

Islam and Civilisational Renewal

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and policy research**

**Special Issue: The Global Financial Crisis –
Economic Challenges and Prospects for Islamic Finance**

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OBJECTIVES AND SCOPE

- **Islam and Civilisational Renewal (ICR)** is an international peer-reviewed journal published by Pluto Journals on behalf of the International Institute of Advanced Islamic Studies (IAIS). It carries articles, book reviews and viewpoints on civilisational renewal.
- ICR seeks to advance critical research and original scholarship on theoretical, empirical, historical, inter-disciplinary and comparative studies, with a focus on policy research.
- ICR aims at stimulating creative and original contributions within contemporary Muslim and non-Muslim scholarship to further civilisational renewal.
- ICR promotes advanced research on the civilisational progress of Muslims and critical assessments of modernity, post-modernity and globalisation.

CONTRIBUTIONS AND EDITORIAL CORRESPONDENCE

Notes to contributors and details of submission can be found at: ICR.plutojournals.org

Comments and suggestions as well as requests to contact one of the contributing authors can be emailed to the Managing Editor at: journals@iais.org.my

CONTENTS

Editorial	223
<i>Mohammad Hashim Kamali</i>	

Articles

The Global Financial Crisis: Can Islamic Finance Help Minimise the Severity and Frequency of Such a Crisis in the Future?	226
<i>Muhammad Umer Chapra</i>	
Towards a Meeting-Point Between Islamic Finance and Globalisation	246
<i>Abbas Mirakhori</i>	
<i>Takāful</i> : Concept, History, Development, and Future Challenges of its Industry	276
<i>Syed Othman Alhabshi and Shaikh Hamzah Shaikh Abdul Razak</i>	
Islamic Banking and Finance in the 21st Century: Selected Issues in Human Capital Development	292
<i>Mohamed Aslam Haneef</i>	
Islamic Finance: A Bulwark against Contagion in the Global Banking System	303
<i>Amer Al-Roubaie</i>	
The Role of Adjustable-Rate Subprime Mortgages and Credit Default Swaps in the Global Financial Crisis	322
<i>Abdul Karim Abdullah</i>	
‘Cash <i>Waqf</i> ’ and Islamic Microfinance: Untapped Economic Opportunities	337
<i>Norma Md Saad and Azizah Anuar</i>	

Viewpoints

Islamic Responses to the Financial and Economic Crises	355
<i>Abdul Karim Abdullah</i>	
‘Banking Panics’ and Islamic Finance Principles: Lessons from the Current Crisis	358
<i>Sanep Ahmad</i>	

Book Reviews

Mubin Sheppard <i>Tunku: His Life and Times. The Authorized Biography of Tunku Abdul Rahman Putra Al-Haj</i> Christoph Marcinkowski	362
Fauziah Mohd Taib (ed.) <i>Number One Wisma Putra</i> Christoph Marcinkowski	366
David Levering Lewis <i>God's Crucible: Islam and the Making of Europe, 570–1215</i> Karim D. Crow	367
Umer Chapra <i>Muslim Civilization: The Causes of Decline and the Need for Reform</i> Ibrahim Umar	371
Muhammad Arif Zakaullah <i>The Cross and the Crescent: The Rise of American Evangelicalism and the Future of Muslims</i> N. Doran Hunter	374

Events and Reports

Visit by the CEO and the COO of IAIS Malaysia to Istanbul (29 May–3 June 2009) Zarina Nalla	380
Visits by the CEO and the COO of IAIS Malaysia to Universities and Research Institutions in New Zealand and Australia (July 2009) Zarina Nalla	382
Three Conferences on Intercivilisational Dialogue (Shanghai, China, 28 June–3 July 2009) Karim D. Crow	384
Fifth International Conference on Children and Youth in MENA Cities: “Education, Reintegration and Rehabilitation of Youth for the Labour Market” (Aleppo, Syria, 6–8 July 2009) Azizah Anuar	387
Public Seminar on Cash <i>Waqf</i> : “Empowerment of the Islamic Economy Through <i>Waqf</i> ” (IAIS Malaysia, 11 March 2009) Azizah Anuar	389
Notes on the Contributors	391
Aims of the Journal	396
Call for Papers	397
Guidelines for Contributors	398
Transliteration Table	399
Subscription Rates	400

EDITORIAL

For this issue, IAIS's journal *Islam and Civilisational Renewal* (ICR) is honoured to have received submissions from several renowned scholars and economists, including Muhammad Umer Chapra, Abbas Mirakhor, Syed Othman Alhabshi and Shaikh Hamzah Shaikh Abdul Razak, Mohamed Aslam Haneef, Amer Al-Roubaie, and others. I am grateful to all of them for their valuable contributions. The volume at hand is a special issue on the current global financial crisis and the perspectives and challenges within this scenario for Islamic economics and finance.

This issue features **seven articles**: The first, “The Global Financial Crisis: Can Islamic Finance Help Minimise the Severity and Frequency of Such a Crisis in the Future?” is by **Muhammad Umer Chapra**, a leading economist with the Islamic Development Bank (IDB) at Jeddah, Saudi Arabia. The author explores and determines the primary cause (or causes) of the financial crises that have plagued almost every country around the world over the last three decades, arguing that Muslim scholars and countries need to explain the alternative Islamic system rationally to create greater awareness about its potential contributions to a more resilient financial architecture that can curb or minimise the scope and frequency of global economic and financial crises.

The next article, “Towards a Meeting-Point Between Islamic Finance and Globalisation”, is by **Abbas Mirakhor**, a renowned expert of Islamic economics and a former Executive Director of the International Monetary Fund (IMF). The author discusses the rules and norms of behaviour prescribed by Islam for individuals and collectivities that meet the conditions for maximum risk-sharing. He presents prospects for the convergence of conventional and Islamic finance, arguing that their growth could lead to a worldwide increase in investment, employment, and economic growth, as well as to a reduction in the inequality of wealth distribution and poverty that could significantly increase global welfare.

“*Takāful*: Concept, History, Development and Future Challenges of Its Industry” is a joint contribution by **Syed Othman Alhabshi** and **Shaikh Hamzah Shaikh Abdul Razak**, two leading scholars from Malaysia in the area of Islamic economics. As they explain, the Arabic term *takāful* denotes the agreement by one party to indemnify another for an anticipated liability and loss. The contractual agreement

that is reached specifies the terms of contributions and payment. The success of the *takāful* companies around the world during the last three decades has also been strongly influenced by the recent upsurge in the petroleum price that has led to the unprecedented increase in sovereign and private wealth. The recent emergence of ‘re-*takāful*’ companies adds up further to the rapid growth in *takāful* operators and funds. The two authors also discuss current challenges to the *takāful* industry.

The following article, “Islamic Banking and Finance in the 21st Century: Selected Issues in Human Capital Development”, is by **Mohamed Aslam Haneef**, another leading Malaysian scholar. The author focuses on a civilisational understanding of Islam – including the *shari‘ah*, the Islamic heritage, and a genuine understanding of modern economics and finance. Both are necessary pre-requisites to enable Islamic banking and finance to play its role more efficiently to meet the current challenge of credibility that the industry is currently facing here in Malaysia and abroad.

“Islamic Finance: A Bulwark against Contagion in the Global Banking System” is by **Amer Al-Roubaie**, a senior Iraqi-Canadian scholar of Islamic economics and finance and currently Dean of the College of Business and Finance at Bahrain’s Ahlia University. The author investigates the performance of Islamic financial institutions in view of the current global financial crisis. He argues that Islamic modes of investment contribute to society’s wellbeing through the creation of wealth and employment to ensure economic stability and human development.

“The Role of Adjustable-Rate Subprime Mortgages and Credit Default Swaps in the Global Financial Crisis” is by **Abdul Karim Abdullah**, a Canadian scholar who is currently Assistant Research Fellow at IAIS Malaysia. The article focuses on selected key factors that contributed to the current crisis, such as the adjustable-rate subprime mortgages and excessive risk taken by financial institutions in the extension of loans and mortgages with scant regard to the borrowers’ ability to make repayment. This was also reflected in their over-indulgence in the practice of securitisation and creation of layers of debt-based instruments that burdened the market beyond its capacity and tolerance.

The last article, entitled “Cash *Waqf* and Islamic Microfinance: Untapped Economic Opportunities” is written by **Norma Md Saad** and **Azizah Anuar**, two scholars from Malaysia (the latter being an Assistant Research Fellow with IAIS Malaysia). Their article informs the reader about the role of Islamic charitable endowment (*waqf*) and how it can be utilised as an instrument of microfinance that can fight poverty among Muslims. Minor exceptions apart, *waqf* in Islamic law can only proceed over immovable assets. The authors highlight the difficulties posed by that

restriction and then explore the possibility of using ‘cash *waqf*’ as a new source of fund for Islamic microfinance.

This time, ICR features two **viewpoints**, which address matters pertaining to the current global financial crisis, as well as a **book review section** with five reviewed works. The present volume also features several **reports on events**, among them international conferences attended by the scholars of IAIS Malaysia that also led to the signing of MOUs with institutions in Turkey, New Zealand and Australia.

I would like to express my appreciation and gratitude to all our esteemed contributors as well as the IAIS Malaysia editorial committee and staff for their support and I look forward to their continued contributions.

Mohammad Hashim Kamali

Editor-in-Chief

THE GLOBAL FINANCIAL CRISIS

CAN ISLAMIC FINANCE HELP MINIMISE THE SEVERITY AND FREQUENCY OF SUCH A CRISIS IN THE FUTURE?

*Muhammad Umer Chapra**

Abstract: The article tries to determine the primary cause or causes of the financial crises that have plagued almost every country around the world over the last three decades. Of particular significance are the 1998 Long-Term Capital Management (LTCM) breakdown and the prevailing subprime mortgage crisis in the United States which is more severe than any in the past and has had devastating spill-over effects worldwide. It argues that one of the major causes of these crises is the lack of adequate market discipline in the financial system. This leads to excessive lending, high leverage and, ultimately, the crisis. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices accompanied by bank failures and economic slowdown. Risk-sharing along with the availability of credit for primarily the purchase of real goods and services and restrictions on the sale of debt, short sales, excessive uncertainty (*gharar*), and gambling (*qimar*), which Islamic finance stands for, can help inject greater discipline into the system and, thereby, substantially reduce financial instability.

