (Adair), speaking as chair of the Financial Services Authority, UK, 6th February 2013,
fsa.gov.uk/static/pubs/speeches/0206-at.pdf>


38. Stockhammer, Engelbert, “Rising Inequality as a Root Cause of the Present Crisis,” *Political Economy
Research Institute*, University of Massachusetts, Amherst, April 2012, Working Paper Series, No. 212,
accessed on line on 29 March 2013, pp. 4-5, <http://www.peri.umass.edu/fileadmin/pdf/working_papers/
working_papers_251-300/WP282.pdf>


40. Stiglitz and Zandi, “The One Housing Solution Left”; See also Leigh, Daniel, Deniz Igan, John Simon, and
Petia Topalova, “Chapter 3: Dealing with household debt,” IMF World Economic Outlook, April 2012,

41. In 2007, 1 million homes were in foreclosure and 550, 000 people declared bankruptcy. In 2008 1.6
million homes were in foreclosure and 1.4 million people declared bankruptcies. In 2009, at the height
of the global financial crisis, 2 million homes were in foreclosure and 2 million persons declared
bankruptcy. 1.6 million homes were in foreclosure in 2010, and 1.8 million declared bankruptcy. In
2011, 1.2 million homes were in foreclosure and 1.5 million declared bankruptcies. Brown, Haughwout,
Lee, and van der Klaauw, “The Financial Crisis at the Kitchen Table,” p. 5.

42. In the US public infrastructure is showing visible signs of deterioration, as there are not enough tax
dollars to pay for repairs. A major reason for the shortage of funds is the massive diversion of tax revenue
towards the payment of interest on government loans.

online on 7 June 2013, <http://www.cbo.gov/publication/21625>


edu.pk/JOURNAL/Vol6-No2/Ali-Ata.pdf>

46. “Credit creation by the banking system produces overinvestment in relation to voluntary saving.” Robert
Skidelsky, in Skidelsky, Robert and Christian Westerling Wigstrom, *The Economic Crisis and the State
49. The debt/GDP ratio was very high prior to the Great Depression. The first global systemic financial crisis of 1873 was similarly caused by excessive credit expansion, high levels of debt, rising inflation and high interest rates. This crisis is also known as the Panic of 1873 or the Long Depression and lasted until 1879. The panic was followed by a series of bank failures both in the US and in Europe. Thousands of businesses, including railroads, failed.
51. Exceptions could be made in the case of the holders of transactions accounts, which would be fully guaranteed but pay no dividends.
52. This administrative charge compensates the sellers for any extra expenses arising from administering the sale on a deferred payment basis.
53. “[T]ax policies … have played a role, if not in explaining the rapid rise in debt, at least in making the level of debt higher than it would have been otherwise. For instance, the preferential treatment of interest payments encourages firms to issue debt – a factor that could be behind the rising corporate indebtedness we see in some countries.” Cecchetti, Mohanty and Zampolli, “The real effects of debt,” p. 8.
ISLAMIC BANKING AND FINANCE TODAY
Issues and Implications

Lateef Kayode Adeyemo and Kamil Koyejo Oloso

Abstract: Far from being a curiosity, Islamic banking and finance products have come of age as a force to be reckoned with in the international financial market, breaking new ground and making giant strides by the day. This growth and geographical expansion has given rise to several challenges which can no longer be ignored but must be addressed by academics and scholars, professionals and practitioners in the industry, technocrats in government circles, standards boards and allied organisations, and Shariah experts and other jurist consultants. Some of these challenges pose a significant threat to the further growth and development of the industry, if left unaddressed. This paper attempts to look into such issues and to proffer solutions to them in order to ensure the even and healthy growth and development of the industry.

Introduction

Islamic Banking and Finance today is making giant strides in terms of products and services and is spreading to all parts of the world. The success story has not come without challenges. These challenges are diverse and multidimensional. The earlier they are addressed, the better for the industry, as this would enable the industry to further move ahead. The challenges range from the Shariah compliance of certain products and services rendered by some Islamic banks to certain risks that are peculiar to the system. They also include the validity or Islamicity of the industry itself, as some scholars are of the opinion that there is no such thing as Islamic banking. The challenges relating to cross-border practices and litigation of cases arising from the practice of IBF, training and retraining of personnel, regulations and codes of conduct are wide ranging and considerable. Islamic Banking and Finance and the war against terrorism, the lack of an enabling environment, the problem of *riba*, controversy among scholars and advisory boards, dual legal systems within particular jurisdictions, confusion in the adjudication of matters relating to IBF, Islamophobia, and the role of the mass media are just some of the challenges that urgently need attention.

Although in many areas Islamic Banking and Finance has come of age, yet some scholars have raised issues about its validity, as far as the Shariah is concerned. To them, it is no more than a clever way of circumventing the law otherwise known as *hilah* in Islamic legal parlance. Consider for example the fatwa issued in 1989 by the late Sheikh al-Azhar, Muhammad Sayyyid Ali Tantawi, in which he ruled that interest from conventional deposits is permissible. This is contrary to the judgment pronounced by Sheikh Taqi Uthmani as well as the fatwa issued...
by Sheikh Annas al-Zarqa. The controversy on the validity of *tawarruq* is not a good omen for the further development of the industry. Muhammad Nejatullah Siddiq (2006) observes that Sheikh Nizam Yaqubi declared organised *tawarruq* as valid even though it brings more harm than good, and the recent judgment on *sukuk* by Sheikh Taqi Uthmani declared that *sukuk* is not Shariah compliant. When Sheikh al-Azhar, Muhammad Sayyid Ali Tantawi, in 1989 concluded that the interest from conventional deposits is permissible, that conclusion was to the utter chagrin of the Muslims across the globe.

For example, while Al Bai Bithaman Ajil (BBA) or “deferred payment sale” is accepted as a valid mode of financing in Malaysia and certain other countries, it, or at least some aspects of it, is considered invalid in the Middle East. This is another issue through which interest is feared to have crept in and is the reason why some states or countries do not see it as a valid product or service. Of course, the idea of *bay al-inah*, which is applied in BBA financing, is actually a legal device to get loans and is invalid according to the Maliki and Hanbali schools and under the Shafi’i school of thought is considered very weak. One is therefore skeptical of its validity. This is perhaps one of the reasons why some scholars have passed a general and blanket fatwa that Islamic Banking is un-Islamic.

The hindrances created by the secular nature of certain states, particularly those of Muslim nations, have limited the practice of Islamic Banking and Finance. The duty of an Islamic state is to uphold justice and the welfare of the citizens including equitably distributing wealth. This can only attained when and where necessary facilities or machineries of the state have been tailored towards this lofty goal.

There are yet some states where common law is used to adjudicate on matters relating to Islamic Finance. This situation often leads to problems or disparities in the system. There are also instances where although Islamic law is adopted along with common law, Islamic law has been subsumed under conventional law and is thus unable to function properly. Such situations have not allowed proper adjudication of cases or issues arising from Islamic financial services and products.

The absence of a codified version of Islamic commercial law in many jurisdictions’ legal and constitutional frameworks equally constitutes a serious challenge to the growth and development of Islamic financial services and products. The misconceptions about Shariah and its objectives when Islamic contracts are prepared by conventional lawyers who have no proper training in Islamic law is a hindrance to the growth of IBF.

Some of these challenges are considered in the survey that follows:

Islamic Finance broadly refers to financial activities that are guided by the teachings of Shariah (the Islamic law), which strictly prohibits the payment and
receipt of interest (Iqbal, 1997:4). However, as Iqbal says, “describing Islamic financial system simply as ‘interest free’ does not reflect a true holistic picture of the System.” Islam in general and Islamic Finance in particular strive for the preservation of property rights, shoring up ethical standards, sharing of risk, and promoting social justice. He posits further that “not only must investment activities be in line with the ethical principles of the Shariah, they should also take into consideration public interests (masalih).” In view of the foregoing, the present practice seems to have been over-burdened with looking at products and services from the perspective of compliance with Shariah rather than being based upon or grounded in Shariah: the “first best” practices envisaged or aimed at by the pioneers of Islamic Banking and Finance. We will return to this theme later.

Validity of Islamic Banking and Finance

On 29 August 2008, a fatwa was issued by a group of jurists declaring Islamic Banking and Finance as inconsistent with Shariah principles and therefore un-Islamic. M. T. Mansori (2010:7, 9) argues that the main contentions were based on the concept of islah. It was argued that Murabaha and Ijarah are legal stratagems (hilah) and not real alternatives to interest. According to Muneeza et al (2010), hilah simply means a legal device. The Arabic term hiyal is the plural form of hilah, which means a device, expedient, artifice, stratagem or way of evading or affecting an object. So, to classical Arabic lexicographers like Ibn Manzur (1999), the original meaning of the word hilah and its other derivatives like hayl, tahayyul, ihtiyal and so forth connote ingenuity, skill in management of affairs, shrewdness, ruggedness of intellect and cleverness. Imams Malik and Ahmad disapproved of the use of hilah in any shape or form.

However, if the findings and conclusions reached by Fage (1978:157) are true, the current controversy over the validity or Islamicity of Islamic Banking and Finance is unfounded, unwarranted and uncalled for. He states: “Beyond the immediate circle of the court, the keys to advancement and wealth were no longer military valour, but success in business or banking, law or scholarship.” However, it is good to examine whether the current practice satisfies Islamic intents and objectives, that is, the maqasid Shariah, the higher objectives of the Islamic law.

The question whether Islamic Banking and Finance has an historical presence or is just an imitation of conventional banking has been discussed by scholars who concluded that certain terms of modern banking and finance originated in Arabic, and were either Anglicised or Gallicised as the case may be, as pointed out by Doi (1980:398-402). In his work, *Shariah - the Islamic Law*, Doi suggested that banking has been part of Islam from the earliest times and it is therefore not alien to Islam and the Muslims, as claimed by some scholars. For example, *Mohatra,*
which means risk, was taken from the original Arabic *Mukhatarah*. The same thing applies to a bill of exchange, which derives its origin from *Suftajah*. Doi concludes that Muslims were the first to lay down the true foundations of proper trade and even banking in modern civilisation, stressing that present-day banking terminology is replete with Arabic words and expressions. The very word cheque is originally Arabic, from *sakk* (pl. *sukuk*); traffic and trafficking originate from the Arabic *tafriq*. He further suggests that *buy* derives from the Arabic *bai’*, a word Anglicised from the original Arabic source. *Acheter* is *ishtara*; *tariff* is *ta’rifah*, both of which were, according to him, Gallicised by the French.

According to Al-Yaqubi (d. 897 CE), an early Muslim historian, ‘Umar Ibn al-Khabat (634-644 CE) was the first to draw cheques and to put his seal underneath and sign them. A similar statement was made by Al-Jahashiyari (d. 942 CE) in respect to Harun Ar-Rashid: that “Al-Fadhl asked him [Ar-Rashid] to draw a cheque in his own hand with regards to this sum of money”. Ibn Miskawaih (d. 1030) in his *Tajarib al-Umam* also mentioned that the wages and salaries of the army were paid via cheques and that one of the major charges made against Muhammad bin Dawud was that he paid the army in cash instead of cheques. So, the custom of using cheques became a common practice among the general populace. Thus, centres of money exchange were established by the Muslim merchants in different parts of the Muslim world and beyond. Muslim states and dynasties all over the world embraced this well-established banking and finance system, scrupulously avoiding *riba* in all shapes and forms. If as a result of Western ascendancy the world has forgotten this aspect of Islamic history on banking and finance, then it is time for this to be changed. Capitalist banking and finance has been struck by major crises. The combined effects of the Great Depression (1930s) and the recent economic meltdown (2008 to date) have perhaps provided an opportunity for Muslims to revisit Islamic economics, banking and finance, with a view to the possible contribution they could make today.

**Cross Border Practices and Litigations**

According to Adeyemo and Mobolaji (2010:5), cross-border practices mean the practice of a trade, profession, or art beyond the shore or border of a nation. Such practices generate an international outlook, consistent with the practice of Islamic Banking and Finance across borders of two or more nations or countries (called jurisdictions in legal parlance). We agree that unless necessary rules and regulations, policies or codes of conduct or ethics are properly formulated and seriously enforced, such practices may be problematic, given differences in laws, jurisdictions, cultures and the prevailing circumstances in each of the jurisdictions concerned.
Litigation for Adeyemo and Mobolaji (2010:5) is the process of making or defending a claim in a court of law, that is, the procedure or process for seeking redress in certain issues of contention or resolving them in a court of law. Thus, in this case it refers to settling disputes or misunderstandings arising from cross-border (global) practices of Islamic Banking and Finance. There should be deliberate, conscious and concerted efforts by the stakeholders in the industry to promulgate necessary laws and formulate suitable policies within the purview or ambits of Shariah, in order to ensure the better functioning of the industry. Otherwise, there will be a continual conflict of laws and jurisdictions, as it will be difficult to determine which of the jurisdictions or laws should be used to adjudicate in a matter. However, in the interim, particularly in a situation whereby such policies and laws are non-existent or yet to be formulated, Alternative Dispute Resolution (ADR) may be resorted to if the parties to the conflict or misunderstanding so agree. This is fast and economical and facilitates an amicable resolution because the matter is based on a mutual diplomatic process. ADR is amenable to the Islamic approach and resembles the Islamic concept of *tahkim*.

Muhammad Zakhiri Bn Muhammad Nor (2010:2) observes that *fatawa*, Shariah resolutions and civil law often tend to overlap and are not properly integrated; the proper integration or co-ordination of all regulations could ensure the healthy growth and proper functioning of the industry. Given the geographical spread of the industry, this is worth considering and would give a positive role to the higher objectives of Shariah, the *maqasid al-Shariah*. This would also facilitate a degree of uniformity in the global practice of Islamic Banking and Finance.