Introduction

The financial system has decidedly played an active role in the accelerated development of the world economy, particularly after the Second World War. An unending stream of financial innovations, including the revolution in information and communications technology, has played a crucial role in this development. The system is, however, now plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades.¹ Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises. The prevailing financial crisis, which started in the summer of 2007, is more severe than any in the past and shows no sign of abating despite a coordinated bail-out of three to four trillion dollars by the

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United States, the United Kingdom, the European Union and a number of other countries. It has seized up money markets and led to a precipitous decline in property and stock values, bank failures, and nervous anxiety about the fate of the global economy and the financial system.

This has created an uneasy feeling that there is something basically wrong with the system. There is, hence, a call for a new architecture. The new architecture demands an innovation that could help prevent the outbreak and spread of crises or, at least, minimise their frequency and severity. Since a number of the crises experienced around the world are generally of a serious nature and have been recurring persistently, cosmetic changes in the existing system may not be sufficient. It is necessary to have an innovation that would be really effective. It may not be possible to figure out such an innovation without first determining the primary cause of the crises.

Primary Causes of the Crisis

There are undoubtedly a number of causes. The generally recognised most important cause is, however, excessive and imprudent lending by banks.² One cannot blame banks for this because, like everyone else, they also wish to maximise their profits in a materialist cultural environment where maximisation of income and wealth is the highest measure of human achievement. The more credit they extend, the higher will be their profit. It is high leverage which enables excessive lending. Excessive lending, however, leads to an unsustainable boom in asset prices followed by an artificial rise in consumption and speculative investment. The higher the leverage the more difficult it is to unwind it in a downturn. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices followed by a serious financial crisis, particularly if it is also accompanied by overindulgence in short sales.

It is the combined influence of three forces which can help prevent the recurrence of crises. One of these is moral constraints on the greed to maximise profit, wealth and consumption by any means in keeping with the mores of the prevailing secular and materialist culture. The second is market discipline which is expected to exercise a restraint on leverage, excessive lending and derivatives. The third is reform of the system's structure along with prudential regulation and supervision appropriately designed to prevent crises, achieve sustainable development and safeguard social interest. Since all of these three forces have become blunted by the philosophies of secularism, materialism and liberalism, mankind has been flooded with different man-made problems, including recurring financial crises, family disintegration, flagrant inequalities of income and wealth, and crime and anomie.

This raises the question of why market discipline has not been able to exercise a restraint on excessive lending. Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so? The market can impose a discipline primarily through incentives and deterrents. If incentives and deterrents do not exist or become weak, market discipline will also become weak. The incentives and deterrents come through the prospect of making profit or loss. The major source of profit in the conventional system is the interest that banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyse their lending operations so as *not* to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This does not happen in a system where profit and loss sharing (PLS) does not exist and the repayment of loans with interest is generally assured through the adoption of a number of measures.

There are four factors that enable banks to assume that they will not suffer losses. The *first* of these is the collateral, which is indispensable and unavoidable in any financial system for managing the risk of default. The collateral can, of course, do this only if it is of good quality. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrowers' ability to repay. The collateral, cannot, therefore, be a substitute for a more careful evaluation of the project financed. However, if there is no risk sharing, the banks may not always undertake a careful evaluation of the collateral and extend financing for any purpose, including speculation. This may be more so as a result of the *second* factor, sale of debt, which further reduces underwriting standards by enabling the banks to transfer the risk of default to the purchasers. The *third* factor that provides added protection to the banks is the availability of credit default swaps (CDSs), which provide insurance to lenders against default by borrowers. The *fourth* factor is the 'too big to fail' concept which assures the big banks that the central bank will bail them out.³ Banks which are provided with such a safety net have incentives to take greater risks than what they otherwise would.⁴

Given that banks lend excessively to maximise their profit, why is it that the depositors do not impose a discipline on the banks? They can do so in several different ways: by demanding better management, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not, however, do so in the conventional financial system because they are assured of the repayment of their deposits with interest.⁵ This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses.

The false sense of immunity from losses provided to bankers as well as depositors impairs the ability of the market to impose the required discipline. This leads to

an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt financing – dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

This shows that the absence of risk/reward sharing reduces market discipline and, thereby, introduces a fault line in the financial system. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources.⁶ It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The International Monetary Fund (IMF) acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are “likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises”.⁷

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability. One of the major reasons for this is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have high debt profile and for the private sector to live beyond its means and to have high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period.

While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms, and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock, and property markets. Jean-Claude Trichet, President of the European Central Bank, has rightly pointed out that “a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds”.⁸

If we examine some of the major crises in the international financial system like the one in East Asia, the instability in the foreign exchange markets, collapse of the Long-Term Capital Management (LTCM) hedge fund, and the prevailing crisis in

the US financial system, we find that the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets due to the absence of risk sharing.⁹ In this article I will refer only to the collapse of the LTCM, the prevailing imbalances in the US economy, and the subprime mortgage crisis in the US financial system.

The Collapse of LTCM

The collapse of the US hedge fund LTCM in 1998 was due to highly leveraged short-term lending. Even though the name hedge fund brings to mind the idea of risk reduction, “hedge funds typically do just the opposite of what their name implies: they speculate”.¹⁰ They are “nothing more than rapacious speculators, borrowing heavily to beef up their bets”.¹¹ These hedge funds are mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector – positions that might be considered ‘imprudent’ if taken by other institutional fund managers.¹² They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others. They now account for close to half the trading on the New York and London stock exchanges.¹³

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains, and the risks to which they are exposed would also be much greater. They, therefore, normally tend to operate in unison. This becomes possible because their chief executives often go to the same clubs, dine together, and know each other very intimately.¹⁴ On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilise the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York.¹⁵ Tun Mahathir Mohamad, Malaysia’s ex-prime minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian ringgit in summer 1997, resulting in the collapse of the Malaysian economy. It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the pound sterling, the Thai baht and some other currencies.

The LTCM had a leverage of 25:1 in mid 1998,¹⁶ but the losses that it suffered reduced its equity (net asset value) from the initial US\$4.8 billion to US\$2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just US\$600 million, or one-eighth its original value, on 23 September 1998. Since its

balance-sheet positions were in excess of US\$100 billion on that date, its leverage rose to 167 times of the capital.¹⁷ There was, thus, tier upon tier of debt, which became difficult to manage. The Federal Reserve had to come to the rescue of LTCM because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the US financial system, with spill-over and contagion effects around the world.¹⁸ If the misadventure of a single hedge fund with an initial equity of only US\$4.8 billion could take the United States and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 9,000 hedge funds managing more than US\$2.8 trillion of assets got into trouble.¹⁹

A hedge fund is able to pursue its operations in secrecy because, as explained by the former Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is “structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals”.²⁰ He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such “highly sophisticated, very wealthy individuals” for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects.²¹

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

The Prevailing Imbalances in the US Economy²²

The lack of discipline in the financial system has also created two serious problems for the United States. Both of these, the public-sector budgetary deficits and the private-sector saving deficiency, ring a worrisome note not only for the United States but also for the world economy. The federal government has been running budgetary deficits ever since 1970, except for a brief respite between 1998 and 2001. The budget moved from a surplus of US\$255 billion in fiscal year 2000 to a

deficit of US\$412 billion in 2004.²³ The deficit declined thereafter to US\$317 billion, US\$248 billion and US\$163 billion in 2005, 2006 and 2007,²⁴ but is estimated to have risen to a record US\$438 billion in fiscal year 2008. Instead of declining, the deficits are expected to rise further in the near future as the government tries to stabilise the financial system by buying illiquid assets from financial institutions, fulfils campaign pledges, and the baby boomers reach retirement age.

The continuing deficits have already raised the gross public debt of US Treasury to more than US\$9.4 trillion in March 2008,²⁵ approximately US\$79,000 on average for every taxpayer.²⁶ Of this, the external debt is around 25 per cent, virtually double the 1988 figure of 13 per cent.²⁷ The rise in external debt resulting from continuous current account deficits has had an adverse impact on the strength of the US dollar in the international foreign exchange markets.

These deficits might not have created a serious problem if the US private sector saving had not declined precipitously. Net private saving (saving by households and businesses minus investment) has been declining as a result of the borrowing and spending spree by both households and firms. This may not have been possible without excessive and imprudent lending by the financial system. Over the last three years (2005–07), the net saving by households has been less than 1 per cent of the after-tax income, compared with an average of 8 per cent from 1950 to 2000.²⁸ Government deficits combined with the gross debt of households and corporations have raised the total American debt to around 350 per cent of GDP. This should have pushed up interest rates but did not because of the inflow of funds from abroad. This inflow has, however, been only a mixed blessing because it did not only raise the US net foreign debt to a record high in both absolute terms as well as a percentage of GDP but also lowered interest rates which has promoted a steep rise in consumer spending along with a boom in residential real estate prices.

This brings into focus the crucial issue of how long will foreigners be willing to continue lending. Confidence in the strength and stability of the dollar is necessary to enable it to serve as a reserve currency. This is, in turn, not possible without the willingness of foreigners to hold dollars. What will happen if the deficits continue, create loss of confidence in the dollar, and lead to an outflow of funds from the United States? This is not just a theoretical question. In the last 40 years, the dollar has experienced four bouts of marked depreciation. Since nearly two-thirds of the world's foreign exchange holdings are still in dollars,²⁹ a movement out of the dollar into other currencies and commodities, as happened in the late 1960s, could lead to a sharp fall in the exchange rate of the dollar, a rise in interest rates and commodity prices, and a recession in the US economy. This might lead the whole world into a prolonged recession. The correction would then come with a vengeance when market discipline could have led to it much earlier with significantly less suffering. Accordingly, the President's Working Group on Financial Markets (PWG) has

rightly concluded in its report on “Principles and Guidelines Regarding Private Pool of Capital” issued in February 2007 that the most effective means of limiting systemic risk is to reinvigorate market discipline.

The Subprime Mortgage Crisis

The subprime mortgage crisis in the grip of which the US finds itself at present is also a reflection of excessive lending. Securitisation or the ‘originate-to-distribute’ model of financing has played a crucial role in this. There is no doubt that securitisation was a useful innovation. It provided lenders greater access to capital markets, lowered transactions costs, and allowed risks to be shared more widely. The resulting increase in the supply of mortgage credit contributed to a rise in the homeownership rate from 64 per cent in 1994 to 68 per cent in 2007.³⁰

However, even a useful innovation can have a negative impact if it is used in a way that reduces market discipline. Mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting.³¹ Consequently loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers increased. According to Mr Bernanke, Chairman of the Board of Governors of the Federal Reserve System, “far too much of the lending in recent years was neither responsible nor prudent [...]. In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly.”³²

The check that market discipline could have exercised on the serving of self-interest did not, thus, come into play. This sowed the seeds of the subprime debt crisis and led to not only the financial distress of subprime borrowers but also a crisis in the US financial system which has had spill-over effects on other countries.³³ Consequently, a number of banks and other financial institutions have either failed or have had to be bailed out or nationalised at the expense of the taxpayer not only in the United States but also in the United Kingdom, Europe and other countries. The general feeling seems to be that more may come if the ongoing recession leads to the default of credit card institutions, corporations and derivatives dealers.

When there is excessive and imprudent lending and the lenders are not confident of repayment, there is an excessive resort to derivatives like CDSs to seek protection against debt default. The buyer of the swap pays a premium to the seller (a hedge fund) for the compensation he will receive in case of debtor default. This may not have created any problem if the protection was provided to only the actual creditor. However, in a typical swap deal, a hedge fund will sell the swap not to just one bank but also to several other wagers who are willing to bet on the default of that specific debtor, even though they have not themselves lent to him. These wagers may again

resell the swaps to others, thereby unduly accentuating the risk. Accordingly the notional amount of all outstanding derivatives is estimated to have risen to the high of US\$692 trillion (including CDRs of US\$62.2 trillion) in the first quarter of 2008, which was more than twelve times the world output of US\$54 trillion in 2007.³⁴ It is surprising that the supervisory authorities allowed banks and hedge funds to indulge in gambling to such an extent with funds that belonged to the depositors.

Since the derivatives market is not regulated and supervised like insurance companies, the dealers are not subject to statutory limits, minimum capital and reserve requirements, and other prudential regulatory measures. This has created a great deal of uncertainty about whether the excessively leveraged six to ten dealers, who are the ultimate settlers of derivatives, will be able to fulfil their obligations in case there is a large number of defaults. The default of any one of them may set in a global chain reaction that might leave buyers of derivatives with billions of dollars of worthless contracts and bring down the international financial system. No wonder George Soros described derivatives as “hydrogen booms”, and Warren Buffett called them “financial weapons of mass destruction”.

When the system has reached a crisis point, then it becomes difficult to apply the brakes. Central banks have no choice other than to bail out banks, lower interest rates, and provide liquidity to avoid a recession. The liquidity made available now at extremely low interest rates will not only raise public and private sector debt but also enable the imprudent funding to continue. This will be followed by a financial crisis, which will again necessitate the pumping of further liquidity into the system to overcome the crisis. Therefore, while measures are being adopted to contain the prevailing crisis, it is also necessary to simultaneously think of some effective way of avoiding crises in the future by checking excessive and imprudent lending through the introduction of greater discipline in the financial system.

Introduction of greater discipline in the financial system will, however, tend to deprive the subprime borrowers of the financing they need for purchasing a house, other indispensable goods and services, and establishing their own businesses. Some kind of an arrangement needs, therefore, to be made to enable such borrowers to have access to financing. Instead of spending billions to save the financial system from the default of such borrowers after the crisis has taken place, it is desirable to create some mechanism before the crisis to provide low-cost financing at affordable terms to such borrowers. Not doing so is likely to increase the gulf between the rich and the poor and give rise to social and political tensions.

Hence there is dire need for a new architecture of the financial system. Bookstaber³⁵ has rightly asserted that today’s financial crises do not arise from economic instability or acts of nature, but from the very design of the financial markets themselves. *The Economist* has also observed that “the world needs new

ways of thinking about finance and the risks it involves”.³⁶ It is here where Islamic finance can make a valuable contribution to the international financial system.

The Islamic Financial System

One of the most important objectives of Islam is to realise greater justice in human society. This is not possible unless all human institutions, including the financial system, contribute positively towards this end. One of the principal needs for this is to subject all aspects of human life, social, economic, political and international, to moral values. This will help curb greed and avarice which have made maximisation of wealth and want satisfaction as the highest measure of human achievement.³⁷

The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions. One of these is that the financier must also share in the risk so as *not* to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources should become available to the poor to help eliminate poverty, and reduce inequalities of income and wealth. Within the framework of Islamic values, it is not possible to achieve sustainable development without justice. Injustice ultimately leads to destruction (Qur’ān 57:25). A number of classical Muslim scholars, including Abū Yūsuf (d. 798), al-Māwardī (d. 1058), Ibn Taymiyyah (d. 1328) and Ibn Khaldūn (d. 1406) have emphasised the close relationship between justice and development. This is also now being emphasised more and more in economic literature.

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

However, since demand depositors do not get any return, it would not be fair to make them participate in the risks of financing. Their deposits must, therefore, be fully guaranteed. In contrast with this, investment depositors share in the profit and should, therefore, participate in the risks. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial

institutions will be like purchasing their shares, and withdrawing them will be like redeeming them. This will motivate investment depositors to monitor their banks, and demand greater transparency, better governance, and more effective risk management, auditing, regulation and supervision. Making the depositors participate in the risk would also help motivate them to take greater care in choosing their banks.

Instead of introducing greater discipline in this manner, the primary focus of the international financial system is at present on regulation and supervision. There is no doubt that prudent regulation and supervision are both necessary and unavoidable, and it is a matter of great relief to know that there has been substantial progress in this direction under the aegis of the Basel Committee on Banking Supervision (BCBS). Regulation and supervision cannot, however, be relied upon totally for two main reasons. Firstly, it is not possible to curb greed and avarice by means of just regulation. It is also necessary to create a moral commitment to the faithful observance of regulations, because unscrupulous persons may circumvent these in a surreptitious manner without being detected. Secondly, regulation may not be applied uniformly in all countries and to all institutional money managers as a result of off-balance-sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. The LTCM collapse as well as the prevailing financial crisis in the United States clearly show how banks can get into difficulties as a result of over-lending even in an apparently well-regulated system.

Regulation and supervision would, therefore, be more effective if they were complemented by a paradigm shift in favour of greater discipline in the financial system by making the banks as well as investment depositors share in the risks of financial intermediation. Just the bailing out of banks, as is being suggested by some analysts³⁸ may not be able to take us far enough because the capital of banks may be only around 8 per cent of their risk-weighted assets. What is also necessary is to strongly motivate not only the banks to undertake careful underwriting of all loan proposals but also the depositors to be cautious in choosing their bank and to monitor their bank's affairs more carefully. The establishment of depositors' associations may make it easier for them to do so.

Islamic finance should, in its ideal form, help raise substantially the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures through the *muḍārabah* (profit sharing) and *mushārah* (joint venture) modes of financing. Greater reliance on equity financing has supporters even in mainstream economics. According to Professor Rogoff of Harvard University, "[i]n an ideal world equity lending and direct investment would play a much bigger role". He further asserts that, "with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted".³⁹ The IMF has also thrown its weight in favour of equity financing by arguing that

[f]oreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily.⁴⁰

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable, but should not be promoted for inessential and wasteful consumption and unproductive speculation. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets through its sales- and lease-based modes of financing (*murābahah*, *ijārah*, *salam*, *istisnā'* and *shukūk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his ability to make the payment later. Islam has, however, laid down certain conditions that would help prevent excessive expansion of debt. Some of these are:

- the asset which is being sold or leased must be real, and not imaginary or notional;
- the seller must own and possess the goods being sold or leased;
- the transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
- the debt cannot be sold and thus the risk associated with it cannot be transferred to someone else. It must be borne by the creditor himself.

The first condition will help eliminate most of the speculative transactions which involve *gharar* (excessive uncertainty) and *qimār* (gambling). The second condition will help ensure that the seller (or lessee) also shares a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. The *sharī'ah* has made an exception to this rule in the case of *salam* and *istisnā'* where the goods are not already available in the market and need to be produced before delivery. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion.

The third and fourth conditions, that the transaction must be a genuine trade transaction and that the creditor cannot transfer the risk to someone else by selling

the debt, will also help eliminate speculative and derivative transactions and also prevent the debt from rising far above the size of the real economy. It will also release a greater volume of financial resources for the real sector and, thereby, help expand employment and self-employment opportunities and the production of need-fulfilling goods and services. The discipline that Islam wishes to introduce in the financial system may not materialise unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability.

Reducing Government Budgetary Deficits

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

Islamic Finance in Practice

The way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with the Islamic vision. It has not been able to fully come out of the straitjacket of conventional finance. The use of equity and PLS modes has been insignificant, while that of the debt-creating sales- and lease-based modes has been predominant. Moreover, even in the case of debt-creating modes, all Islamic banks and branches or windows of conventional banks do not necessarily fulfil the conditions laid down by the *sharī'ah*. They try to adopt different legal stratagems (*hiyal*) to transfer the entire risk to the purchasers (debtors) or the lessees. The result is that the Islamic financial system, as it is being practised, does not appear to be a genuine reflection of what it is expected to be.