**Training and Re-training of Personnel**

With Islamic banking and financial products becoming more popular not only among the Muslim nations but within non-Muslim states, there is a resultant dearth of competent personnel, including Shariah scholars, to serve on the Shariah advisory boards of banks and the Shariah Advisory Councils of several central banks. Universities and colleges need to establish relevant programmes at both the undergraduate and graduate levels in order to overcome this challenge. More than simply one-off training for those going into the industry, there should also be in-service (refresher) training opportunities for those who are already practicing, and there is a need to organise conferences, symposia, seminars and workshops to address new issues that are arising, given the dynamism of the industry. This would provide avenues for practitioners, researchers and university and college dons to interact, exchange ideas and provide solutions to problems as they arise. Scholarships should be awarded to promising students, particularly at the graduate level, for research grants in certain areas.
More Shariah scholars who are well grounded in Mu’amalat are needed, as Mansoor observes (2010:3), in order to ensure the validity of new products and sustain public confidence. Adeyemo et al (2010:8) have noted that ‘Umar Ibn al-Khatab said: “No selling (is permitted for anyone) in our market save (for those who) comprehend religion.” They see the above hadith, credited to ‘Umar al-Khattab, who was more than just one of the leading companions of the Prophet but one of the Rightly-Guided Caliphs, as allowing the question of whether modern training in IBF is adequate, particularly of those who are not Muslims. For the knowledge intended by Caliph ‘Umar in this report is one that leads to practices born of conviction as the direct result of acquired knowledge. They believe that the Islamic epistemology and philosophy of education and learning is *Learn to know, know to practice, practice to become; you are what you practice*. One who has learnt Islam is therefore required to practice it; by so doing he becomes a practicing Muslim; for knowledge is useless when left unused by the one who acquires it. Islam is a practical religion; if one acts in contradiction to what he advocates, he lacks credibility and courts rejection by others.

The present situation whereby a person may serve on as many as seventy boards across the globe is unhealthy and beyond the limits of sound advice: issues cannot be properly attended to before decisions are reached. The observation made by Muhammad Razif Abd. Kadir (2009) is worth repeating here: “For Islamic finance to move forward, we have to review how we practice Islamic finance ... Currently, Islamic finance assessment is compliance-based ... ; compliance is not the problem, but we must ask ourselves, is that enough?” There is a need for a paradigm shift, that is, a shift to basing the assessment of the system on the spirit of the Shariah rather than on compliance with the letter of Shariah, favouring a Shariah-based approach as distinct from a more mechanical Shariah compliance, as has been in vogue for quite a while.

Iqbal A. Khan (2008) has elaborated on this recommendation:

The challenge we now face is to enable a transition from Shariah-compliant to a Shariah-based approach. A Shariah-based approach represents holding to the spirit as well as the letter of Shariah, and look to finance genuine economic activity with a more authentic model. It represents an attempt to capture the essence of Islamic economic ethics, which, to me, is built on fairness, risk sharing, and an investment orientation. No matter how successful Islamic banking is today, we must confess that a contemporary model of Islamic banking is not exactly the “first best” that we were hoping for ... So far, Islamic banking is the product of financial engineers trying to design structures that can deliver the same economic outcome of conventional banking products while meeting requirement of Shariah-compliance. The end result is the mere modification of an already existing system to meet constraints ... [This practice] only considers “legalistic” limitations by observing the constraint of *haram*.
The paradigm shift from Shariah-compliance assessment to Shariah-based should be incorporated into the curricula or syllabi of personnel training, to improve on the present system’s approach, which is akin to *hilah*. Perhaps this is why some scholars are contesting the Islamic validity of current practice.

**Regulations and Code of Conduct**

There is an urgent need for harmonised rules and regulations. *Fatawa* are persuasive but not binding before a court of law and are valid only when duly gazetted and codified. This will ensure uniformity and facilitate easy access to legal facilities in the event of misunderstandings arising from Islamic Banking and Finance, particularly in regard to diverse global practices. Indeed, regulatory and Shariah considerations apart, there are compelling reasons for good corporate governance of Islamic financial institutions. Mansoor (2010:7) includes as incentives, implementation of effective corporate governance strategies: the ability to reduce the cost of capital, enhancing operational efficiency, reduction of risk and fostering resilience to external shocks.

For Mansoor, an effective corporate governance framework must have key strategies with performance measurement methods of defining responsibilities and clearly visualised accountability, appropriate internal controls and monitoring mechanisms. This framework ensures compliance with rules and regulations, promotes a culture of compliance and rewards those who value good governance in Islamic Finance Institutions (IFI). It would protect employees who have been steadfastly compliant with regard to corporate governance. “If the Islamic Finance Industry does continue to grow at the pace it has sustained in recent years, there is likely to be tremendous challenges alongside the successes of the industry. From all indications and given the market potentials, there is no doubt this industry will grow tremendously unless factors of a very serious nature unexpectedly emerge to hamper its growth.”

The World Bank publication *Risk Analysis for Islamic Banks* points out: “The activities of Islamic banks and banking may affect the welfare of more than 20 percent of the world population mostly concentrated in developing countries, and their corporate governance arrangements matters for economic development.” According to Iqbal et al (1999), corporate governance in Islamic Finance entails implementation of a rule-based incentive system that preserves social justice and order among all members of society. There can be no doubt that there is an urgent need to come up with codes of conduct and a Shariah-based, not merely Shariah-compliant, corporate governance system suitable for IBF. From the World Bank *Risk Analysis for Islamic Banks* comes the observation: “Islamic banks emphasise services to multiple stakeholders. Governance processes and structures inside
and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders.”

Hence the Shariah validity requirement must exist side by side with effective corporate governance in the industry. Directors, for their part, must ensure that the directives of the Shariah Board are being complied with. Hence there is a need for proper monitoring mechanisms, the *sine qua non* for the realisation of these objectives. The management must also be vigilant at the post-Shariah Board approval stage. For it has been observed that a product which may seem compliant when examined in isolation by the Shariah Board may pick up deviant characteristics at the stage of implementation, as these involve human participation, and certain product features may have been missed by oversight at the approval stage. Hence the Shariah Board’s attention may be needed at the product implementation stage as well. If products are Shariah-based rather than merely compliant, we would be spared many of the problems and challenges currently faced. There should be a provision for regulating the extent of disagreement and controversies so that they do not transcend the limit set by Islam, which is on the whole aimed at *islah*. Hence, the lawmakers, or rather the standard-setters, must be guided by certain rules and regulations to ensure the general acceptability of the standard set by them.

**Islamic Banking and Finance and the War against Terrorism**

Alex Anderson and Mahbub Bhuiyan (2010:427) have observed that with the act of terror of 11 September 2001, a black mark was left on Islam and the Muslims, and this has changed not only the lives of Muslims around the world but also the security landscape across the globe. Islamic finance was blemished and blamed for an international flow of funding to terrorists. This connection has yet to be proven. Nevertheless, international terrorism has emerged as the most immediate threat to not only global security but the future of the world in its entirety and of Muslims in particular. Crimm (2008) has noted that “Islam stresses the importance of *Zakat* and *Sadaqah* to Muslims as philanthropy and charity. Islam places a high value on compassion, wealth redistributions, social justice, and supporting and enhancing fellow humans; both philanthropy and charity [therefore] play crucial roles for Muslims and their societies”. Muslims, particularly those who live as minorities in Europe, America and elsewhere across the globe, may feel disenfranchised, isolated and alienated from their fellow Muslims and the rest of the world as an outcome of the West’s waging war against terrorism and the quest to flush out those funding terrorism. This situation has subjected Islamic banks and banking to certain risks and greater scrutiny, and has therefore led to certain constraints in their operations.
Creating an Enabling Environment

Countries operating IBF today do so either as a full-fledged Islamic Banking and Finance system or as a window under the existing conventional system. But in any case IBF operates under laws and environments that are if not totally alien to it then are at least at times unfriendly, thereby exposing it to certain peculiar risks. Sometimes cases emanating from Islamic banking and financial services and products are referred to civil court for adjudications. This is particularly problematic in a situation in which those hearing the case have little or no training in Islamic commercial law or *Muamalat*. There are cases in which dual legal systems are practiced in certain states, yet under such circumstances Shariah is typically applicable only in principle but subordinate to common law in practice. This situation has severely constrained some of the Islamic banks; hence there is a need to review existing law to bring about some comparative advantage, in order to compete favourably with the existing conventional system. The United Kingdom has provided a cue in this direction which is worth considering.

The Problem of Riba

Scholars have raised concerns about the validity of certain products which are *riba* or interest based. The avoidance of interest in an Islamic economy is of paramount importance, although Islamic Banking and Finance entails more than simply being interest-free. It is in any case critical to ensure that all products and services rendered by Islamic banks and similar financial outfits are devoid of interest, regardless of what form it may take, whether *Bai’al-Inah*, *tawwaruq* or commodity *murabahah*, sales of debt derivatives and so forth, to ensure the uniformity and vitality of the industry. Beyond what is clearly lawful or clearly prohibited, there is a need to spotlight ambiguous or gray areas and to stay clear of doubt and unlawful indulgence; for whosoever falls into ambiguity strays towards the *haram*.

Controversies among Shariah Scholars and the Problem of a Dual Legal System

There is continuing controversy over whether gold or silver should be the basic unit of value. Throughout the long history of Islam and in Islamic economics, money has been considered to be a means of exchange and not a commodity. The question of whether money should necessarily consist of gold or silver is perhaps problematic. Caution should be exercised in proffering solutions that may create greater problems, or a solution that is more pernicious than what needs to be solved. Most of the issues should now perhaps be addressed by scholars of different legal schools, so that they could deliberate on issues and
reach consensus on the best advisable course, taking into consideration the higher objectives of Shariah.

In Malaysia, for example, Islamic banking and financial matters fall within the jurisdiction of the civil court though they are fiqh mua’malaat matters. Scholars have offered solutions to this problem; however, it has not worked out as expected. For instance, Muhammad Zakhiri advocates integration of al-fatwa, al-imaamah and al-qadaa. He stresses that there should not be conflict between them and therefore there is a need to work together, harmonise and codify these ordinances. Unfortunately, as he has observed, we can see that Shariah has been used as an escape route by the debtor not to pay the creditor, as in the case of the Investment Dar Company KSCC v Blom Development Bank SAL, when a certain product had been declared as invalid by the court even though the Shariah Board had already issued a resolution/fatwa and approved that the product is Shariah compliant, using the argument that Islamic banking businesses are not fully Islamic as they are dependent on their conventional counterparts. Disparities of this kind will not only put the Islamic finance industry in a state of uncertainty and cause confusion among the general public but more importantly put the industry into disrepute, if it is not able to realise its set objectives, he observed.

Salim Ali Al-Ali & Younes Soualhi (2010) assert, “Whereas, from a regulatory point of view, Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) resolved that surplus in takaful fund belongs to takaful participants only, hence, takaful operators are not entitled to receive any part of the surplus. However, contrary to this, Bank Negara Malaysia (BNM) ruled that surplus should be shared between takaful participants and operators.”

Anne Sophie Gintzburger (2010) observes that the variation in opinions on contracts may be attributed to a diversity of backgrounds, to schools of jurisprudence, the college or the university where training was acquired, as well as to the environment in which the members of the Shariah board functions. In theory, Islamic Finance relies on equity participation—the system is still developing currently, it is yet to develop real equity finance globally. There is an urgent need for dialogue between Malaysian Islamic financial experts and those of Gulf Co-operation Council in order to exchange ideas, cross fertilise them and avoid unnecessary controversy. This will bring about a convergence of opinions rather than divergence and conflict. In determining the validity of a product or service, the Qur’an, the Sunnah, Ijma’, etc. should in this order be given priority, and as Adeyemo and Mobolaji note, any ambiguity should be avoided.

Edib Smolo and Elmin Habibovic (2010) point out that “being a niche industry, Islamic Finance is faced with a long list of tasks ahead that need to be conquered before it may be elevated to the next level.” Singh (2009) states
that Islamic Finance industry is in its adolescence when it comes to issues like transparency, accounting and ratings, with very different standards being used. Robinson (2005)\textsuperscript{27} adds that there is therefore an urgent need for standardisation to ensure uniformity, one that is aimed at effecting transparency, credibility, integrity and accountability in the industry.

The name Islamic Finance may lead someone to believe that it is only for the Muslim countries with majority Muslim populations. However, it is being argued that the majority of Islamic finance customers are actually non-Muslims. Today, Islamic finance attracts both Muslim and non-Muslim market participants (Monger & Rawashdeh, 2008).\textsuperscript{28} In fact, the United Kingdom is leading the Western, non-Muslim countries in developing Islamic finance services. With $19bn of reported assets as of the end of 2008, the United Kingdom is ranked eighth and is considered Europe’s premier place for Islamic Finance. This was attained by the joint efforts of the UK government, the Bank of England and the Financial Services Authority (FAS), who identified the main barriers for the introduction of Islamic Finance and took proactive steps in creating a level playing field for Islamic financial services to thrive. Other countries are joining the bandwagon. For example, Singapore, Hong Kong, France, Germany, Luxemburg and Ireland, to mention a few, all either amended their laws or are on the track to do so in order to facilitate the development of the Islamic financial industry. Other countries, including Muslim and non-Muslim states, should emulate the United Kingdom by providing a level field for Islamic Finance to thrive and compete favourably with the existing conventional system.