This raises the question of why the system has been unable to make significant headway in the direction of attaining greater authenticity. One of the primary reasons for this is that the institutions that are necessary to minimise the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations have not yet been established. Such institutions are needed to enable the banks to obtain reliable information about their clients and to ensure

that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They are also needed to help receive repayments on schedule, and to get justice promptly in case of dispute with, or wilful procrastination of payment by, the banks' clients. They are also needed to help banks gain liquidity when it is needed by them in situations of liquidity crunch resulting from unforeseen circumstances. The establishment of such institutions would go a long way in providing an enabling environment for Islamic finance. The longer it takes to establish such institutions, the longer it will take to realise the vision.⁴¹

Making Some Arrangements for Subprime Borrowers

While the introduction of greater discipline into the financial system through risk/reward sharing will help promote justice between the financier and the entrepreneur, it will not help spread equitably the benefit of the nation's savings mobilised by the financial institutions to all sectors of the economy. Subprime borrowers will most probably be weeded out. The financial system has generally tended to do so in almost all countries around the world and, thereby, accentuated the inequalities of income and wealth. Arne Bigsten has rightly observed, that "the distribution of capital is even more unequal than that of land" and that "the banking system tends to reinforce the unequal distribution of capital".⁴² Khawaja and Mian have shown in a recent paper that banks tend to favour politically connected firms.⁴³

This bodes ominously for society because it leads to the recruitment of entrepreneurs from only one social class and to the failure to utilise the society's entire resource of entrepreneurial talent.⁴⁴ Since the financial system plays a dominant role in the determination of the power base, social status and economic condition of individuals in the economy,⁴⁵ it may be difficult to realise the socio-economic goals of Islam without restructuring the system in a way that would facilitate the realisation of these goals.

This becomes even more important because – as already indicated – the effort to introduce greater discipline into the financial system may worsen the inequalities further by depriving primarily the subprime borrowers from getting credit. Therefore, what needs to be done is to introduce some suitable innovation in the financial system to ensure that even such borrowers are able to get adequate credit to enable them to realise their dream of owning their own homes and micro-enterprises. Any society where the poor are not able to get out of wage slavery by establishing their own enterprises and satisfying their basic needs satisfactorily from the higher income earned thereby, cannot be considered a just society. Dr Muhammad Yunus, the founder of the Grameen Bank, has aptly emphasised that financing for self-employment should be recognised as a right that plays a critical role in attaining

all other rights. The Select Committee on Hunger established by the US House of Representatives even concluded in its Report that “the provision of small amounts of credit to micro-enterprises in the informal sector of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies”.⁴⁶

Experience has shown that micro-enterprises have generally proved to be viable institutions with respectable rates of return and low default rates. They have also proved to be a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings.⁴⁷ Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 per cent since the Bank’s inception.⁴⁸

A number of countries have, accordingly, established special institutions to grant credit to the poor and lower middle class entrepreneurs.⁴⁹ Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance in the interest-oriented microfinance system. A timely study by Dr Qazi Kholiquzzaman Ahmed, President of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 per cent.⁵⁰ This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also borrow from money-lenders. This engulfs them unwittingly into an unending debt cycle which will not only perpetuate poverty but also ultimately lead to a rise in unrest and social tensions.⁵¹ No wonder the Minister of Finance for Bangladesh described microcredit interest rates in that country as extortionate in an address he delivered at a microcredit summit in Dhaka in 2004.⁵²

It is, therefore, important that, while the group lending method adopted by the Grameen Bank and other microfinance institutions for ensuring repayment is retained, microcredit is provided to the very poor on a humane interest-free basis. This may be possible if the microfinance system is integrated with *zakāh* and *awqāf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularise the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance in Muslim countries not only to avoid interest but also to prevent the misuse of credit for personal consumption.⁵³

Another problem faced by microfinance is that the resources at the disposal of microfinance institutions are inadequate. This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks to enable the use of a significant proportion of their vast financial resources for actualising a crucial socio-economic goal. Commercial banks do not at present fulfil this need and the Select Committee on Hunger is right in observing that

“formal financial institutions in these countries do not recognise the viability of income generating enterprises owned by the poor”.⁵⁴ This may be because it is too cumbersome for commercial banks to get directly involved in the business of financing micro-enterprises. They do not, however, have to do this. They can operate through their own subsidiaries or through the institutions that already exist for this purpose, like the agricultural banks, cooperative banks, development banks and leasing and finance companies. Nevertheless, it is important to reduce the risk and expense of such financing for not only commercial banks but also the microfinance institutions.

The risk arises from the inability of micro-enterprises to provide acceptable collateral. One way of reducing the risk is to use the group lending method which has already proved its effectiveness. Another way is to establish the now-familiar loan guarantee scheme which has been introduced in a number of countries. To reduce the burden on the loan guarantee scheme it may be possible to cover the losses arising from the default of very small micro-enterprises from the *zakāh* fund provided that the loan has been granted on the basis of Islamic modes of finance and does not involve interest. A third way is to minimise the use of credit for personal consumption by providing credit in the form of tools and equipment through the *ijārah* (lease) mode of Islamic finance rather than in the form of cash. The raw materials and merchandise needed by them may be provided on the basis of *murābahah*, *bay‘ al-salam* and *istisnā‘* modes. If they also need some working capital, it may be provided as *qardḥasan* (interest-free loan) from the *zakāh* fund.

The additional expense incurred by commercial banks in evaluating and financing micro-enterprises also needs to be reduced. In the case of financing provided to the very poor on the basis of Islamic modes of finance, a part of the expense may also be covered from the *zakāh* fund, one of the primary purposes of which is to enable the poor to stand on their own feet. For those who are not eligible for *zakāh* but still deserve some help, it would be worthwhile for the governments to consider subsidising a part of the cost, at least in the initial phase, in the interest of helping realise the cherished goals of increasing self-employment opportunities and reducing inequalities of income and wealth. As the system matures, the dependence on *zakāh* as well as the government subsidy may tend to decline. This would be better than spending billions to stabilise the financial system after the crisis has occurred as a result of subprime loans.

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

Lessons for the Future

The Islamic financial system has so far been able to gain a very small share of the global financial market and, even if it operates perfectly as desired by the *shari'ah*, it may not be able to create a significant impact on the international financial system in the near future. The likelihood is that a substantive reform of the structure of the conventional financial system is not likely to take place. The stopgap measures that have been adopted in the West so far to overcome the present crisis, even though necessary and unavoidable, will steeply increase the public and private sector debt which is already very high. This may have the effect of intensifying crises in the future. So what should Muslim countries do? The only option they have is to explain the Islamic system rationally to create a conviction about its superiority. This will be more effective if they themselves implement the system seriously and sincerely in their own countries to practically establish its effectiveness in promoting financial health and stability.

Notes

1. Joseph Stiglitz, "Dealing with Debt: How to Reform the Global Financial System", *Harvard International Review* 25, no. 1 (Spring 2003), 54.
2. This is clearly recognised by the Bank for International Settlements (BIS) in its 78th Annual Report released on 30 June 2008 by stating that the fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period (Basel: BIS, 2008, p. 3).
3. See Frederic Mishkin, "The Causes and Propagation of Financial Instability: Lessons for Policymakers", in: Federal Reserve Bank of Kansas City, "Maintaining Financial Stability in a Global Economy, Proceedings of a Symposium Sponsored by the FRB Kansas City, Jackson Hole, Wyoming, August 28–30, 1997", 61, available online at <http://www.kc.frb.org/publicat/sympos/1997/pdf/s97mishk.pdf> (accessed on 7 October 2009).
4. *Ibid.*, 62.
5. *Ibid.*
6. Bank for International Settlements, *Annual Report* (Basel: BIS, 1982), 3.
7. International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, September 1998), 83. The IMF acknowledged this fact in its May 1998 *World Economic Outlook*.
8. J.C. Trichet, "Asset Price Bubbles and Monetary Policy", MAS Lecture [Monetary Authority of Singapore], 8 June 2005, 4, available online at <http://www.bis.org/review/r050614d.pdf> (accessed on 7 October 2009).
9. See M. Umer Chapra, "The Case Against Interest: Is it Compelling?", *Thunderbird International Business Review* 49, no. 2 (March–April 2007), 166–73.
10. F.R. Edwards, "Hedge Funds and the Collapse of Long-Term Capital Management", *Journal of Economic Perspectives* 13, no. 2 (Spring 1999), 189.
11. *The Economist*, "The Risk Business", 17 October 1998, 21.
12. Edwards, "Hedge Funds", 190; Rene M. Sulz, "Hedge Funds: Past, Present and Future", *Journal of Economic Perspectives* 21, no. 2 (Spring 2007), 175.
13. Sulz, "Hedge Funds", 175.
14. J. Plender, "Western Crony Capitalism", *Financial Times*, 3–4 October 1998.

15. *The Economist*, "The Risk Business", 17 October 1998, 21.
16. BIS, *Annual Report* (Basel: BIS, 1999), 108; Sulz, "Hedge Funds", 179.
17. IMF, *World Economic Outlook and International Capital Markets* (Washington DC: IMF, December 1998), 55.
18. This was clearly acknowledged by Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own" (A. Greenspan, December 1998, "Statement before the Committee on Banking and Financial Services", US House of Representatives, Federal Reserve Bulletin [1 October 1998], 1046).
19. The number of hedge funds is from Financial Stability Forum (www.fsforum.org). The amount of assets they manage is for the third quarter of 2007 from Institutional Investor News and Hedge Asset Flows and Trends Report, 2008.
20. Greenspan, "Statement", 1046.
21. IMF, *World Economic Outlook and International Capital Markets* (Washington DC: IMF, December 1998), 51–3.
22. See the address entitled "Imbalances in the US Economy" by Donald Kohn, member of the Board of Governors of the US Federal Reserve System, at the 15th Annual Hyman Minsky Conference, the Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, 22 April 2005 (published in *BIS Review* 28 [2005], 1–2).
23. Kohn, "Imbalances"; IMF, *International Financial Statistics* (Washington DC: IMF, August 2008), 602.
24. IMF, *International Financial Statistics* (August 2008), 1188.
25. Federal Reserve, *Statistical Supplement*, August 2008, Table 1.41.
26. According to the US National Debt Clock, the outstanding public debt was US\$10.2 trillion on 5 October 2008. The statutory ceiling on the national debt has already been raised to US\$11.315 trillion to accommodate the expected rise in debt.
27. Wikipedia, "United States Public Debt", available online at http://en.wikipedia.org/wiki/United_States_public_debt (accessed on 8 October 2009), 1 and 5.
28. Kohn, "Imbalances", 1; Organization for Economic Cooperation and Development (OECD), *Economic Outlook* 82 (2008), Annex Table 23, available online at http://stats.oecd.org/Index.aspx?DataSetCode=EO82_MAIN# (accessed on 8 October 2009).
29. At the end of the third quarter of 2007, 63.8 of the identified official foreign exchange reserves in the world were held in US dollars (see <http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf>).
30. Ben Bernanke, "Subprime Mortgage Lending and Mitigating Foreclosures", 20 September 2007, *BIS Review* 104 (2007), available online at <http://www.bis.org/review/r070926a.pdf> (accessed on 7 October 2009), 1.
31. Atif Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis", NBER Working Paper 13936 (April 2008), available online at <http://www.nber.org/papers/w13936.pdf> (accessed on 7 October 2009); Benjamin Keys, Tanmoy Mukherjee, Amit Seru and Vikrant Vig, "Did Securitization Lead to Lax Screening? Evidence From Subprime Loans 2001–2006", available online at <http://w4.stern.nyu.edu/emplibary/securitize.pdf> (accessed on 7 October 2009).
32. Ben Bernanke, "Fostering Sustainable Homeownership", speech at the National Community Reinvestment Coalition Annual Meeting, Washington DC, 14 March 2008, available online at <http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm> (accessed on 7 October 2009), 1.
33. Roughly 4.2 million mortgages were overdue or in foreclosure at the end of 2007, according to the Mortgage Bankers Association. An additional 3 million borrowers may default in the near future. (David Herszenhorn and Vikas Bajaj, "A Bipartisan Bid on Mortgage Aid is Gaining Speed", *New York Times*, 2 April 2008, available online at <http://www.nytimes.com/2008/04/02/washington/02housing.html> [accessed on 7 October 2009], 2.)

34. World Bank, "World Development Indicators [WDI] 2008, World Bank Data Base Online", available at <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20398986~menuPK:64133163~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html> (accessed on 8 October 2009).
35. Richard Bookstaber, *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* (Hoboken NJ: John Wiley, 2007).
36. "Wall Street's Crisis", *The Economist*, 22 March 2008, p. 25.
37. See John K. Galbraith, *The New Industrial State* (New York: New American Library, 1972), 153.
38. C. Calomiris, "The IMF's Imprudent Role as Lender of Last Resort", *Cato Journal* 17, no. 3 (1998), 275–95; A. Meltzer, "Asian Problems and the IMF", *Cato Journal* 17, no. 3 (1998), 267–74; I.B. Yeager, "How to Avoid International Financial Crises", *Cato Journal* 17, no. 3 (1998), 257–65.
39. K. Rogoff, "International Institutions for Reducing Global Financial Instability", *Journal of Economic Perspectives* 4, no. 13 (1999), 40.
40. IMF, *World Economic Outlook* (Washington DC: IMF, May 1998), 82.
41. For a brief discussion of some of these institutions, see M. Umer Chapra, "Innovation and Authenticity in Islamic Finance", a keynote lecture delivered at the inaugural session of the Eighth Harvard University Forum on Islamic Finance held on 19–20 April 2008 at the Harvard Law School, available online at <http://ifptest.law.harvard.edu/ifphtml/pdfs/Forum%20Speech.pdf> (accessed on 7 October 2009).
42. Arne Bigsten, "Poverty, Inequality and Development", in: Norman Gemmell (ed.), *Surveys in Development Economics* (Oxford: Blackwell, 1987), 156.
43. Asim Khawaja and Atif Mian, "Do Lenders Favour Politically Connected Firms? Rent Provision in an Emerging Financial Market", *Quarterly Journal of Economics* 120, no. 4 (2005), 1371–411.
44. Charles Leadbeater, "Rags to Riches: Facts or Fiction", *Financial Times*, 30 December 1986, 5.
45. Stijn Claessens and Enrico Perotti, "Finance and Inequality: Channels and Evidence", *Journal of Comparative Economics* 35, no. 4 (July 2007), 748–73.
46. United States Congress, House Select Committee on Hunger, *Report* (Washington DC: U.S. Government Printing Office, 1986).
47. *The Economist*, 16 February 1985, 15.
48. Wikipedia, "Grameen Bank", available online at http://en.wikipedia.org/wiki/Grameen_Bank (accessed on 8 October 2009), 3.
49. For the experience of microfinance institutions in some selected Muslim countries, see Mohammed Obaidullah, *Role of Microfinance in Poverty Alleviation: Lessons from Experiences in Selected IDB Member Countries* (Jeddah: IRTI/IDB, 2008).
50. This is highly plausible because some other studies indicate even higher effective rates of interest. According to Nimal A. Fernando, Principal Microfinance Specialist in the East Asia Department of the Asian Development Bank, the nominal interest rates charged by most microfinance institutions in the region range from 30 to 70 per cent a year. The effective interest rates are even higher because of commissions and fees charged by them (Nimal A. Fernando, *Understanding and Dealing with High Interest Rates on Microcredit* [Manila: Asian Development Bank], available online at <http://www.adb.org/documents/books/interest-rates-microcredit/microcredit-understanding-dealing.pdf> [accessed on 7 October 2009], 1). According to Mannan, the effective rates range from 54 to 84 per cent (M.A. Mannan, "Alternative Microcredit Models in Bangladesh: A Comparative Analysis of Grameen Bank and Social Investment Bank Ltd. – Myths and Realities", paper presented at the First International Conference on Enhancing Islamic Financial Services for Micro and Medium-sized Enterprises, held on 17–19 April 2007 in Brunei, 2 and 12).
51. Qazi Kholiquzzaman Ahmed, *Socio-Economic and Indebtedness-Related Impact of Micro-Credit in Bangladesh* (Dhaka: Bangladesh Unnayan Parishad, 2007), xvii–xix; Sudhirendhar Sharma, "Is Micro-Credit a Macro Trap?" *The Hindu*, 25 September 2002, available online at <http://www.thehindubusinessline.com/2002/09/25/stories/2002092500810900.htm> (accessed on 7 October 2009).

2009). Sharma (ibid., 2) stated that “while the Grameen Bank model of micro-credit has landed poor communities in a perpetual debt trap, the rising number of loan defaulters has given a serious setback to the Bolivian experiment”.

52. Cited by Fernando, *Understanding and Dealing with High Interest Rates on Microcredit*
53. Ehsan Habib Feroz, “The Halal Way to Social Change”, *Islamic Horizons* (January–February 2007), 42.
54. United States Congress, House Select Committee on Hunger, *Report* [1986].

TOWARDS A MEETING-POINT BETWEEN ISLAMIC FINANCE AND GLOBALISATION

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Abstract: This article focuses on the conditions that should be met for financial globalisation to achieve maximum risk-sharing. The author suggests that the Islamic prohibition of debt-based finance and simultaneous promotion of risk sharing are consistent with the fundamental purpose of Islamic teachings, i.e., the unity of mankind, itself a corollary of the fundamental Islamic axiom of the Unity (*tawhīd*) of the Creator. He then discusses the rules and norms of behaviour prescribed by Islam for individuals and collectivities that meet the conditions for maximum risk-sharing. He also refers to a historical episode of globalisation from the Middle Ages, where trade, finance, investment, and production were based on partnership and equity finance and explains how and why this episode witnessed finance evolve until the dominance of debt-financing which has lasted to the present. Toward the end, the author brings the ideas about the prospect for the convergence of conventional and Islamic finance to conclusion: he argues that their growth could lead to worldwide increase in investment, employment, and economic growth, reduce inequality and poverty, and increase global welfare.

Introduction

Societies face two inter-related problems. Solutions to these problems determine the society's stability and continuity. These are the problems of uncertainty and coordination. The first stems from the fact that the future is unknown. Yet, humans have to make decisions and take actions that affect their future as well as that of others. Making decisions is considered as one of the most fundamental capabilities of humans. It is inexorably bound up with uncertainty. Facing an unknown, and generally unknowable, future, people make decisions and choose among alternative courses of action based on their expectations of future consequences of their actions. These expectations are inevitably subject to uncertainty. Uncertainty, if severe

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enough, can lead to a state of inaction and paralysis both in the case of individuals and their collectivities. The problem becomes more complicated when uncertainty about the future is coupled with ignorance about how other individuals, or their collectivities, behave in response to unknown states of the world. A state of ignorance can take on a variety of forms.

The problem of decision-making under uncertainty is compounded by two additional factors, the competence of the decision-maker and the difficulty of selecting the most preferred among alternative possibilities, especially if there is a once-and-for-all decision since, once made, it destroys the possibility of making that decision again. The gap between competence and difficulty enhances uncertainty leading to errors, surprises and regrets. The level of uncertainty regarding the state of the world, as well as with respect to decision-action of other individuals, makes collective action – necessary if the society is to survive and flourish – a challenge. It then becomes crucial for societies to find ways and means of solving the problem of uncertainty and promoting coordination among individual decision-makers. Because of the interdependence among members of the society, decisions made and actions taken by individuals directly and indirectly affect others.