Islamic Finance is faced with a number of challenges calling for the prompt attention of the Muslim scholars, most particularly those who are specialists in Fiqh Mu’amalat. The industry will move ahead if the right responses are given at the right time. Karuvelil (2000:155)\textsuperscript{29} thus states, “The industry [Islamic Finance] faces considerable challenges; its response to them will determine whether it will become a significant alternative to the conventional system in global financial markets.” There is therefore a pressing need to make provision for an efficient legal framework, qualified personnel, standards, procedures and codes of conduct, and to find the will power on the part of governments to support the industry in order to safeguard it from increased risks to which it is exposed (Khorshid, 2009).\textsuperscript{30} Divergence of opinions among Muslim jurists regarding the validity or non-validity of certain products needs to be restrained for the good health and even growth of the industry. Hence, opinions need to be harmonised, standardised and codified (Shanmugam & Zahari, 2009).\textsuperscript{31} The use of different terms and terminologies among scholars, banks and other Islamic financial outfits should be moderated too and adequately regulated. There is a need therefore for integration and harmonisation in order to ensure uniformity and to guard against
confusion, particularly among the general public, most of whom are not, at least as of now, conversant with them.

**Conclusion**

Although Islamic Banking and Finance is doing very well and making giant strides by the day, the growth has not come without challenges. If these challenges are met appropriately at the right time, further growth of the industry can be expected. However, if they are neglected or wrong and unsuitable solutions are proffered, that may have an overall devastating effect on the industry. Voices have been raised questioning the validity, or Islamicity, of certain products. Experts are now saying that rather than “Shariah-compliant” (which invariably signifies adopting/adapting the existing products of the conventional system), we should look inwardly into Shariah-based products. The controversy between the various Shariah boards and councils should be laid to rest and an attempt should be made to unify and codify their resolutions and *fatawa*. The need for the training and retraining of professionals and experts in this field cannot be over-emphasised. Such training should be focused on Shariah-based products and services so as to move beyond Shariah compliance, which is second best, and move ahead to Shariah-based products and services: a positive approach to Islamic finance as indeed “the very first best” is intended by our predecessors. Research needs to be encouraged in this field of studies. The following policy recommendations are for consideration by the appropriate authorities.

**Policy Recommendations**

- Governments or their agencies in each of the jurisdictions where IBF operates should, in conjunction with standard boards, come up with codes of conduct not only for the practitioners but equally for Shariah advisors and advisory boards;
- More universities and colleges should introduce relevant programmes to cater for the growing need for trained personnel in the industry;
- In order to ensure the effective global operations of IBF, all regulations, laws, and *fatawa* should be properly codified and harmonised and made easily accessible;
- There should be regular conferences, symposia and seminars where scholars, university and college dons as well as researchers exchange ideas, cross fertilise them and proffer solutions to challenges as they arise, to further develop the industry;
- Research grants, scholarships and endowments should be offered to motivate scholars and researchers to engage in further in-depth enquiry;
• Scholars who make ground-breaking discoveries or contributions should be recognised through suitable awards and prizes of varying degrees to motivate innovative scholarship;

• There should be a paradigm shift from mere Shariah compliance to laws based upon the foundations of Shariah, a shift which should be reflected equally in syllabi for training personnel and in training materials;

• Civil courts that have no experts in *Fiqh Mu’amalat* (Islamic Commercial Law) should not be allowed to adjudicate on matters relating to IBF without the presence of qualified Shariah experts;

• There is a need to harmonise major terms and technical expressions used in IBF in order to avoid confusion.

Notes

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5. Ibid.


RELIGIOUS VIEWPOINT: A democratic system of rule is on the whole acceptable to Islam.

Muslim scholars have differed in their assessment of democracy and constitutionalism from the viewpoint of Islamic principles. The view has gained ground, however, that a democratic system of rule is on the whole acceptable to Islam. This acceptance is because democracy is about fundamental rights and liberties, the rule of law, a representative and participatory government, separation of powers and equality before the law. Rights and liberties are a manifestation of human dignity which must be protected against the coercive power of the state. A constitution is also an instrument of limitation, organisation and division of power among the various organs of state.

Broadly, Islam approves of most of these concepts and takes affirmative positions on the protection and realisation of people’s welfare and maslahah, a consultative government committed to accountability (muhasabah) and justice. Islam advocates a limited government, which is committed to the advancement of the goals and purposes (maqasid) of Shariah. Islam and democracy both seek to realise people’s welfare and basic rights of life, personal security, privacy and ownership. The Shariah recognises these, as also the rights to education and employment, and the individual’s entitlement to the essentials of life.

There is much evidence to suggest that Islam envisages a civilian system of rule, not a theocracy. Because the head of state is elected by the people through consultation, nomination and pledge of allegiance (bay’ah), this process translates into the modern day equivalent of a popularly elected government in which the locus of authority rests with the people. The head of state is accountable to the people and subject to the court of justice, and the people have the authority ultimately to depose him in the event of flagrant violation and miscarriage of duty. The head of state has no papal authority to exonerate sin or to interfere with the religion of a person. The civilian character of his office is thus manifested in the legal maxim of fiqh that “the affairs of the head of state are judged by reference to public interest (amr al-imama manut bi’l-maslahah)”. The essence of stewardship in Islam is proclaimed in the hadith that “the leader of the people is their servant (sayyid al-qawmi khadimuhum)”. 
Yusuf al-Qaradawi approves of democracy and the electoral process, with the latter being tantamount to testimony (shahadah), in that by voting for a candidate, the people testify to the suitability and trustworthiness of the person, and giving shahadah is a collective obligation (fard kifa’i) of the Muslim community. Party politics, according to al-Qaradawi, is a means of organised participation in government affairs. This too resembles the fiqh schools, or madhhab, which the learned scholar has characterised as juridical parties, manifesting differences in jurisprudence.

As to the question that democracy is a Western rather than an Islamic doctrine and that it carries Western values and viewpoints, al-Qaradawi responds that Islamic tradition and scholarship have maintained a relatively open profile of receptivity and contribution to other civilisations. It has taken from other traditions that which is of merit and acceptable to its own values. Electoral democracy does not authorise the people or government to change the beliefs of Islam (‘aqa‘id) nor any of its devotional principles (‘ibadat), the halal and haram, and the essentials of morality. These are firmly grounded in the Quran and Sunnah and no one may in the name of democracy interfere with them. As for the management of community affairs and realisation of people’s welfare, democracy is more likely to facilitate these than obstruct and undermine. Hence democracy is not contrary to Islam. The Islamic public law doctrine of Shariah-oriented policy (siyasah shar‘iyyah) also enables the ruling authorities to address urgent issues and problems that affect people’s lives through Shariah-compliant ordinances and initiatives, even at the expense of some unavoidable departure from the rulings of the existing schools and scholars.

On the subject of sovereignty which belongs to the people, the constitution, or Parliament (France, the United States, and the United Kingdom respectively), it is not an Islamic doctrine but an aspect of political democracy over which Islamic scholars have expressed reservations. Yet many have also drawn a distinction between what they term as absolute sovereignty (siyadat al-hukm), which can make or unmake any law, and executive sovereignty (al-sultan al-tanfidhi). Only the latter obtains in Islamic polity, simply because it is not vested with the authority to change the essentials of Islam and Shariah.

Hence what remains is a kind of executive sovereignty in which political authority is vested in the people and government exercises it on their behalf.

The challenge facing Islamic scholars in Malaysia and elsewhere is perhaps to highlight aspects of harmony between Islam and democracy, and for the government authorities to set in place rules and procedures to ascertain unity and integration of values, of both Islam and democracy, in its legislative processes, with the purpose ultimately to eliminate or minimise the duality of laws in favour of substantive integration and unity. Another aspect of this challenge is
to enhance human rights and integrate these principles into the applied laws and procedures of both civil law and Shariah.

Democracy in this digital age presents new challenges to the people’s right of privacy, which demands enhanced vigilance from the standpoint of both the Shariah and civil law.

There is also a need to specify with greater clarity what roles the media and education should play in the advancement of both democracy and Islam. It must be added, however much in passing, that Malaysia is not new to most of these challenges, and some work is also underway on the harmonisation of Shariah and civil laws with the legal system of Malaysia, which has gained a fresh momentum with the milestones of progress Malaysia has made in Islamic banking and finance.

Note

* Mohammad Hashim Kamali, Founding Chairman and CEO of IAIS Malaysia, graduated from Kabul University, and took his PhD in Islamic and Middle Eastern Law at the University of London in 1969. Professor Dr M.H. Kamali served as Professor of Islamic Law and Jurisprudence at the International Islamic University Malaysia (IIUM, 1985–2007), then Dean of the International Institute of Islamic Thought and Civilization (ISTAC). He also held Visiting Professorships at McGill University’s Institute of Islamic Studies; Capital University, Ohio; and the Wissenschaftskolleg, Berlin. A member of the Constitution Review Commission of Afghanistan (2003), he has provided expert legal consultation to the new constitutions of Iraq, the Maldives and Somalia. Eminent authority on Islamic legal studies, he has published over 150 academic articles and 35 texts, including standard textbooks at universities worldwide.
Malaysian Muslims Lead in Balancing Religious Observance and Social Development

Daud AbdulFattah Batchelor

It has always been a big question: Which Muslims in what Muslim country are closer to achieving the ideal of Islamic wellbeing? Whose country is doing better at applying Islamic values? One response is a newly formulated rating index, the Islamic Index of Well-being (IIW), which suggests that Muslims in Malaysia lead the Muslim countries surveyed in Islamic well-being, just ahead of their Indonesian cousins. These two countries were clearly ahead globally in the group of 27 out of the 51 Muslim-majority countries for which full data was available to be assessed. Senegal, the Palestinian territories and Bangladesh came next, followed by other Middle-eastern countries, then the sub-Saharan African countries. Ex-communist bloc Muslim countries have the lowest indices, no doubt a consequence of the severe anti-religious policies formerly applied there, including widespread persecution. The results reflect a relative lag of Middle-eastern countries in this index, given that they are traditionally considered as the heart of the Muslim world.

The new rating method follows an objective approach, applying principles derived from Islam’s revealed scripture, the Qur’an, and the Sunnah, the example and teachings of Prophet Muhammad (pbuh). This analysis identified two key fields for wellbeing: personal religious observances, or acts of worship (ibadah), and good social interactions (mu‘amalah): each is given equal weighting in calculating the index.

Personal religiosity levels were obtained from the results of interviewing 38,000 Muslims throughout the world from 2008 to 2012, as published by the respected Pew Research Center in the United States. Gulf Arab countries and Brunei, the ‘oil shaykdoms’, did not participate, but it is hoped they could be represented in future surveys. These surveys provide the key information on the percentage of Muslim citizens who perform obligatory (fardu ‘ayn) practices of praying five times daily, men attending the mosque at least once weekly for Friday prayers, and Muslims fasting in the month of Ramadan. Extensive published research over the past ten years confirms that those who are more attached to traditional religious practices, among both Muslims and non-Muslims, generally experience higher levels of psychological well-being.

Five fields were assessed for determining social interactions of Muslim countries. These were first, the proportion of citizens having an education at least to secondary school level, then a good status given to women, good care of young children, not too much disparity in family income levels as reflected in the Gini
index of income inequality, and the elimination of corruption. From an Islamic perspective, governments are required to assist vulnerable members of society, assistance which is reflected in the indicators used to determine the status of women, children and the poor. As this information was freely available from the United Nations and other reputable published sources such as Transparency International (for corruption levels), virtually all Muslim countries could be rated for their achievements in societal well-being. Not surprisingly, United Arab Emirates is first, Brunei second, Kuwait and Oman are both third, performing best in this field, followed by Malaysia and some of the former communist bloc Muslim countries.

The most surprising and perhaps most significant finding of the study is that the West African bloc of countries (Nigeria, Chad, Senegal, Niger, Mali) and Afghanistan that display the highest levels of personal religiosity at the same time demonstrate the lowest levels of the social interaction indicators. This contrast suggests that countries with pious Muslim citizens do not necessarily do well in building their social institutions, such as in public health and education, and in their broader community interactions. Certainly this anomaly deserves follow-up investigation to clarify the main reasons for the disparity. As an example, in Nigeria, it has been estimated that one million women and children die every year from largely preventable causes. Most of the childhood deaths are due to polio, malaria, measles, bacterial meningitis, and malnutrition. Because these are mostly poorer Muslim countries, lack of financial resources to improve their social welfare condition may be a cause. It is countries such as these that deserve greater support from the wealthy Muslim countries blessed with natural resources.

Muslims from a broad national platform deserve recognition for Malaysia’s good standing as reflected in its high Islamic Index of wellbeing. The impressive achievement of Malaysia in the Muslim world was also acknowledged in October last year in a letter to Malaysian Prime Minister Datuk Seri Najib Tun Razak by the eminent scholar, Shaykh Yusuf Al-Qaradawi, who observed that “Malaysia has been distinguished among Muslim countries with its impressive development strategy and openness, evolving as a referential centre and model for the Muslim world.” A number of possible reasons for the high level of well-being of Southeast Asian Muslims could be suggested: the relatively soft approach towards Islamisation historically; the substantial role of Muslim women in these societies; the lack of destructive wars in the region; the benefit provided from the Asian “economic miracle” in building strong economies, accompanied by the appropriate allocation of public funds to enhance education, health and social welfare. Also the transformation in Indonesia from military rule to a functioning system of representative governance has benefited the people of the world’s largest Muslim country.
The approach discussed here holds promise in assisting state planning efforts to improve well-being, particularly of the most vulnerable citizens, and to encourage improvements in education, health, and religious practice. It is a broadly applicable analytical tool to help monitor progress, as Muslims move forward into the future, both in the reverential practice of their faith and in attention to their daily affairs in society, within their country of residence.

The new IIW methodology, which was developed at the International Institute of Advanced Islamic Studies (IAIS) in Kuala Lumpur, was published in the Institute’s April 2013 Journal of Islam and Civilisational Renewal.

Note

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Many are the Crimes Committed in the Name of Islam

Ali Mohammed Fakhro

During the French Revolution, a cry began to spread: “Oh, Freedom, How many crimes are committed in your name!” Today, in Arab and Muslim lands, we appear to need a similar rallying call: “Oh Islam, How many crimes are committed in your name!”