Given the rapid growth of financial globalisation, on the one hand, and that of Islamic finance, on the other, this article probes whether it is possible that, at some point in the future, conventional and Islamic finance would converge. The underlying justification for this enquiry is that, from a theoretical point of view, the objective of globalisation and Islamic finance is to achieve maximum risk-sharing. The fundamental axiom of Islamic finance is the simultaneous prohibition of debt-based financing and promotion of equity financing: the first reduces risk sharing and the second increases it. Similarly, financial globalisation aims at spreading the investor base, and diversifying and sharing risk globally. This could be done through reliance on the most effective vehicle: equity or equity-like finance. Therefore, at least from a theoretical standpoint, as the conventional and Islamic finance progress through development of sophisticated risk-sharing instruments (including in the field of risk-insurance), it could be expected that they converge, and it is natural that there would be perturbations, missteps, and short-run setbacks. However, in the longer run, they would both expand and their convergence would be feasible. From an empirical point of view, there is tantalising evidence that, particularly in the last decade, the growth of financial globalisation has been accompanied by increasing equity and equity-like cross-border flows. This growth has been faster than debt flows (bonds), especially to emerging markets. On the other hand, the basic Islamic financial transaction modes are increasingly instrumentalised and securitised to enhance their attractiveness to global investors, thus, making convergence between Islamic and conventional finance a distinct possibility. We shall also consider financial globalisation and its progress over the last decade.

Spiritual Foundations for Islamic Finance

After a millennium of atrophy, Muslims have begun a critical re-examination of Islamic thought in all its dimensions in light of the present state of the world. Arguably the first discipline that began this process during the early decades of last century was political philosophy. The re-examination of economics started much later in the second half of the twentieth century and has continued uninterrupted to the present. There is an ongoing constructive debate among scholars on the fundamental question of whether there is a discipline that can be defined unambiguously as Islamic economics and if so what are its distinguishing characteristics. This article is a modest contribution to that debate. It seems reasonable to suggest that any label or prefix that is attached to an economic discipline must bear concrete relationships with the economic system that the discipline serves. Thus, disciplines such as socialist economics, capitalist economics, Buddhist economics, Christian economics, Jewish economics, Gandhian economics and others, relate to an envisioned system defined by its characteristics.

More specifically, Islamic economics can be considered as a discipline concerned with:

- the rules of behaviour (institutions) prescribed by Islam as they relate to resource allocation, production, exchange, distribution and redistribution;
- economic implications of the operations of these rules; and
- policy recommendations for achieving rules compliance that would allow convergence of the actual economy to the ideal economic system envisioned by Islam.

The fountainhead of all Islamic paradigms – including economics – is the Qur’ān. It provides the framework within which all relevant envisioning conceptions of reality find their source. This eternal source specifies rules of behaviour (institutions) applicable to all societies at all times. These rules are immutable temporally and spatially. No one understood the Qur’ān more than the Prophet, appointed to deliver it to mankind. During his life, he was both the spiritual and temporal authority for his followers. The economic system which he established in Medina is the archetype of Islamic economic systems. In this archetype, there is a core of institutional structure which is immutable because it is firmly established based on the Prophet’s authoritative operationalisation of the rules prescribed in the Qur’ān.

The Islamic economic paradigm is a Creator-centred conceptualisation of reality. Its view of man distinguishes between the exterior, physical form (*bashar*) and the non-physical, substantive and internal substance full of potentialities (*insān*). The two concepts roughly parallel Man and Human. In exteriority, they are similar

in appearance, but there are significant differences between the two. The most important difference is an active awareness of the supreme Creator and Cherisher Lord of the Worlds which separates a *bashar* from an *insān*. Both share the same general physical attributes and the same physical needs. What is different is what is inside them. Outwardly they are alike; inwardly, however, the attributes may range from being worse than animals in the sense of non-recognition of their full human potential yet possessing the powers invested in mankind such as cunning, ability to carefully devise and execute premeditated plans that make this creature more dangerous than animals. At the other end of the spectrum, humans may be inwardly so aware of the potentialities of the human state that, by actualising these potentialities, they may surpass even the angelic state.

In more practical terms, while the postulates of self-interest and rationality are crucial in decision-making in both paradigms, they are radically different in their substance. The third postulate of the classical-neoclassical tradition is that of scarcity. In the Islamic paradigm, scarcity takes on three different aspects. First, the Qur'ān repeatedly asserts that from a macro-global standpoint, Allah has created all things in "exact measures" (Qur'ān 49:52) indicating that the Lord Cherisher, Sustainer of all creation provides sufficient sustenance for all in His creation including for mankind. The Qur'ān, however, recognises two other aspects of scarcity. It acknowledges a micro-actual scarcity stemming from maldistribution of resources, and from greed and gluttony. Hence, one encounters in the Qur'ān the overwhelming emphasis on social justice, rules against waste, accumulation of wealth, and extravagance. The third aspect refers to the real scarcity arising from the fact of finite conditions of man on this plane of existence. The physical conditions of man impose a finitude constraint. Becoming aware of these constraints as well as of the potentialities of human state, human consciousness, once awakened, not only allows humans to grasp potentialities but also permits the realisation in them of their ability to transcend the limits of their physical existence to imagine 'what is and what could be'. Humans, thus, realise that their physical existential constraints impose limits on how much of their potentialities they can actualise; they must then 'choose between the alternatives grasped by transcending consciousness'. This aspect of scarcity is addressed in the Qur'ān where there is a constant reminder of limitation of time on this earth and the rapidity of its passage.

Financial Globalisation: Benefits, Costs, and Conditions for Better Risk-Sharing

In recent years, more and more economists have raised serious questions regarding the basic postulates of the classical-neoclassical economic paradigm. Aside from those who have focused their criticism on the separation of economics from ethics,

such as Amartya Sen, others have focused on the postulate of rational self-interest of the paradigm without rejecting its other features. However, even those who advocate reintroduction of ethics into economics decouple ethics from religion to the point of holding an anti-religion attitude. This conflict found its reflection in economic thought.

Neoclassical economics takes as given the classical economists' postulates regarding man, society and their interrelationships. That is, the worldview – or the meta-framework – of the neoclassical economics is that of the classical economics. This value system had its religious roots in Calvinism and Puritan ethics. After the economic success of capitalism and full development of the market economy, this value system was decoupled from its religious moorings and some of its elements, especially asceticism, were either modified or jettisoned altogether. The rest of the elements – accumulation, quantification, labour, individualism, competition, and rational conduct – were preserved.

The institutional framework that supported the classical-neoclassical notion of how the economy works developed in order to allow the flourishing of these values. The most salient features of this institutional framework were:

- the sanctity of private property in order to ensure that accumulation, individualism, and labour would find their unhindered expression;
- free markets organised to allow competition, reward labour, initiative, and innovation;
- consumer sovereignty in order that production finds easy markets;
- sanctity of contracts to reduce uncertainty of future transactions; and
- a legal structure that fully supported these features with enforcement power.

Globalisation is a multifaceted and multidimensional process of growing interconnectedness among peoples and nations. Its main dimensions are cultural, socio-political, and financial. The last dimension is composed of financial globalisation – the cross-border movement of capital – and financial integration – interconnectedness within and among financial markets. The economic and financial globalisation combined refers to growing trade flows and unhindered movement of investment, production, and finance. This is accompanied by standardisation of associated processes, regulations, and institutions, and facilitated by the free flow of information, ideas, and technology. In general, globalisation is the result of reduced costs of information and transportation as well as liberalisation of trade, finance, investment, capital controls, and factor movements.

Since 1990, the world has witnessed a dramatic and rapid change in the structure of financial markets and institutions. Advances in the theory of finance, rapid innovation in the practice of finance, revolution in information technology,

deregulation and liberalisation, and institutional reform have changed the nature of financial relations leading to the emergence of the 'new finance'. As a result, the cost of finance has reduced and investment in many instruments matching different risk-return profiles has been made possible, leading to better risk-sharing among market participants across the world. Financial transactions have become more at arm's length, allowing broader participation in deeper and expanded markets. This, in turn, has expanded the number of participants in financial markets, dispersed ownership and spread risks.¹ Between 1991 and 2000, gross capital flows (the sum of absolute value of capital inflows and outflows) expanded by 300 per cent among industrialised countries alone, the bulk of which was due to the rise in foreign direct investment (FDI) and portfolio equity flows – both rising by 600 per cent – while bond flows over the same period increased by 130 per cent.² Over the same period, both stocks and flows of capital movements have increased substantially, especially in relation to the volume of domestic GDP and the size of financing markets. After the market turbulence in 2000–02, these trends have resumed, with FDI and portfolio equity flows assuming a larger share of the total flow. The largest increase in FDI in 2006 was in the emerging parts of Europe and the Middle East. Empirical evidence suggests that the composition of capital flow matters a great deal. Equity flows (portfolio equity flows + FDI + venture capital) promote better risk-sharing, reduce volatility, and strengthen stability.³ There is a substantial body of evidence to suggest that these flows, especially FDI, are positively associated with economic growth.⁴ FDI is considered an important channel for transfer of technology and organisational knowledge.⁵ Over the past few decades, stock markets too have shown increasing vitality, growing with a rapid surge. The development of the stock markets increases the rate of saving and leads to growth in investment, while enhancing its quality. Stock markets diversify the investor-base while distributing risks across investors, which, in turn, increases the resilience of the economy to shocks. As mentioned earlier, the composition of capital-flows has a significant influence on economies, with FDI and equity flows exerting a great stabilising influence on the economy's vulnerabilities to shocks and financial crises. It has been demonstrated that greater reliance on debt-flows exposes a country to a higher probability of sudden stops of international capital-flows and to financial crises.⁶ A growing body of research has demonstrated the positive impact of stock market development on economic growth.⁷

There is an organic, interactive relationship between financial globalisation and financial integration. On the one hand, the degree of progress of the latter depends on how well developed financial sectors are in countries. On the other hand, financial globalisation plays an important catalytic role in the liberalisation and development of the domestic financial markets.⁸ An important dimension of the process of financial sector development is the expansion and quality improvement in

credit and share markets.⁹ The process of financial development deepens markets and services that channel savings to productive investment and strengthens risk sharing. Liberalisation of stock markets reduces the cost of equity-capital,¹⁰ leading to a surge in the growth of investment and expansion of employment and output. The effect would be stronger when stock market development is accompanied by privatisation as the latter would be a signal of the country's commitment to liberalisation.¹¹ Financial sector development constitutes the most important channel of economic growth, particularly in countries that are finance-constrained.¹² Empirical research over the last two decades, which has established the strong link between financial development and economic growth, has also identified the conduits between the two. These channels include:

- greater involvement of private sector and better risk-sharing;
- reduced risks that lower expected returns, leading to lower cost of capital and resulting in investment in higher-risk, higher-return projects;
- enhancement of competition and innovation;
- improved productivity;
- lower output and income volatility;
- cost-efficiency gains in mobilising resources for public investment;
- financial deepening as financial development leads to greater financial intermediation by banks, capital markets, and non-bank financial institutions; and
- reduced income inequality and poverty.¹³

The benefits listed above will accrue if legal and institutional developments accompany financial development. The most important dimensions of the former are legal protection of creditor, investor, and property rights as well as contract enforcement.¹⁴ Good governance, transparency, and accountability are the important institutional aspects that support financial development.¹⁵ It is considered that, once a threshold level of availability of these legal and institutional developments is surpassed, the beneficial effects will accrue.¹⁶ Empirical evidence suggests that countries with weak governance and low transparency receive less FDI and equity flows and have to resort to debt financing through bank loans that, as mentioned earlier, expose them to vulnerabilities and volatilities, leading to financial crises.¹⁷ Another factor that could exacerbate these problems is economic instability with research suggesting macroeconomic policies as an important determinant of the composition of capital flows. On the other hand, better legal institutions and improved governance and transparency reduce informational problems (adverse selection and moral hazard) and market frictions.¹⁸ This, in turn, will assist in the process of integration and deepening in the financial sector, which, in turn, will allow emergence of active and liquid equity markets, reduced cost of capital, and

improved credit rating.¹⁹ As a result, more investment projects become viable leading to greater risk-sharing. More active equity markets are also associated with reduced volatility, again suggesting improved risk-sharing. On the other hand, equity market opening against a backdrop of weak financial sector, inadequate institutional and legal development, and unstable macro-economy “may not reduce variability at all and may even increase it”.²⁰ Research suggests that an interactive relationship exists between financial sector liberalisation and development of an active equity market when a country achieves a threshold-level of higher bureaucratic quality, lower level of corruption, and strengthened legal institutions.²¹ Stulz²² states that “financial systems with a higher degree of legal and institutional development that support finance increase stock market trading volumes and enhance the effect of financial openness”. In short, financial sector development – which is accompanied by legal and institutional developments that protect investor, creditor, property rights, enforce contracts, improve transparency, and lower corruption – promotes an equity market that, in turn, increases risk sharing.²³

Domestic financial sector development allows integration with the global market as it increases diversification opportunities and expands the set of financial instruments available for risk sharing. Economies that are open to two-way investments – domestic investors can invest in foreign assets and foreign investors in domestic assets – are said to be globally integrated. Financial integration, in turn, becomes an important channel of global risk-sharing. There appears to be a symbiotic and interactive relationship between domestic financial development, financial integration, and financial globalisation. Importantly, there is empirical evidence that financial development and integration reduce poverty through increased investment, employment, income, and reduced income inequality. Recent research has found that

- the impact of financial development on poverty exerts two independent influences with half of the impact on economic growth and the other through reduction in income inequality;
- financial development leads to considerable deceleration in rate of growth of income inequality; and
- as the process of financial development gathers momentum, the rate of reduction in the proportion of population living in poverty accelerates.²⁴ In sum, there appears to be considerable benefit to financial sector development and financial integration which is increased and accelerated as globalisation of finance positively impacts and interacts with these two processes.

On the assumption that significant informational problems and transactions costs are absent, theory suggests that integration and globalisation of finance allow

portfolios to be well diversified internationally and that capital flows into markets with the most favourable risk-return profiles. Thus, as risk-sharing expands globally capital is allocated more efficiently and welfare increases. Empirical evidence, however, suggests that risk sharing within countries and across borders is yet an insignificant fraction of its potential.²⁵ There are important paradoxes contradicting this theory:

- the Lucas paradox
- the home equity bias puzzle
- the equity premium puzzle.

First, Lucas²⁶ argued that this theory suggests that capital-scarce countries have high rates of return to capital and should be able to attract investment from rich countries. The available data, however, did not show large flows of capital from the latter to the former. Indeed, most of the international capital flows, especially FDI and portfolio equity flows, took place among rich countries.²⁷ Also, even then, equity flows were much more biased in favour of domestic (rather than international) markets than the theory suggests.²⁸ Research indicates that a very high percentage of aggregate stock market wealth is composed of domestic equity.²⁹ Furthermore, even in domestic markets of rich countries, investment in stock markets is a fraction of what theory suggests, given that the returns to equity are much larger than justified on the basis of aversion to risk.³⁰ Mehra and Prescott³¹ demonstrated that, over many decades, a large differential existed between the real rate of return to equity than to safe assets, i.e., US Treasury bills. They also demonstrated that this differential was too large to be explained by existing theories of rational investor behaviour. The implication presents a puzzle as to why rational investors, noting the differential, would not invest in equities up to the point where the remaining differential could be explained as the risk premium on equities. While Mehra and Prescott focused on US data in their 1985 paper, subsequent research emphasised that a paradox existed in a number of countries, including India.³² Recent research has shown the global character of this puzzle and has attributed a significant part of it to institutional factors.³³ Interestingly, in one of his recent papers, Mehra³⁴ reports that the real worth of one dollar invested in equity in 1802 would have been worth nearly US\$560,000 in 1997, whereas the real worth of the same US\$1 invested in Treasury bills in 1802 would have been only US\$276 over the same period.

There is validity in the critics' arguments on globalisation that – despite the fact that globalisation was expected to help the poor – poverty has not been reduced and that measures of inequality reveal that it has not decreased.³⁵ Moreover, there is empirical evidence of increased risks of volatility and financial crises.³⁶ In answer, researchers argue that the process of globalisation is far from complete and that, at

present, global economy and finance are undergoing major structural changes that create a situation of ‘fluidity’. These have changed the usual ‘determinants of market valuation, volatility, leverage, velocity, and liquidation’. Each of these changes is significant on its own and in the way it interacts.³⁷

Researchers suggest that, while the benefits of globalisation have not been fully forthcoming with the scope and magnitude expected, the problem has not been the process of globalisation, but rather the way in which it has proceeded, where the playing field has not been quite levelled and where many financial markets have a long way to develop to allow meaningful integration of wider and deeper risk-sharing. Financial globalisation does not automatically provide the benefits expected for many countries unless they have attained threshold levels of legal and institutional developments mentioned earlier.³⁸

Evidence suggests that countries that attain the threshold level of good legal and institutional development are likely to attract more FDI and portfolio equity flows. In one such study, Faria and Mauro³⁹ measured institutional quality as the average of six indicators – voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption – and found that countries that ranked higher on these indicators attracted more equity-like flows. Wei⁴⁰ found evidence from a study on mutual funds that countries with a high degree of government and corporate transparency attract more equity investment because, as explained in a joint study by Erbas and myself,⁴¹ transparency reduces adverse incentive and ambiguity effects. There is mounting evidence to suggest that in the last decade many developing countries have implemented reforms that promoted legal and institutional developments. They have improved governance, transparency and accountability and have adopted regulatory, supervisory, standards of best international practice in accounting and data reporting. They have also stabilised their economies with sound macro policies and debt management. Some have even borrowed or rented additional credibility by cross-listing their domestic corporate shares in more advanced markets.⁴² As a result, they have received increased capital inflows, with FDI and portfolio equity flows constituting a major portion of these flows.⁴³

The data on the composition of households’ financial assets in Europe, the United States, and Japan between 1995 and 2003 demonstrate that in the Euro area, the European Union, and the United States, households allocated a larger portion of their portfolio to risk-sharing instruments. While comparable figures are not available in other areas, similar behaviour could be expected as policy, institutional, legal, and financial development progress in developing countries. Considering the Lucas paradox, scholars concluded that “institutional quality is the leading causal variable” in explaining the paradox based on their empirical study.⁴⁴

Recent empirical evidence also suggests that, since 2001, there has been a systematic decline in home bias, at least in US equity investments.⁴⁵ There has been also some empirical evidence that social capital,⁴⁶ especially trust, institutional and legal developments as well as greater transparency and availability of information may, at least tentatively, explain the equity premium puzzle. The last decade has witnessed a growing body of empirical research demonstrating that finance – particularly risk-sharing instruments like equity – is trust-intensive and, therefore, in societies where the level of trust was high, financial sectors were deeper and more developed. In particular, this literature indicates that there is a high correlation between trust and development of the financial sector.⁴⁷ Importantly, if the level of trust is high, more reliance is placed on risky assets, such as equity. People invest a larger portion of their wealth in stocks, use more checks, and have access to greater amount of credit than in low-trust societies. Over the last decade, a number of researchers have demonstrated the impact of trust on economic performance.⁴⁸ Arrow had suggested in 1975 that trust “is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people’s word.”⁴⁹ Fukuyama⁵⁰ asserts that the general level of trust, an important component of social capital,⁵¹ was a strong explanatory factor in the economic performance of industrial countries; the high level of trust was reinforced in these societies by strong institutions. A recent empirical paper⁵² demonstrates low trust as a crucial factor in explaining the low level of stock market participation, i.e., the equity premium puzzle. Based on the analysis of cross-country data, the paper suggests that where the level of trust is relatively high, investment in equity, in general, and in the stock market, in particular, are relatively high as well. Moreover, the paper asserts that in low-trust countries, equity participation depends on observance of the rule of law and the existence of legal institutions that protect property, creditor and investor rights, and those that enforce contracts. It suggests that in low-performing economies not only is the level of trust low, but property and investor rights are poorly protected, and legal contract enforcement weak. The policy implication for these economies is to strengthen legal institutions, improve transparency, accountability, and governance – both in private and public sectors – and to provide the public with more information on risk sharing, in general, and equity markets, in particular. The growing body of empirical evidence over the last two decades has focused on the existence (or the lack) of strong institutions as a powerful factor explaining cross-country differences in economic performance. Recent research has underlined that the same legal and institutional factors are responsible for financial sector development and the ability of integrating with the global finance which strengthen economic performance.⁵³