The Arab and Islamic worlds do not have the right any longer to disregard or pass over in silence the crimes that sweep across the planet on a daily basis in the name of Islam. It is not only a matter of mistakes and excesses committed under the false banner of jihad for Islam. These are unspeakably crazed and wanton crimes, sordid and full of treachery. There can be no doubt that they are committed to the beat of Satan’s drumming the Satan who is the enemy of both God and Man. They are terrifying events that defame Islam’s reputation and disgrace Muslims, and distort the meaning and objectives of the Quranic message and key terms such as al-jihad, as well as other words that are arbitrarily wrested from their context in a Holy Quranic verse to be deployed in political skirmishes.

For can it be acceptable, under any standard of measurement, but especially under the standards of the Islamic faith which equate the unjust killing of one soul with that of killing all human souls, for one to blow himself up, or to detonate a car bomb, in the name of the religion of right, justice and balance? To target a mosque in which people are prostrate and offering their prayers? Or a church in which people whom Islam declared to be brothers, as People of the Book, are also praying? Or a school in which innocent children are sitting in rows, or a queue in which people are seeking sustenance to nourish their children and their partners, or in a crowd at a sporting event whose fans have nothing to do with political struggles or politicians? The list is long of sinful acts of violence annihilating innocent lives, devastating people unaware of the devilish conspiracies that spin in sick minds and end up filling God’s universe with tears and the agonies of loss and bereavement and with orphans, widows, and wholesale destruction of any residual feelings of morality and human values in the souls of a nation’s people.

No, it is not conceivable for us to remain silent regarding this oppressive, ignorant abuse of the religion of the Lord of the Heavens and the Earth, the Lord of Mercy and Love, Justice and Forgiveness. To do so would be to remain silent in front of those who would try to lie to their God, whether intentionally or not, and then encourage Arab and Muslim youth to violate the underlying fundamental objectives of their religion in a barbaric suicidal operation, something that can never be approved by God, or by any code of law, whether worldly or heavenly. In their actions they only bring the entire world to despise Muslims, and to seek
to banish and eradicate them. They will add to the hysterical uproar against the Muslim Quran and the Muslim Prophet and their history, and lead to marginalising Arab and Muslim peoples all along the course of human civilisation.

This article does not seek to prescribe what can be done. It is simply to condemn the transactional approach to the issue that we see on the part of governments, civil society institutions, and most of all, Islamic political parties, Islamic Ulama and the bureaucracies of the Arab and Islamic summit conferences, to condemn the manner chosen by all and sundry to deal with what is taking place in the name of Islam. Here we have emphasised the matter of suicidal “jihadi” because it is the most tragic and painful expression of the problem, for us, as Arabs and Muslims. But the problem goes beyond that, as it encompasses social life in the broadest sense in Arab and Muslim lands, posing the imminent threat of sectarian strife and giving some people cause to doubt the beauty and purity of their Muslim faith, and giving others a reason to abandon the faith in disgust and repugnance, in response to the cruel crimes committed in its name.

This is no longer a minor problem or a side issue; it has become the main issue, THE Issue. There is no longer any need to ask “Why?”, “How?”, or “Where are we headed?” When the flames are surging, as they are in many countries inhabited by Arabs and Muslims, as well as non-Muslims, then it is time for quick action to extinguish the flames, and not for soul-searching questions.

A couple of thousand wayward, deluded and possibly duped young Muslims, whose innocence and pure intentions have been exploited, can no longer be allowed to ravage the earth under the feet of a billion and a half of their fellow Muslims: Muslims who ask themselves with every new day, upon hearing the news of the atrocities that have been carried out, what catastrophe must lie ahead if things go on like this, a trend in which they are in no way supportive, much longer.

We know that some jurists of rigidly narrow-minded and backward versions of Islamic fiqh are complicit in this black theatre, but we nonetheless look to the best Islamic scholars and Muslim minds to unify ranks and speak in one voice, in a daily exhortation, from all pulpits in the mosques and from all media platforms, to combat this “jihadi” contagion which harvests the lives of innocent Muslims while in many instances remaining indifferent to the real enemies. Meanwhile, the Zionist and imperialist enemy can bide their time in peace and security as many societies go up in flames: the Iraqi, Syrian, Afghan, Yemeni, Sudanese, and Pakistani societies among others.

Islamic religious scholars, some of whom nevertire of discussing life’s marginal issues, trivialities and banalities, are most definitely called upon to lead a wide-ranging, religion-based cultural and political mobilisation, not an arbitrary and violent security clamp-down, to support and defend the religion of Islam which is
now facing a severe historic trial involving tremendously dangerous dimensions and repercussions. But this is not about channelling Unitary [Islamic] Faith into contemptible sectarian strife, such as the meaningless oppositional Sunni-Shi’ite strife: this would only add to Islam’s tribulations and the devastation of the societies of its faithful followers, and present the entire world with a picture of tragic absurdity.

Let everyone think of the torment of a day that is not far off, a day in which all will see what their hands have wrought, from the disastrous days of Afghan jihad up to the present day and, one hopes, for only a short time continuing in the future.

(Translated by Michael K. Scott, IAIS Visiting Fellow, 30 April 2013)

**Note**

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The MENA Saga

Anis H. Bajrektarevic

The MENA theatre is situated in one of the most fascinating locations of the world, the Middle East and North Africa. It represents, along with the Balkans-Caucasus, the only existing land corridor that connects three continents. It also holds over a half of the world’s proven oil-gas reserves (56 percent – oil, 48 percent – gas). Furthermore, the Gulf OPEC states and Libya have by far the lowest costs of oil extraction, thanks to the high crude purity (measured by overall properties such as the state of aggregation, excavation gravity, viscosity, weight, sulfuric content and other contaminants) which simplifies and reduces the cost of the refinement process. These petrol-exporters also enjoy the close proximity to open warm seas for low-cost, fast and convenient overseas shipments. Hence, the costs per barrel of crude for Libya and the Persian Gulf states are under US$ 5; for other OPEC members, below US$ 10. This is in a sharp contrast to countries such as the US, Russia, Norway, Canada and many others that bear production costs of several tens of US$ per barrel, according to the International Energy Agency (IEA).

Therefore, it is an absolute imperative for the external/peripheral powers to dominate such a pivotal geo-economic and geopolitical theatre by simply keeping its centre “soft,” and pre-empting, preventing or hindering any emancipation that might come through any indigenous socio-political modernisation. This is the very same imperative that has remained a dominant rationale of inner European and Asian machtpolitik for centuries.

No wonder the competition taking place in the MENA theatre, with its long history of external domination or interference (and largely pertaining to the Versailles, Anglo-French drawn borders), is harsh, multi-dimensional and unpredictable. The region is predominantly populated by Sunni (Arab) Muslims. With its high population density and a demographic growth far outpacing any economic counterpart, and a very young median population (on average 23–27 years old), frequently lacking any universal access to education, health and housing, the scene seems to be dominated by juveniles, often angry males, mainly unemployed or underemployed, but socially mobilised.¹ Fuelled by severe socio-economic exclusion, and exacerbated by exploitation of the Shia–Sunni and Muslim–Jewish antagonisms, political radicalisation is surely one of the most effective instruments of tacit control and the preservation of local governing authorities. These remain far from incapacitated, however predatory, alienated, unauthentic and weak they may be.
Each and every one of the predominantly Sunni-Muslim Balkans-MENA countries of the secular republican type, where the external powers have brokered the political settlement, often by compromising the very sovereignty and territorial integrity, is enveloped in what seems to be a series of perpetuated instabilities, remaining thus paralysed. So far, not a single absolutistic monarchy has been significantly affected. From Bosnia, nearly 20 years ago, then Kosovo, Afghanistan, Iraq and Libya as well as in the post-‘Spring’ Egypt, Tunisia, Yemen, all the way to “ungoverned” Mali, South Sudan and Algeria’s south, and up to the post-assassination, revolt-torn Tunis or anti-Avanti Mursi Cairo, a purposely dysfunctional and indecisive central government seems to have been put in place.

Conclusively, most observers would agree that while the so-called Arab Spring had a cross-Arab ripple effect, this was far from being a pan-Arab movement. It was more of a spontaneous social revolt, a series of events connected more by Al-Jazeera’s potted coverage of them than any directional process. To channel the energy of something so unexpectedly inflammatory and trans-nationally Arab, while studiously avoiding the spirit of pan-Arabism, let alone any hint of real structural socio-economic reform and political emancipation, was something that could have only been achieved by lighting the torch of Islamism. Playing on a single string couldn’t possibly bring about the blossoms of a true Spring! How could MENA democratisation possibly be realised when primary loyalties are forcibly returned to sect, tribe or ethnicity? This dilemma relates not only to democracy, but also to the very quest of secularism – for the one presupposes the other – as history has shown ever since the French Revolution. In this or any other part of the (developing) world, democracy without secularisation of state leads to a dysfunctional, destabilising and self-defeating government. The current state of the MENA republics affected by the Arab Spring, as well as that of the Gulf Cooperation Council (GCC) monarchies, provides the best proof of this.

For one thing, as it now seems, the euphorically touted “Facebook revolutions” across MENA were simply strategic distractions innocently dressed up in the diverting banality of social media networks: the very same role those networks well played elsewhere too. Thus, sadly, it should be of no surprise that the broad and universal right of self-determination has been reduced to the right of internet-freedom, with many fundamental human rights currently compressed like a zip-file, emailed and entrusted to just a pair of omnipotent, self-centred and self-interested non-state and semi-state actors of unilateral globalism/egoism: private IT corporations and intelligence agencies.

Presently, the announced reduction of the American physical presence (or “footprint”) in Afghanistan, the limitations it faces in the nearly failed nuclear state of Pakistan, and the massive overextension it has suffered on the south-western flank of the Euro-Asian continent as well as the recent US Army
pullout from Iraq, are felt with mounting alarm within the GCC (and in France, UK, Israel and Turkey too). This change could lead to dangerous exposure to a neighbouring and increasingly assertive Iran as well as to Russia and China following. Right now, Syria pays a (proxy war) price for this: a multi-religious country of rich ancient cultural layers may end up entirely combusted, thereby creating a dangerous security vacuum in the heart of MENA. Or to use the words of frustration of the senior French diplomat who recently confided to the writer in Brussels: “We have to quickly delegitimize the legitimate Syrian government and topple al-Assad in order to convince Israel not to bomb Iran.”

“Western national interests no longer determine the moral and political impulses of today’s global community. ... Whatsoever the outcome, Syria’s agony has underscored a further irreversible weakening of the West’s dominant global role,” claims former Indian Foreign Minister Jaswant Singh. Perhaps so: the West indeed has become too weak to build a new architecture, but it certainly remains strong enough to destabilise what it sees as its political peripheries.

Recently, the “Group of Friends of Syria” with their recognition of the so-called Syrian opposition all but brought Turkey to war with Syria. If I may at this point venture to be both instructive and predictive: the fall of al-Assad will most certainly trigger dissolution of Syria. It will also lead to a formalised federalisation of Iraq in a desperate move to prevent its total decomposition, as well as to a serious crisis of Lebanese and Jordanian statehoods, crises that will probably be beyond repair. The winners in such a scenario would then seem to be Israel (a country that remains enveloped in its traumatic Holocaust past and detached from its present neighbours) along with the GCC monarchies, at least in the short run. However, over the long term the “winners” would be the Kurds and Shias, even though the northern portions of Syria have already been occupied by the Turkish army for quite some time.

Consequently, with any proclamation of a Kurdish (Black Sea – Eastern Mediterranean) state, the Erdoğan government (as well as Iraq) would not be able to survive, as it has already created enough enemies at home and in its neighbours abroad. Ergo, besides the dispersed, rarified and terrified MENA Christians, the (modernised) Sunnis are definitely the long-term losers.

Possible, yet not probable, epilogue

However, while the cacophony of European contradictions works towards a self-elimination of the EU from the region, Turkey tries to reinsert itself. The so-called neo-Ottomanism of the current (Anatolian, eastern rural power-base) government is steering the country right into the centre of grand bargaining for both Russia and for the US. To this emerging triangular constellation, PM Erdoğan wishes to beat his own drum.
Beyond the Arab Spring, neither will Russia effectively sustain its presence in the Middle East based on a strict pan-Arabic secular, republican and anti-Islamic idea, nor will the US manage to politically and morally justify its continuous backing off of the absolutistic monarchies that are so energised by a most backward, dismissive and oppressive Wahhabism. Ankara tries its best to sublimate both tendencies in an effective manner, employing a mix of secular republican modernity leavened with a traditional, tolerant and emancipating Islam, so as to advertise this as an attractive future model across the Middle East. Simply enough, Bosporus wakes up to itself as the empiric proof that Islam and modernity work together. In fact, it is the last European nation that still has both demographic and economic growth.

Moreover, Ataturk’s Republic is by the world’s most successful Muslim state; never resting its development on oil or other primary-commodity exports, it has been blessed with a vibrant socio-economic sector and solid democratic institutions. This is heavy competition not only for Russia, but primarily for the insecure regime of the House of Saud (and the other GCC autocracies), which rules by direct royal decree over a country of recent effervescence, an oil-export dependent present and an improbable future. No wonder that on the ideological battlefield these two belligerent parties will be dominating the Middle East, in a phase of self-questioning that will endure beyond yet another round of calamities. The outcome will be felt significantly beyond the Arab region and will reverberate all across the Sunni Muslim world.

Ankara is attempting to promote the view that the Saudi-promoted Islam is actually a toxic, separatist and sectarian Wahhabist ideology that self-censors Muslims, and keeps them on the wrong side of history by hindering their socio-economic and political development. It does so by keeping Muslims on a permanent collision course with the rest of the world. An Islam that is Turkey-promoted would not be an armed ideology, but a modus vivendi, one which would permit progress and be acceptable to all (including non-Muslims), with a centuries-long history of success.

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Notes

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1. As Wilkinson and Pickett rightfully concluded, social ills like trust erosion, crimes, drugs abuse, political violence and the like are closely related to income inequality.

2. In other words; the selective R2P (Responsibility to Protect) without the Brazil-proposed and UNSC-institutionalised RWP (Responsibility While Protecting) will remain too tempting for anyone wishing covert regime change. Therefore, the altruistically envisaged R2P doctrine increasingly loses its legitimacy.

3. Starting with the military deployments in Bosnia, Kosovo, Afghanistan, Iraq and Libya to the post-conflict “resolution” momentum in these countries: it is always rather late in the process when most options are gone that we are asked to choose between what is left: bad and worse. Some would call it poor time-management: others would say it is a well-calibrated policy of timing.

4. As the concepts of an atheistic but of not decisively secularised and democratised state have historically failed, so the attempts of democracy without secularism are inevitably defeated. A secular state needn’t necessarily be an atheistic one. It is simply an edifice that breeds a normative order of a rationalised administration, optimised economy and just society ready for true democratic contents.

5. Cybernetworks...cyberspace – an overstated buzzword whose importance people intuitively accept without really asking themselves what and why: Google is the most powerful database of information ever searched on internet, and Facebook is the most powerful database of persons ever on internet.


6. The expanded surveillance (disguised in freedoms promised) for many, the power and/or revenue for a few: the social media explosion of the last years finally enhanced the (self-) authentication of cyber residents. This, in return, has further assisted the monetisation of information on cyber lives and cyber data, as well as Minority Report movie-alike data fusion, including the pattern-based data mining and the so-called predictive network analysis. All that is for an unspecified number of state and non-state actors. According to a cyber-pioneer turned scholar, Eli Pariser, even “the private data broker Acxiom, for example, has an average of 1,500 items of data on 96% of Americans currently in its database.” Cyber fascism? Well, not yet.

7. Former Italian State Secretary for Foreign Affairs, Ms. Marta Dassù makes a sharp and very accurate diagnosis: “A less pre-eminent U.S. therefore, opens up major questions for intra-European relations ... a vacuum filled first of all by France – rather than by Europe.” (Europe’s World, How Obama II is likely to see Europe, the EU Policy Journal Spring 2013/23, 96)

8. The post festum apology now comes from the newspapers that were trumpeting the early justifications for the US military involvement in Iraq (and elsewhere): “…And the war – having cost thousands of American lives and scores of thousands of Iraqi lives, having imposed financial costs vastly higher than the war’s boosters predicted – left America weaker, not stronger, and ended up creating an Iraqi regime that is closer to Teheran than it is to Washington...” Then, the letter’s author, Paul Krugman of the IHT, continues: “...if you hear that ‘everyone’ supports a policy, whether it’s a war of choice or fiscal austerity, you should ask whether ‘everyone’ has been defined to exclude anyone expressing a different opinion. And policy arguments should be evaluated on the merits, not by who expresses them...” (IHT/New York Times, Marches of Folly, Paul Krugman, 19 March 2013, 7).

Indeed, it is more than just these few nationalities of external authors ever admitted to the New York
Times narrative. Despite this or similar periodic “regret letters”, the phrase “international community position” will remain close to its original meaning; the jointly agreed Anglo-American policy action to which these two have coerced the rest of (Atlantic) Europe and the world, or the most of it.

9. The more Malaki’s Bagdad-based government imposes its authoritarian rule on (Kurdish and Arab) Sunni areas and the oil-rich Basra region, the greater the chances for wider and deeper inter-ethnic unrest. The politico-military demands for larger territorial autonomies from Bagdad are on a steep rise. Practiced federalism surely optimises governability, but in the context of prevailing political cultures of the Middle East, it would inevitably lead to statehood disintegration. Simply, much of the seen limbo is an absence of war but also an absence of peace and progress. As we have witnessed in Bosnia, Libya, Afghanistan and Kosovo, federalism does not work without a domestication of authentic national reconciliation, at first. Turning Iraq (and adding Syria now) into a proxy battlefield between Iran and two confronted versions of Sunni Muslim world, that of Turkey and of Saudi Arabia, is a dangerous game without a beneficial epilogue for these on and those behind the scene.

10. There are two main reasons for Erdoğan’s sudden deal with Ocalan/PKK. The domestic one is the expectation to win the votes of the pro-Kurdish BDP party that has 33 seats in Parliament. It is a support needed in the Prime Minister’s quest for the constitutional change aimed to introduce the de Gaulle-like semi-presidential system in Turkey before expiration of his second term next year. The other reason is an attempt to equalise the increasing Iranian and Syrian influence over the Kurdish regions. Ankara lately improved relations with the Kurdish Regional Government of northern Iraq, but the influence of Turkish Kurds and its PKK is significantly counterbalanced by the Syrian PYD and Iranian PJAK Kurdish parties respectively. It is yet to be seen whether the Ocalan deal will remove the Kurdish threat from Turkish lands and break down the constraints Turkey suffers in northern portions of Iraq and Syria.
KDC: A number of Muslim countries have experienced conflicts and bloodshed in recent decades, Palestine, Afghanistan, Iraq, and Southern Thailand, to mention a few. What policies might Muslim nations collaborate upon, on an Islamic basis, to promote security and reconciliation?

TAB: The problems faced by these countries are many. Poverty, unemployment, trans-border relationships with other countries, instability in internal affairs, and war are among the major problems which need to be addressed. There is also another problem we have noticed recently, which is truly our Muslim problem: sectarian conflicts. It is not easy to provide solutions to all these problems right away. We have to begin with analysing our internal situation first. We must ensure we have a program aiming to eradicate poverty. Poverty can be the root of terrorism and extremism and many other problems: it creates anger and desperation and leads people to fight. So it is very important to deal with poverty issues first.

The approach that has to be made in order to solve these problems is to develop our education system. The education should be of quality; we just cannot have one madrassah and think that people are going to be educated! With quality education we will be able to create human capital, which we especially need in order to eradicate poverty. At the same time, these programs will help us to improve our economy.

OIC member countries should also provide adequate opportunities for education, especially to those who do not have such opportunities. We have also opened our doors of education for others. Let them come to Malaysia and study here at our universities. Other countries which have the same opportunities and facilities can provide that too. This is very important for the Ummah.

And most importantly, we have to engage constructively with other countries, with other powers, which have problems in their relationship with these Muslim countries. This approach must be made by a number of Islamic countries, and the OIC has to be more effective in this.
KDC: You were well known for advocating the ten principles of “Islam Hadhari” during your tenure as Prime Minister. Now that you are no longer a prime minister, how do you envision advancing and extending the program of Islam Hadhari? After all, there has been so much talk about jihad, and people pointing to ijtihad; how do you see Islam Hadhari’s program in the new era that lies ahead?

TAB: IAIS and IKIM – Institut Kefahaman Islam Malaysia (the Institute of Islamic Understanding Malaysia) are the two brother organisations I am involved with which concentrate on developing a better understanding and application of the ten principles of Islam Hadhari. Islam Hadhari does not need to have a twenty-storey tower! Developing the idea of Islam Hadhari in people’s minds, in their spirit, that is really what is necessary. Once people are convinced that this is good for Muslims, then the next consideration they will have is how it can be applied. In fact there are many programs introduced to promote Islam Hadhari, because these ten principles deal with many aspects of development, which are all important. The ten principles emanate from the Qur’an. If we believe in Islam Hadhari, it can be promoted through books, publications, or seminars and talks. Islam Hadhari can continue to create awareness of our responsibility towards the Ummah. We can promote Islam Hadhari because we believe that it will be good for our people, for Muslims.

KDC: Of course IAIS works to unpack and explain the ten principles of Islam Hadhari. The tenth principle is “good defence”. So when we talk about peace and security, we mean advancing a sound defence for Muslim nations. How do you view our approach to advance peace and security generally throughout the Muslim world and specifically in Malaysia? How are we doing; how would you assess our progress?

TAB: Peace must begin with every one of us who values peace, who wants peace at all costs and is ready to advance peace. And we must develop the best of relationships with all other countries. This is very important. To put blame on others all the time while claiming that we do not have problems among ourselves is totally wrong. And we should not be overly apologetic about what we want to do, for that doesn’t help create any impact at all. We have to deal with the problems we have in our country, including problems of poverty, extremism and conflict. These are real ones which we have to know, understand and deal with diligently. At the same time, sound relationships with other countries are important and we must address our economic problems. Our economy has to be shaped in the right direction to implement effective economic programs.

To blame other governments for the wars that are raging in the Muslim world is unacceptable. We have to look at ourselves first, and then we can look...
forward. And we should do it convincingly in the best way we can. We have to mobilise our people; we have to create awareness among all of us that we have a responsibility to do the best for our country, for our *Ummah*. And we must make every effort in this. It is necessary to develop bilateral relations that bring about help, support, and assistance. This is already happening. But we have to expand this kind of effort.

**KDC:** During your tenure as Foreign Minister of Malaysia and service as Prime Minister of Malaysia, what were the most significant challenges that you faced in seeking peaceful solutions to major international problems? Can you tell us about a few major problems you dealt with as Foreign Minister or Prime Minister?

**TAB:** If you are talking about OIC of which I was the chairman for three years, what we need to do is to strengthen our mechanism to help the OIC member countries in need of help. At the same time, OIC should play the role of advocacy, visibly and effectively, when it comes to issues of Islam relating to Muslims, and how Islam affects non-Muslims. The issue of Palestine has been there for a very long time but the situation appears to be worsening. The territory is very much affected because of the Israeli settlement programs; it is getting more and more problematic. What do we do? We can appeal to certain important influential countries because you cannot ignore the United States; we have to talk to them, and also to other countries in Europe. At the same time, Muslim countries must continue to show their determination to solve these problems. We Muslims would not want to see these problems continue, whether it’s Afghanistan, Palestine, Iraq, or possibly other problems which will appear in the future. I hope there will be no problem with Iran. If there is, that is going to be dangerous for us! We have to address these issues, and it cannot be done alone. It has to be done collectively with certain influential countries from a strong position with the ability to engage with the powers that are involved with these [Muslim] nations. We have to ensure that we can be effective. And if we want to be effective, we have to be collectively effective.

One of the problems we faced is that the OIC sits in a meeting and comes out with a certain program and a certain resolution which we want to propose to the UN. But unfortunately that resolution of the OIC is regarded as a document which does not affect the policies of certain member countries. The member countries of OIC, too, have their national policies which they want to pursue. And the national policies of these countries are sometimes inconsistent with the OIC policies. So, this does not strengthen the collective influence that OIC wants to create. This certainly is a problem that has to be understood, and dealt with, between the respective countries and the OIC. It is very important that OIC retain its strength collectively. It cannot have some members adopting the resolution while others have their own policies.
The other problem is that we would like the OIC do be more assertive in resolving economic deficiencies among the Ummah. Of course the OIC is facing problems, the major part being problems associated with war and peace. The problems of the countries we are facing are mostly political problems. This often involves problems of Islamic minorities in [non-Muslim] countries, which we also have to resolve. But at the same time, we cannot forget that many OIC countries are still poor in every aspect: poor in education, poor in their economies. Of course there are some countries which are able to help and have been helping others, but we have to do more, and be more effective. Our economic policies must help the people; then we will be able to reduce tension between the countries. Conflicts between countries have to be reduced. We have to address these conflicts. Sectarian conflict is a very serious thing. We cannot allow this. So, Muslims must resolve the problems among themselves. God does not want to see us fighting. That is not what God created us for. God wants for us a world that is peaceful. We, the human beings, are the khalifah, and we have to bring peace and prosperity. But sometimes I wonder, maybe we have forgotten the Quran. God created the world for us, created human beings as khalifah, and gave us guidance from the beginning through all the messengers of God; they carried the same message until the final messenger Prophet Muhammad (pbuh). The Quran has been given to us to be guided. There is divine guidance in the Quran. There is definitely peace for us. But yet we quarrel and fight. What is this? Have we forgotten the Quran? Or have we lost our belief in the Quran, in the guidance that the Quran provides us which comes from Allah through Prophet Muhammad (pbuh)? Or what is worse; have we forsaken Allah without knowing it? The different things we do are all against Allah’s commands, against Allah’s wish. If we are ignoring this, and act against it, that means we don’t seem to care for Allah; do we not believe Him? Our behaviour tends to create the impression that we ignore God’s commands, and we have forgotten about Him. It is very sad.

**KDC:** What is your vision for IAIS as an Islamic think-tank within the next decade?

**TAB:** IAIS is established as a think tank, and it must provide leadership: leadership in thought. But it is not only to think about programmes; programmes should be implemented, so that we can see the good results. That’s what we should do.
Media Conference on the Launch of
a Joint Appeal to Sunni and Shi’a Muslims by His Excellency
Dr Mahathir Mohamad and His Excellency S. Muhammad Khatami
(Putrajaya, 22 May 2013, organised by
JUST-International Movement of Justice)

A Joint Appeal to Sunnis and Shi’as

We, the undersigned, are greatly saddened by the violence and bloodshed which have characterised Sunni-Shi’a relations over time. Thousands have been killed in feuds between the two, mostly in certain Muslim countries. It is tragic that many innocent women and children have been among the victims.

Sunni-Shi’a animosity and antagonism have clearly weakened the Muslim ummah. It has made us more vulnerable to the manipulations and machinations of outside elements determined to subvert the unity and integrity of the ummah. It has allowed those who seek to establish their hegemonic power over us to succeed in their objectives.

It is indisputable that Sunni-Shi’a antagonism and conflicts which have resulted in massacres have tarnished the image and dignity of the ummah in the eyes of the world. Few other occurrences in recent times have had such a negative impact.

We appeal to all Sunnis and Shi’as, bound as we are by the same faith in Allah, guided by the same Noble Quran, honouring the same last Messenger of Allah, and facing the same Kiblah, to desist from massacring and the killing one another immediately.

NO MORE VIOLENCE
NO MORE BLOODSHED
NO MORE KILLINGS

The two of us – a former Prime Minister from a Sunni majority state, and a former President from an overwhelmingly Shi’a nation – also address this appeal to the Organisation of Islamic Cooperation (OIC) which represents all Muslims of whatever sect or doctrine. The OIC could perhaps set up a task force that will examine the Sunni-Shi’a divide in depth and submit concrete proposals for the political and religious leaders of the ummah to act upon.

We also appeal to sincere, concerned individuals and civil society groups from all over the world to join in this endeavour to stop the violence and bloodshed and to promote peace and understanding between Sunnis and Shi’as.
This joint appeal will be widely circulated mainly through the online media. We shall follow up on this appeal with other activities and programmes.

May Allah Subhanahuwataala guide us in all our humble efforts to serve Him.

S. Muhammad Khatami
President of the Islamic Republic
of Iran (1997 - 2005)

Dr. Mahathir bin Mohamad
Prime Minister of Malaysia

Peace and Security Forum 2013:
“Islam and Diplomacy: In Search of Human Security”
(Kuala Lumpur, 16-17 May 2013)

Tengku Ahmad Hazri, IAIS Malaysia*

On 16 May 2013, IAIS Malaysia, in collaboration with the Institute of Diplomacy and Foreign Relations (IDFR), the State of Qatar, The Cordoba Foundation (TCF) and the Global Movement of Moderates Foundation (GMMF), held the Peace and Security Forum 2013, with the theme, “Islam and Diplomacy: In Search of Human Security”. It was the second such event, after the first in 2011. The Forum featured a keynote address by His Royal Highness Raja Dr Nazrin Shah, Regent of the state of Perak Darul Ridzuan, Malaysia, and eight speakers and moderators. Prof. Mohammad Hashim Kamali (Founding Chairman and CEO, IAIS Malaysia) and His Excellency Dr Khalid bin Muhammad al-‘Atiyyah (Minister of State for Foreign Affairs, the State of Qatar) delivered the welcoming addresses.

Raja Nazrin’s keynote address set the theme for much of the discussion that was to follow, pointing to the inadequacy of a statist paradigm of security. Instead, human security shifts the focus to the security of the human person, which means more than just protection from physical threats and external aggression from foreign states, but also security from want, etc., including employment, health and environment. Linked to this is the concept of human development – also formulated by the economist Dr Mahbub ul-Haq – which promotes and advances what human security protects and preserves. Unlike conventional security, human security emphasises the security of the human person and the community, not the state. Human development and human security thus complement each other. But
in the contemporary Muslim world, the level of human security leaves much to be desired, hence the urgency to rectify this among others through diplomacy. Diplomacy, when carried out by the state, is interchangeable with foreign policy. And this offers an avenue to engage with the global community, e.g., through the Organisation of Islamic Cooperation (OIC). Early works of Muslims, like al-Ţabarî’s *Tārīkh al-Rusūl wa'l-Mulūk* (The History of Messengers and Kings), point to a preference for diplomatic negotiations over military means of resolving conflicts.

Prof. Kamal Hassan (International Institute of Islamic Thought and Civilization (ISTAC)) in his presentation linked human security to “soft power” (Joseph Nye) and “symbiotic realism” (Nayef al-Rodhan). These are attempts to reach minds and hearts through persuasion rather than coercion. Yet these concepts are vulnerable to manipulation; for instance, in RAND Corporation’s report on *Civil Democratic Islam*, the Muslim world is divided into groups, with strategies formulated to keep them apart.

The normative foundations of peace, security and diplomacy in Islam can be traced back to the Qur’an and examples of the Prophet (may peace and blessings of God be upon him!). These were elaborated at length by Prof. Mohammad Hashim Kamali in his presentation. He cited the Prophet’s (pbuh) wisdom in resolving the controversy over the Black Stone as well as the Prophet’s (pbuh) negotiations over the Madinah Charter and Hudaybiyah Treaty as early examples of diplomacy in Islam. Islamic diplomacy, said Kamali, rests on a value structure directed towards constructive engagement. Its conceptual significance can be discerned by looking at related values in the structure. For instance, Dr Karim Douglas Crow (IAIS Malaysia) pointed out that salām/salāmah is related to amān and şulh (setting aright what has been made wrong). The Qur’anic basis of *aslaha baynahum* (literally, making peace between them) represents the essence of all initiatives towards conflict resolution. There are parallels between human security and the virtue of moderation, and these were explored by Asrul Daniel (GMMF). He noted the exhortation towards moderation in various traditions: the ennoblement of the moderate life in the Bhagavad-Gita, the Confucian doctrine of the mean, the Greek virtue of temperance and the Ghazalian virtue of ‘iffāh.

These normative postulations notwithstanding, Chandra Muzaffar (International Movement for a Just World (JUST)), as moderator, questioned why there has been a persistent gap between the ideal and reality. In response, allusions were made to self-interest and lack of will. Kamali argued that this has partly to do with the marginalisation of the Shariah with the onset of colonialism which also brought with it worldviews that disproportionately emphasised the material dimension of progress and development.
The statist paradigm thus broken, the pursuit of security then becomes a diffused effort, giving prominence to non-state actors in securing peace. Amjad Saleem (TCF), elaborating the role of non-governmental organisations (NGOs) in such endeavours, raised concern about a disconnect between the high rates of Muslim contributions and the poor rates of distribution. He noted how Muslim individuals and groups have been very efficient in responding to humanitarian needs during conflict and emergencies, more effective in fact than governments. The disconnect could be due to the lack of a sense of mission (not being clear about goals and aspirations), no clarity of issues and the fact that charity missions are sometimes integrated into state security concerns (for instance, in Canada). Opportunities lie in the fact that there is always a continuous source of income for these charities. He argued for the need to link peace with development. Peace-building is a long-term initiative, hence the need to invest towards it. Of course, states themselves should not be side-lined. The state of Qatar, for instance, as we learned from Dr Hassan bin Ibrahim al-Mohannadi (The Diplomatic Institute of the State of Qatar), has played a key role towards peace-making in the Gulf region, particularly in Lebanon, Sudan, Yemen and Syria.

Despite these promises, Islamic diplomacy confronts a number of challenges and difficulties. Geopolitical issues have always been a major challenge. The Sunni-Shi’ah fault line is always exploited. Also, the tendency towards hard diplomacy and militarised responses on the part of the state are not easily changed. Chandra also drew attention to the militarisation of states in the Asia Pacific as indicated by the increase in military expenditures in the Asia Pacific, according to the Stockholm International Peace Research Institute (SIPRI). On the domestic side, Nasharudin Mat Isa (Al-Quds Foundation of Malaysia) emphasised the need to think beyond occupying power at the level of the federal government (Putrajaya) and called for the unity of the Pan-Malaysian Islamic Party (PAS) and the United Malays National Organisation (UMNO), the two leading Muslim-dominated political parties in Malaysia.

The forum was followed by the Peace and Security Forum Round Table Discussion (RTD) the next day (17 May 2013). It was then proposed that a collective network called Peace and Security Forum (PSF) be established which will link various institutions in the public and private sectors. The initiative will be result-oriented, focusing on advancing Islamic solutions to conflict and violence as well as nation-healing. A working group was set up to carry the project forward, which will report regularly.

The two-day event offered crucial insights and perspectives from academics and practitioners in the field of diplomacy and security.

*Credits to Tawfique al-Mubarak and Elmira Akhmetova for their input on the 17 May event.*
An International Seminar “Islam in Bangladesh: Recent Decades, Current Turbulence and Future Prospects” was hosted by the IAIS Malaysia on 17 April 2013. The event was organised jointly by IAIS Malaysia and the Global Peace Malaysia (GPM). Dr Azam Adil, the Deputy CEO of IAIS and chairman of the event, introduced the seminar with a brief sketch of the advent of Islam in the first century hijrah and its subsequent development in Bangladesh. The promotion of Islam in Bangladesh was mainly supported by the generous donations and endowments of the wealthy Muslims. Islamic culture and festivals have always been observed with exuberance and retained tremendous significance all through the history of Bangladesh. However, current trends and developments in the Bangladeshi politics have challenged Islam as an ideology and Muslims in particular. Other presenters who spoke at the event included Professor Abdullahil Ahsan, Professor Ershadul Bari, Lt. Gen. (Retd.) Dr Aminul Karim and M. Raimi Abdul Rahim.

The speakers provided an overview of Islam in Bangladesh and spoke on the current upheavals which shocked the nation very recently. Professor Abdullahil Ahsan gave a general account of the historical perspective of Islam and the Muslims in Bangladesh. During the English colonial reign, only a very few number of English speaking Muslims were to be found in the entire Indian subcontinent. The Muslim elites lagged behind, ultimately resulting in a leadership vacuum in the Muslim dominant East and West Pakistan after its separation from India. Bangladeshi leader Sheikh Mujibur Rahman’s movement for self determination in response to Bengalis being deprived of their rights under the united Pakistan was later turned into an independence movement. And the cause for Islam took a different shape in independent Bangladesh. The ongoing trial at the International Crimes Tribunal (ICT) concerning the crimes committed during the war of independence has also played a vital role in forming a public context for Islam. He suggested that Bangladesh should develop a better relationship especially with the OIC and the ASEAN.

Professor Ershadul Bari shared his views on the constitutional reforms in Bangladesh and the roles that secularism and Islam played. The first constitution of independent Bangladesh was based on secular ideology, where secularism was declared as one of the four fundamental principles of the state. Since then,
the influence of Islamic culture has slowly diminished. He further discussed the feasibility of passing a new blasphemy law in Bangladesh, which was demanded by the Hefazat-e-Islam in response to some anti-Islamic bloggers. Remarking on the blasphemy law, Professor Bari thinks that the existing 1927 Amendment of the Penal Code could be enhanced to protect any contempt of religion.

Lt. Gen. (Retd.) Dr Aminul Karim believes that the current crisis in Bangladeshi politics is the result of artificially constructed divisions in the psyche of Bangladeshi Muslims. Bangladesh is a homogenous state, and artificially constructed divisions should not compromise national interest. He concluded by suggesting that ummatic bonding should unite Bangladesh with other Muslim states. Raimi Abdul Rahim from Global Peace Malaysia spoke on the mutual ties between Malaysia and Bangladesh and Malaysia’s role in enhancing the good relationship. He also briefed participants on the ongoing political tensions and issues in Bangladesh. Raimi’s suggestion to overcome these tensions was to dissolve the ICT and hold a fresh trial at the International Criminal Court (ICC).

International Seminar on
Islam and Democracy: What is the Real Problem?
(6 April 2013, IAIS Malaysia, Kuala Lumpur)

Tengku Ahmad Hazri, IAIS Malaysia

On 6 April 2013, IAIS Malaysia and the Islamic Renaissance Front (IRF) co-organised an International Seminar on “Islam and Democracy: What is the Real Problem?” There was consensus among the speakers that the Qur’an and Sunnah prescribe no form of government but insist on commitment to principles such as justice (’adl) and welfare (maslahah), thus implying the “compatibility” of democracy with Islam. Prof Mohammad Hashim Kamali (Founding Chairman and CEO, IAIS Malaysia) in his keynote address drew attention to the institutions of democracy, seeing in them prospects for the crystallisation of Qur’anic principles of consultation (shura), consensus (ijma’) and independent reasoning (ijtihad).

Dr Syed Farid Alatas (National University of Singapore) cautioned against the idealisation of democracy and the disproportionate emphasis on the ideal itself. Democracy means more than the ballot box and requires supporting infrastructures, such as a strong business community and even the correct mindset. The latter is intertwined with theology; for instance, a religious approach that focuses on the punitive dimensions of religion is hostile to a democratic society.

Dr Dzulkifly Ahmad (Islamic Party of Malaysia (PAS)) distinguished between the fixed (thawabit) and changeable (mutaghayyarat) components of Islam and
endorsed democracy on the grounds that forms of government belong to the latter. But contrary to widespread assumptions, this approval has nothing to do with necessity (darurah), for in cases of necessity, the Shariah permits appropriation only to the extent necessary for survival. Yet in democratic societies individuals have gone beyond mere survival to flourish and thrive with their own talents and capabilities.

Dr Farouk Musa (IRF) linked democracy with freedom, rationality and social justice, in the tradition of Muhammad Asad, Ali Shariati and Rachid Ghannouchi. If man has been dignified by Allah (Qur'an, 17:70), it is because of the gift of reason, by means of which also man affirms al-tawhid (Oneness and Unity of Allah). At the social level, al-tawhid is the underlying principle of human fraternity enjoined in Islam, hence its antipathy to sectarianism, such as racism.

**International Seminar on Islam without Sectarianism**  
(10 March 2013, The Renaissance Hotel, Kuala Lumpur)

*Michael K. Scott, IAIS Malaysia*

“Islam without sectarianism,” a seminar held in Kuala Lumpur on 10 March 2013, provided a forum for a number of scholars to speak out against the rising scourge of sectarianism throughout the world. This was a bold collective attempt by leading scholars and activists in Southeast Asia to tackle one of the most sensitive issues that have plagued relations among Muslims in recent years, organised by the Malaysian Islamic Renaissance Front, IAIS Malaysia and the Kuala Lumpur-based Islamic Book Trust.

Professor Mohammad Hashim Kamali, founding chairman and CEO of IAIS Malaysia and the first presenter at the seminar, reviewed the history of sectarian developments in Islam and some of the relevant dicta of the Quran and the Hadith. He underlined the spirit of tolerance that historically governed relations between the various schools of Islamic Law and the atmosphere of mutual respect that accompanied the early rise of schools of thought in Islam. Despite the polarisation underway today, most authoritative Muslim scholars continue to call for taqrib, or the rapprochement of the madhahib, most notably between Shi’as and Sunnis, by urging an end to condemnatory rhetoric between them.

“The Amman Message was a strongly worded fatwa coming from leading Sunni and Shi’a scholars denouncing the idea of charging Muslims of any sect as kufr [disbelief],” Professor Kamali stated, referring to the declaration by prominent Muslim scholars and leaders in 2004. Although it would not be practical to abolish the madhahib, Muslims, according to Kamali, “should focus
on commonalities”, reminding the audience that the Imams of all the madhahib had left Muslims with a legacy of respect and not hatred.

Elaborating on this point, Dr Syed Farid Alatas, head of the Department of Malay Studies at the National University of Singapore, was concise in his appraisal of sectarianism, narrowing it down to the rise of intolerance around the world, including Malaysia. All too often, in Malaysia as elsewhere, religious authorities also played a part in the process, getting involved in the demonisation of the “other”. Professor Alatas observed that religious authorities must realise that “no serious [Sunni] Muslim scholar demonises Shi’a scholars,” since “Shi’as go to Hajj while no non-Muslim could attend the Hajj”, and that Iran – a Shi’a majority country – is a member of the OIC.

He also noted that prominent Sunni scholars had in the past explicitly recognised Shi’ism as part of the Ummah, including former Grand Shaykhs of Al-Azhar University, most notably Mahmud Shaltut through his famous fatwa of 1959. Others included prominent scholars and Islamic activists like Muhammad Abduh, Salim Bishri, Muhammad al-Madani, Sayyid Sabiq, Hasan al-Banna (founder of the Muslim Brotherhood) and Syed Tantawi. “You will not find a serious Sunni scholar who would define Shias as not legitimate,” Professor Alatas stressed. Islamic authorities in the Malay world had once displayed more enlightenment in their response to different schools of thought. An example can be found in Habib Alwi bin Thohir al-Haddad, who served as mufti of Johor in the 1930s. He granted the ijazah (teaching certificate) to a Shi’a scholar of that time. While many practices in Shi’ism, such as the commemoration of the Karbala tragedy in the month of Muharram, have also been questioned by Shi’a ulama, Muslims “should not confuse such practices with the theological and jurisprudential school of thought,” said Alatas.

The divide between Shi’as and Sunnis dominated the discussion, understandably, given the recent and widely reported sectarian violence in Pakistan, Iraq, Bahrain and Syria. Writer and social critic Dr Farish Noor, Professor Karim Crow of the International Institute of Advanced Islamic Studies (IAIS) and Dr Haidar Bagir from Indonesia’s Paramadina University also provided insights into the topic.

Professor Crow gave an overview of current Middle East politics, linking it with the sectarian strife seemingly promoted by US-backed Arab regimes. He also said it was critical that Muslims objectively study the foundational myths of their respective schools of thought. He lamented the so-called traditionalist scholars’ penchant for polemical hostility, which hampers efforts towards convergence, and recalled movement toward convergence in the past undertaken by Islamic thinkers and authorities more open to the reasoned tradition of rational inquiry than to dogmatic self-affirmation and polemic dispute. Describing the global export of sectarian strife to Muslim countries, Dr Haidar
Bagir, a prominent Indonesian philanthropist, captured the audience’s attention with a wry reference to “footloose jihadists,” suggesting the rise of sectarianism is “much more complex than [arising solely] for religious reasons.” He urged Muslims to reject attempts to manipulate sectarian sentiments, and he saw hope in overcoming sectarian hatred in gestures by leaders from both sides calling for a ceasefire of condemnatory statements. For example, Iranian leader Ayatollah Seyyed Ali Khamenei and Iraq’s Grand Ayatullah Sistani have discouraged inter-sector “conversions”: “Sunnis too love the ‘Ahl al-Bayt’ – the title used for members of the Prophet Muhammad’s (PBUH) family, whose sayings form the core of Shi’a Islam.


Saim Kayadibi, International Islamic University Malaysia

The 2nd International Conference on Islamic Economics and Economies of the OIC countries (ICIE 2013) was convened in Kuala Lumpur, 29-30 January 2013. It was jointly organised by the Department of Economics (College of Economics and Management Sciences) of the International Islamic University Malaysia (IIUM), the Malaysian Ministry of Finance and the Islamic Research and Training Institute (IRTI), with the collaboration of two universities: University of Medeniyet, Turkey, and Bogor Agricultural University, Indonesia, as partners. A total of 33 different countries participated. The two keynote speakers, Savaş Alpay (Director General of Statistical Economic Social Research and Training Centre for Islamic Countries [SESRIC]), and Monzer Kahf (Laureate of Islamic Development Bank [IDB] Prize in Islamic Economics), were joined by the Second Finance Minister of Malaysia, Ahmad Husni Mohamad Hanadzlah, and public and government representatives and international academics, in the presentation of ninety-two (92) different papers on diverse themes.

This year’s conference built on the achievements of the 1st ICIE 2009 to focus on Islamic Economic Solutions for OIC Countries: Theory and Policy. Increasing financial and economic crises seem to offer OIC countries an opportunity to embrace Islamic economics as an alternative approach to guide economic policy. ICIE2013 provided a platform to bring together both academics and policy makers to enhance discussions in this area.

The Honourable Rector of International Islamic University Malaysia, Zaleha Kamaruddin, welcomed the participants and highlighted the importance of
Islamic Economics and the vital role of OIC in the world. Director General of the Islamic Research and Training Institute (IRTI) M. Azmi Omar underlined the necessity of cooperation among the OIC Member Countries in research. Dean of the IIUM Faculty of Economics and Management Sciences Khaliq Ahmad Israil stressed the role of ethics in economic policies which affect today’s economy. In launching the conference, Second Finance Minister of Malaysia Ahmad Husni Mohammad Hanadzlah noted that in Islamic economics, socio-economic justice is the primary objective, with a premium placed upon principles of justice, fairness and equity. As such it can offer a solution to the economic problems of Muslim communities globally, but only if theories developed in Islamic economics are linked to practical policies.

The first keynote address, “Critical Perspectives on Socio-Economic Development and Transformation in the Islamic World”, was given by Savaş Alpay (Director General of Statistical Economic Social Research and Training Centre for Islamic Countries [SESRIC]). This paved the way for the first day’s plenary session: “Toward Islamic Economic Policy in the OIC Countries”. Among four parallel working groups in the plenary, Geoffrey Ngene and M. Kabir Hassan (Mercer University, USA, and the University of New Orleans) explained nonlinear price discovery in sovereign credit risk and equity markets of the Organisation of Islamic Cooperation (OIC) countries, and parallel sessions dealt with various topics: the sustainability of Islamic banking in Nigeria; non-banking financial institutions as an alternative to Islamic banks; the role of microfinance as an important tool in eradicating poverty and improving microenterprise performance; the perceptions of bankers and regulators on Islamic microfinance in Pakistan; attitudes concerning interest-free and conventional banking of customers in Turkey; and the link between women’s empowerment and economic development.

During the second day, scholars explored economic concepts in the Qur’an and the Sunnah, hisba literature as a source of Islamic economy, an evaluation of a Pan-Islamic multilateral investment bank, and the socio-economic importance of the Turkish tourism sector as a model for the development of tourism of OIC countries. Saim Kayadibi focused on economic cooperation among the OIC countries, analysing as a case study in Turk-Malay economic cooperation. Turkey and Malaysia have enjoyed steadily growing economic relations over the last decade, with bilateral trade expected to rise to $2.5 billion by 2012.
BOOK REVIEWS

Mustafa Akyol, *Islam without Extremes: a Muslim Case for Liberty*  

Tengku Ahmad Hazri, *IAIS Malaysia*

Freedom is frequently a topic of controversy in discussions of Islam and the West. Mustafa Akyol’s recent book goes further than making the claim that freedom is indigenous to Islam, and it reads closer to an ideological manifesto in offering a spirited defence of liberalism and free market capitalism from an Islamic perspective: “[L]iberty is ... what everyone needs to find God.” But freedom in Islam is morally assured, legally secured and theologically grounded and sanctified—and thus forms a crucial part of the entire worldview of Islam. It can be conceived as a higher purpose (*maqsid*) of the Shariah, and not merely a principle or a transient reality. An ideological reading of freedom, as we find in Akyol’s book, actually truncates that worldview, as it dislodges freedom from its Islamic theological-moral-spiritual sanctuary in favour of classical liberalism.

Akyol’s principal claim is that freedom is coeval with the Qur’an itself and realised by the Prophet during his lifetime. Islam created the individual out of the tribe, extolled man as God’s viceroy on earth and enjoined righteous deeds as part of religious faith. Such proto-liberal tendencies within Islam, Akyol argues, brought about radical transformation to the Arabian society of the time—endowing women with hitherto unknown rights, protecting the weak and the powerless, freeing the individual from the shackles of tribal ethics, and more. But when the Prophet died, this all proved to be short-lived. His death gave way to a “medieval war of ideas” between two camps, one that championed reason, freedom and pluralism, and another, espousing a rigid, dogmatic, literalist and exclusivist variety of Islam. Examples of the former, according to Akyol, include the *ahl al-ra’y* (People of Opinion), Abu Hanifah, the Hanafis, the “Rationalist” Mu’tazilites, and the “Pluralist” antinomian Murji’ites. Examples of the latter would be the *ahl al-hadith* (People of Tradition), Ahmad Ibn Hanbal, the Kharijites, the Wahhabis, the Ash’aris, Abu Hamid al-Ghazali, al-Shafi`i and the hadith literature.

In Akyol’s view the eventual triumph of the latter camp has led the Muslim world to the stagnation that has persisted till today. However, Akyol considers the external environment—the social milieu, geographical landscape, land fertility, etc.—to have been central to the triumph of this latter camp. Above all, trade allowed for rational, liberal and plural traditions within Islam to flourish, if only for a while. The decline of trade brought about the decline of rationality and, along with it, freedom (and everything else that is good).
Contemporary Turkey offers a promising hope to actualise the dormant—or rather, suppressed—liberal tendencies within Islam. Historically, the Ottomans nurtured a healthy liberal and plural tradition. The millet system enabled different communities to flourish with their own culture and mores. It offered refuge to Jews fleeing persecution in Europe, winning the admiration of Martin Luther and Jean Bodin. But when the winds of change swept across Europe, once a hotbed for bloody ethnic, religious and cultural wars, and for oppression and tyranny, the continent then rapidly transformed itself to define new standards of civilisation. The Ottoman accomplishments paled by comparison. Ottoman leaders, conscious of the need to adapt and compete gradually undertook reforms along European lines, called the Tanzimat (Reorganisation). During this time and the later Second Constitutional Period, known as the Hurriyyet (liberty), the reform-minded Young Ottomans emerged, and a single law for all Ottoman citizens was introduced. Mustafa Kemal, “Ataturk”, the father of modern Turkey, cut this short and led a rebellion against the last remnant of the Ottomans to establish Turkey as a modern state. The new state did not continue the liberal agenda of its predecessor, evincing instead an excessive infatuation with secularism, forcing citizens to wear brimmed hats, keeping religion out of the public and emulating the West down to the lowest detail. This attracted various forms of backlash: “zealots” with an authoritarian Islamist ideology were a by-product of Kemalism, as were liberals joining Muslims in an alliance against secularist authoritarianism. We believe that hope for the future in Turkey lies in the latter direction.

Akyol’s narrative is compelling, and his discourse offers a defence of freedom and liberty from within Islam. But when the author equates religion with authority, duty and obedience alone, he falls into something of an all-pervasive error in this text. By such logic then, the moment something ceases to be obligatory, it ceases to be a religious matter. So the Prophet’s tactics in war were for example not religious, since they were not obligatory (247). The state is not obligatory, therefore not religious (252). A related error is the author’s failure to see Islam not as ideal but as reality, or of viewing religion as being synonymous with scripture, instead of being based on it. This gives rise to false distinctions such that religious is contrasted with intellectual, rational, and secular. This seriously cripples an otherwise compelling analysis, in our view.

Akyol’s defence of the “freedom to sin” (262-272) is a case in point, arguing that “the means to commit sin should be available” (272) so that one may be able to exercise free choice in choosing what is right and refraining from what is wrong: choice should not arise as a result of state coercion, but out one’s own volition. It seems that for Akyol freedom itself is not free from the state, insofar as freedom depends on the state abstaining from coercion! The resolution of this contradiction is for freedom to be anchored to the source of freedom itself, i.e.,
to God Himself, as was most succinctly captured by the Sufi Ibn al-‘Arabi in his dictum “freedom (hurriyyah) is slavery to God.” It is when we are closest to God that we are truly free “from man’s lordship over man”.

Akyol defends the Mu’tazilite argument that man has free will and creates his own actions, which are not predetermined by God. Nevertheless, “environmental determinism” (131) is so powerful as to be able to “[shape] not just the mindsets of individuals and the culture of societies but also the political structures of states” (132-133). Is man free enough to resist divine determination, but helpless against his environment?

Akyol seems to take it for granted that the salvation of Muslims today lies in wise economic policies and social planning: in other words, seeking solutions to the challenges that lie outside man, not those that are within him. One may argue that such an external basis for freedom is at best unstable and at worst precarious.

Islam is precisely a force to enable individuals to remain righteous and ethical despite economic hardship. A moral and just society dependent on economic stability offers only a false sense of security and a fragile basis for a moral order. The Quranic attitude is seen in its challenging of the Makkani practices of burying babies alive on account of poverty (al-Nahl, 16:58-59), asking instead for them to put their trust in Allah (al-‘Isra’, 17:31), offering neither pennies nor policies but quite simply hope. To lapse into crime and immorality as a result of poverty suggests the failure, not merely of policy but of remaining true to absolute moral constraints enshrined by religion.

Nevertheless, despite caveats, in the book Islam without Extremes: a Muslim Case for Liberty, Akyol’s analysis of the Turkish Islamo-liberal experiment remains compelling.

R. Skidelsky and C. W. Wigström, Eds., The Economic Crisis and the State of Economics

Abdul Karim Abdullah, IAIS Malaysia

The Economic Crisis and the State of Economics, published by Palgrave Macmillan in 2010, is a product of a symposium held with the purpose of identifying the causes of the current financial crisis as well as prescribing remedies. Robert Skidelsky, organiser of the symposium, is a British economic historian, former politician, and author of the acclaimed three-volume biography of J. M. Keynes. He is Emeritus Professor of Political Economy at the University of Warwick, UK. Christian Westerlind Wigström is a graduate student of philosophy at Merton College, Oxford.
The symposium was “inspired by a dissatisfaction with the silence of the economics profession on the causes of the current economic downturn and the remedies for overcoming it,” writes Skidelsky. “Here was an event that was freely compared to the Great Depression, but comments in the financial press were being provided entirely by financial journalists. Where were the economists?” (ix). On 13 February 2009, “some of the best of the economists” (ix) met at the House of Lords, London, UK. The participants came from diverse backgrounds: academic, business, and government. This diversity gives the book an interdisciplinary character.

The discussion centred on three themes: risk and uncertainty, macroeconomics and ethics. The “efficient market hypothesis” (EMH) in particular received a significant amount of attention. The EMH became popular beginning in the mid 1960s, during a period known as “financialisation” (1960s onwards). Financialisation is the growth of the finance sector at the expense of the real sector.

According to the EMH, markets are efficient. But they are not efficient in the customary (economic) sense in the way they allocate resources. Markets are efficient because they determine prices, in particular the prices of securities, accurately. Determining prices and allocating resources, however, are two very different things. Achieving the former does not necessarily guarantee achieving the latter.

Viewing markets as efficient on account of their ability to establish prices accurately is the sense in which the term efficient is used in finance. It is in this sense that this term is also used in the discussion. It would appear that even intellectual discourse is not exempt from being influenced by financialisation.

The 2008 global financial crisis showed that markets were not efficient, the participants noted, because prices of securities, in particular the collateralised debt obligations (bundles of debt), collapsed dramatically.

However, it is hard to see how a narrow notion of efficiency such as that used in finance can be of much help in solving problems that extend beyond losses experienced by investors. Larger problems—such as a misallocation of resources—affect the entire society rather than only a part of it, the investors.

Moreover, it appears that the contributors intended the characterisation of markets as inefficient to apply to all markets, including the real sector markets. Characterising real sector markets (including the stock market) as inefficient, however, on the basis of what happened primarily in the credit markets, may be premature. There is a major difference between real sector markets and credit markets.

The reason for this difference is that credit markets and real sector markets operate in radically different ways. Activity in the credit markets is driven by an incentive in the form of interest. Activity in the real sector is driven by an incentive in the form of profit.

Despite appearances, interest and profit constitute fundamentally different incentives. Contracts in which these incentives are paid by one counterparty to
the other establish radically different relationships between counterparties. The differences in the terms on which capital is provided to entrepreneurs by investors or lenders, respectively, result in significant differences in the way resources will be allocated. Profit is an excellent incentive for ensuring efficiency in the real sector, assuming competitive conditions and the absence of regulatory and market failure. Interest is not.

Approximately two-thirds of all business financing takes place in the form of debt. Thus, how the greater part of the resources will be allocated in the real sector depends first of all on how resources are allocated in the credit sector. Any misallocation of resources in the credit sector will cause a corresponding misallocation of resources in the real sector. This is what happened in the 2008 global financial crisis. For this reason, failures in the credit markets should not be interpreted as failures of the real sector markets.

Evidence of inefficiency in the real sector showed up in the construction of millions of houses, financed with subprime loans, for which in the end there were no buyers. When subprime borrowers eventually defaulted on their housing mortgages, the houses were repossessed by financial institutions and are now being torn down due to dilapidation. This constitutes clear evidence of waste on a massive scale. Thus, it is clear that failure in the credit markets did not only take the form of the inability to indicate prices of securities accurately. It also took the form of a failure to allocate resources efficiently.

In Shakespeare’s *Hamlet*, Claudius observes, “Diseases desperate grown, by desperate appliances are relieved, or not at all” (IV, iii). There is no doubt that a desperate disease, an economic depression, is afflicting the modern financial and economic system. However, while there is agreement on what the disease is, there is less agreement on what caused the disease, and still less agreement on how to cure it. The major reason for this impasse is that analysis, whether of problems, causes or solutions, continues to take place within the proverbial box, in the confines of the dominant intellectual paradigm.

This paradigm takes for granted that lending at interest is not only an efficient but also an ethically acceptable way of financing, whether of investment, consumption or government spending. A closer look, however, shows that interest-based financing constitutes a major anomaly within the free enterprise system. The main reason is that the earning of income by mere lending contradicts one of the most basic principles of the free enterprise system, if not also of justice. This principle is that reward needs to be linked, and indeed be proportionate, to performance.

Unlike payments of dividends to investors, payments of interest to creditors do not depend on the efficiency (productivity) of the enterprises they finance. Neither do they depend on the total amount of profit earned. Rather, they depend on the total amount of capital supplied (loaned), as well as on the rate of interest charged. Thus, in financing business investment by lending at interest, the
reward (interest) paid to creditors is not linked in any way to the performance (profitability) of the business. Moreover, the amount of interest to be paid to lenders is determined even before it is ascertained whether the enterprise utilising loan financing has earned any profits to begin with.

As a result, lenders have little incentive to channel funds to enterprises that are more efficient (profitable) than what it takes to repay loans with the interest. Moreover, because many loans are secured with collateral, lenders have little incentive to perform due diligence to ensure that any proposed projects (such as the construction of subprime houses) are commercially viable over the longer term. This is due to the perception that they face little or no risk, as the loans are “collateralised”. One consequence of the absence of the link between compensation and performance, as well as the perception that lenders faced little or no risk, was a misallocation of resources on a scale hardly seen before.

To prevent a repeat of this fiasco, decisions on how resources are allocated in the real sector have to be made in the real sector rather than in the credit sector. This requires taking the decisions on how to allocate resources out of the hands of the credit sector and entrusting them to the real sector. This can be achieved by phasing out interest-based financing and replacing it with profit and loss sharing.

The book concludes with an essay on morals. This would have been a good place to ask whether interest-based financing is ethical. But this does not happen. Instead, we are alerted to the fact that capitalism is in a “moral crisis” (119). Yet it is not capitalism that is in a crisis, but rather the people, businesses, and entire nations that are deeply in debt, and unable to come out of it.

In his *General Theory* Keynes wrote: “The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds” (Preface, *The General Theory of Employment, Interest, and Money*, 1935). The best way we can learn from Keynes is to follow his advice and escape from some old ideas. In this case, however, we need to escape from *his ideas*, in particular his ideas about usury.

It is time to consider alternative, less damaging and unjust modes of financing: interest-free financing. This can be done by adopting *bona fide* Islamic financing, not the instruments that replicate conventional bonds, and thus also their weaknesses, in particular indebtedness and the risk of default. It is too late for Keynes to benefit from his own advice. It is not too late, however, for those who still think that the analytical framework in which he operated, and indeed helped to design, is capable of producing a solution to the current crisis.

One of the “most fruitful results” of the discussions, Skidelsky observes, “was the widespread agreement” on the need for new economic models (9). The interest-free financing system may be just such a model. It is worth exploring. It may just provide the type of cure spoken of by King Claudius in Shakespeare’s *Hamlet*. 

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In 1971, by a devastating war, Bangladesh (then East Pakistan) achieved independence from (West) Pakistan. Since then, both parties have documented and presented their research findings on the war. However, many of these findings have lacked credibility. Perhaps the only objective account on the 1971 war has been Richard Sisson and Leo Rose’s *War and Secession: Pakistan, India and the Creation of Bangladesh* (1991). Sarmila Bose’s recent work, *Dead Reckoning*, today constitutes a significant contribution to the research on Bangladesh’s war of independence, all the more so for its unique methodology in using multiple sources of original information and cross-checked eyewitness testimonies from all parties involved. Pakistani army personnel as well as Bangladeshi *muktijoddhas* (freedom fighters) and victims of the war were interviewed to authenticate currently available materials, many of which appear to have been exaggerated with the force of emotion. This distinguishes the work from many other books authored by proponents of either party to the conflict. This book is certainly an eye-opener for researchers on the 1971 war.

The book is divided into nine chapters, each referring to the approximate chronology of events from December 1970 until the end of the war in December 1971. Chapter one (“Call to Arms”) describes the general election of 1970 and the victory of the Awami League (AL) led by Sheikh Mujibur Rahman with a majority of seats in the parliament. Bhutto, despite losing the election, aspired to be Prime Minister of all Pakistan, and hence refused to accept the negotiations mediated by Yahya Khan, who was then the President and Chief Martial Law Administrator of Pakistan. Sheikh Mujib, too, was adamant that he should become Prime Minister. The negotiations ended without fruitful results; thus Yahya announced the postponement of the national assembly. This immediately set off violent revolts by the Bengalis. Sheikh Mujib’s speech on 7 March stopped just short of declaring independence; he was still negotiating with the expectation of becoming the Prime Minister.

The Bengalis’ revolts spread throughout the state immediately after the announcement. The following chapter (“Military Inaction”) describes how the control over East Pakistan weakened and shifted to a parallel government led by Sheikh Mujib, with no mutually agreed resolution to the conflict. In the Joydevpur incident of 19 March 1971, two Bengali citizens were killed in a shootout between civilians and the Pakistan army, exacerbating the tense situation between the two parts of Pakistan.
Chapter three (“Military Action”) describes “Operation Searchlight” conducted on the Dhaka University campus by the Pakistani government on the night of 25 March 1971, “a military solution, which ultimately proved to be catastrophic for Pakistan.” The Pakistani army crushed the resistance of the students in the residential halls, and elsewhere in adjoining apartments of the faculty, innocent unarmed civilians were massacred.

Chapters 4-8 detail the brutal atrocities committed by both of the warring sides. “Uncivil War”, the fourth chapter, illustrates through ten cases the bitter feud that festered during subsequent months, following the military action of 25 March. As the Pakistani army had killed innocent civilians and Bengali Hindus, the Bengalis also killed their Bihari brethren in East Pakistan. In Joydevpur and Gazipur, Bengali soldiers revolted against the non-Bengali and West Pakistani army personnel, killing West Pakistani officers and their families. In Khulna, at the People’s Jute Mill, the Bengalis took up whatever weapons they found and attacked the Biharis, “killing everyone they could find – men, women and children.” Similar incidents took place at Mymensingh, Santahar and at Chittagong’s Karnaphuli Mill. The Pakistan government’s White Paper on the gruesome situation estimates that about 15,000 Biharis were killed. Chaos and bloodshed spread widely throughout the state during the earlier months after the military action.

Chapter 5 (“Village of Widows”) describes the mass killing at Thanapara village in Rajshahi by the Pakistani army on 13 April 1971. Men were separated from women and children and brutally shot, their bodies stacked in a pile and set on fire. Bose writes with emotion that this was “one of the grisliest of stories I heard in the course of my study of the 1971 war!”

The chapter “Hounding of Hindus” describes how Hindus were murdered by the Pakistani army at Chuknagar, at the borders of Khulna and Jessore districts, while they were fleeing their homes because of looting and harassment, mostly by local Bengali Muslims. Questioning the popular Bengali narration that 10,000 people were murdered there, Bose considers it a figure “too large” that an army contingent of just three truck loads of soldiers could murderously dispatch within just a couple of hours that many people. The scepticism that Bose, a Hindu, here evinces suggests a concern for strict objectivity of analysis in her research into what was certainly a heinous crime.

The seventh chapter (“Hit and Run”) provides documentation of instances in which underground Bengali guerrillas like Alvi and Rumi, having trained in India, demonstrated their dedication to an independent Bangladesh. The bestial killings of prominent Bengali scholars by the Al-Badr and Al-Shams groups at the Rayerbazar brick-kiln and other places are described in the eighth chapter (“Fratricide”). The muktijoddhas too, it must be said, similarly killed Bengali supporters of a united Pakistan in the most brutal manner. Bengalis killing other
Bengalis for either supporting or opposing a united Pakistan became a regular occurrence during the last weeks of December 1971.

The last chapter (“Words and Numbers”) addresses the myth underlying ‘Sheikh Mujib’s famous statement: “I discovered that they had killed three million of my people.” Bose argues that so far no authentic references have substantiated the claim. She concludes that between 50,000 to 100,000 people perished in the war of 1971, including combatants and non-combatants, on both sides. Similarly, the often-cited figure of 93,000 Pakistani soldiers taken as POWs is also unrealistic, given a contingent which had a total of only 55,000 members in East Pakistan during the war, civilian officials and army personnel combined.

The fundamental contribution of the book is that it reveals how the whole discourse of liberation and separation has been sullied by fictions. Although the popular Bengali versions of the 1971 war describe the atrocities committed by the Pakistani army, rarely is mention made of Bengali attacks on Biharis and non-Bengalis.

Bose does not directly address the current situation in which political leaders are undergoing trials at the International Crimes Tribunal (ICT) in Bangladesh, but her descriptions suggest that these trials are largely driven by concocted discourses for political motives. The book is significant for employing a robust methodology to uncover the myths and realities surrounding the 1971 war, which Bose concludes left “a land of violence with a legacy of intolerance of difference and a tendency to respond to political opposition with intimidation, brutalization and extermination” for the next generation.
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