Islamic Finance

The central proposition of Islamic finance is the prohibition of the type of transaction in which a rent is collected as a percentage of an amount of principal loaned for a specific time period without the transfer of the property rights over the money loaned to the borrower, thus shifting the entire risk of the transaction to the borrower. As it prohibits debt-based contracts, the Qur'ān simultaneously recommends an alternative: in consonance with its systemic approach that as something is prohibited, an alternative is simultaneously recommended. The alternative to debt-based contract is *al-bay'*: a mutual exchange in which one bundle of property rights is exchanged for another; consequently, the risk of the transaction is shared. It is clear that the objective is to promote risk sharing. But why? Here, an economic hermeneutic of the relevant verses placed within the systemic context of the Qur'ān strongly suggests that risk sharing, along with other prescribed behaviour rules, e.g., exhortation on cooperation (Qur'ān 5:2), serves to bring humans closer to unity which is itself a corollary of Islam's central axiom: the Unity of the Creation. An Islamic philosophic axiom declares that from *one* Creator only *one* creation can issue. The Qur'ān itself unambiguously declares: "Neither your creation (was) nor your resurrection (will be) other than as one united soul" (31:28). In a series of verses, the Qur'ān exhorts human beings to take individual and collective action to achieve social unity and cohesion and then strive to preserve and protect collectivity from all elements of disunity (e.g., 6:153; 3:103). Unity and social cohesion are so central among the objectives of the Qur'ān for mankind that all conducts prohibited may be regarded as those that cause disunity and, conversely, those prescribed to promote and protect social cohesion. It is a natural consequence of such a system to require risk-sharing as an instrument of social integration. Therefore, promoting maximum risk-sharing is, arguably, the ultimate objective of Islamic finance. It is for this reason that Muslim scholars consider profit-loss sharing and equity participation as first best instruments of risk sharing.⁵⁴ Indeed, there is some evidence that stock market and social interaction are related.⁵⁵

One scholar who has recognised the full potential benefits of risk sharing for mankind is Shiller. He points out that "[m]assive risk-sharing can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. The reduction of risks on a greater scale would provide substantial impetus to human and economic progress."⁵⁶ Arguably, the most meaningful human progress will be achieved when all distinctions among human beings on the basis of race, colour, creed, income, and wealth are obliterated to the point where humanity truly views itself as one. The Qur'ān (4:1 and 49:13) unambiguously calls attention to the fact that, despite all apparent multiplicity, humans are fundamentally of one kind and rejects all bases for distinction between and among them except righteousness. This

axiom applies to all dimensions of human existence on this planet, including in the fields of economics and finance. The objective of the unity of mankind could well be promoted by financial globalisation since it has the potential of being the great equaliser of our time. It has the ability to unwind and unbundle, direct, analyse, and price-risk searching for the highest return. It can explore all risk-return to assets and the real rate of return, leading to greater risk-sharing. It can do so across geographic, racial, national, religious, cultural, language, and time boundaries. In the process, it can level playing fields of finance and help remove barriers among people and nations. The same potential holds for Islamic finance if progress follows the trajectory envisioned by Islam, which specifies preconditions for the successful operation of financial arrangements within its framework firmly anchored on a network of norms and rules of behaviour (institutions) prescribed for individuals and collectivities.⁵⁷ This network includes, but is not limited to, those institutions that modern scholarship considers crucial for financial development, integration, and globalisation.⁵⁸

Among the institutions prescribed by Islam are:

- property rights
- contracts
- trust
- governance.

The word ‘property’ is defined as a bundle of rights, duties, powers and liabilities with respect to an asset. In the Western concept, private property is considered the right of an individual to use and dispose of a property along with the right to exclude others from the use of that property. Even in the evolution of Western economies this is a rather new conception of property that is thought to have accompanied the emergence of the market economy. Before that, however, while a grant of the property rights in land and other assets was the right to use and enjoy the asset, it did not include the right to dispose of it or exclude others from its use. For example, the right to use the revenues from a parcel of land, a corporate charter, or a monopoly granted by the state did not carry the right of disposing of the property. It is thought that the development of the market economy necessitated a revision of this conception of property since it was thought that the right not to be excluded from the use of assets owned by another individual was not marketable; it was deemed impossible to reconcile this particular right with a market economy. Hence, of the two earlier property rights principles – the right to exclude others and the right not to be excluded by others – the latter was abandoned and the new conception of property rights was narrowed to cover only the right to exclude others. In Islam,

however, this right is retained without diminishing the role of the market as a resource allocation and impulse transmission mechanism within the framework.⁵⁹

The first principle of Islamic property rights is that the Supreme Creator is the ultimate owner of all properties and assets, but in order that humans become materially able to perform duties and obligations prescribed by the Law Giver, they have been granted a conditional right of possession of property; this right is granted to the collectivity of humans. The second principle establishes the right of collectivity to the created resources. The third principle allows individuals to appropriate the products resulting from the combination of their labour of these resources, without the collectivity losing its original rights either to the resources or to the goods and services by individuals. The fourth principle recognises only two ways in which individuals accrue rights to property:

- through their own creative labour and/or
- through transfers – via exchange, contracts, grants, or inheritance – from others who have gained property rights title to a property or an asset through their labour.

Fundamentally, therefore, work is the basis of acquisition of right to property. Work, however, is not only performed for the purpose of satisfaction of wants or needs, it is considered a duty and obligation required from everyone. Similarly, access and use of natural resources for producing goods and services is also everyone's right and obligation. So long as individuals are able, they have both the right and the obligation to apply their creative labour to natural resources to produce goods and services needed in the society. However, *if* individuals lack the ability, they no longer have an obligation to work and produce without losing their original right to resources. Therefore, an important principle called 'immutability or invariance of ownership' constitutes the *fifth* principle of property rights in Islam.⁶⁰ The latter writes the duty of sharing into Islam's principles of property rights and obligations. Before any work is performed in conjunction with natural resources all members of the society have equal rights and opportunities to access these resources. When individuals apply their creative labour to resources, they gain a right of priority in the possession, use or market exchange of the resulting product without nullifying the rights of the needy in the sale proceeds of the product. As a result, the *sixth* principle imposes the duty of sharing the monetary proceeds after the sale of the property. This principle regards private property ownership rights as a trust held to affect sharing. The *seventh* principle imposes limitation on the right of disposing of the property – presumably absolute in the Western conception of property rights. Individuals have a severely mandated obligation not to waste, destroy, squander, or use property for unlawful purposes. Once the specified property obligations

are appropriately discharged, including that of sharing in the prescribed amount and manner, property rights are held inviolate and no one has a right to force appropriation or expropriation. This right is held so sacred that even in relatively modern times a rule had to be developed to accommodate emergency cases (e.g., exercise of an eminent domain for the expropriation of land for public utility development). It was called *ikrāh ḥukmī*, i.e., ‘unpleasant necessity’, a legitimate violation.⁶¹ Even in these unusual cases, action could be undertaken only after adequate compensation was paid to the owner.

The inviolability of appropriately acquired private property rights in Islam deserves emphasis. As observed by Habachy, given the divine origin of Islam,

its institutions, such as individual ownership, private rights, and contractual obligations, share its sacredness. [...] Private ownership and individual rights are gifts from God, and creative labor, inheritance, contract, and other lawful means of acquiring property or entitlement to rights are only channels of God’s bounty and goodness to man. [...] All Muslim schools teach that private property and rights are inviolable in relations between individuals as well as in relations with the state. [...] It is not only by their divine origin that the Muslim institutions of private ownership and right differ from their counterpart in Western system of law; their content and range of application are more far-reaching [...]. If absolutes can be compared, it can be safely said that the right of ownership in Muslim law is more absolute than it is in modern system of law. [...] ⁶²

In a terse, unambiguous verse, the Qur’ān exhorts the believers to be “faithful to contracts” (5:1). This command, buttressed by other verses (2:282, 288; 4:33; 6:15 1–153; 9:4; 16:91–4; 17:34–6; 23:1–8), establishes the observance and faithfulness to the terms of contract as the central anchor of a complex relationship between:

- the Creator and His created order, including humans;
- the Creator and the human collectivities;
- individuals and the state, which represents the collectivity;
- human collectivities, and
- individuals.

The concept of contracts in Islam transcends its usual conception as a legal institution ‘necessary for the satisfaction of legitimate human need’. It is considered that the entire fabric of the Divine Law is contractual in its concept and content.⁶³ Contract binds humans to the Creator, and binds them together. As Habachy suggests:

This is not only true of private law contacts, but also of public law contracts and international law treaties. Every public office in Islam, even the Imamate (temporal and spiritual leadership of the society), is regarded as a contract, an agreement (*‘aqd*) that

defines the rights and obligations of the parties. Every contract entered into by the faithful must include a forthright intention to remain loyal to performing the obligations specified by the terms of contract. The fulfilment of contracts is exalted in the Qur'ān to rank it with the highest achievements and noblest virtues (2:172).⁶⁴

The divinely mandated command of faithfulness to the terms and conditions of contracts and abiding by its obligations is undergirded by the equally strong and divinely originated institution of trust.⁶⁵ There is strong interdependence between contract and trust; without the latter, contracts will be difficult to enter into and costly to monitor and enforce. When and where trust is weak, laws and complex, expensive administrative apparatuses are needed to enforce contracts. Perhaps this is why so much emphasis is placed on trust: to make entering into and enforcing contracts less costly. Accordingly, the Qur'ān, in a number of unambiguous verses (2:58, 283; 7:172; 8:58; 12:52; 16:93, 94; 17:34, 36; 23:1–8; 42:107, 125, 143, 162, 178, 193; 48:10) proclaims trustworthiness as a sign of true belief and insists on remaining fully conscious of the obligation of ensuring that the intention to remain trustworthy in fulfilling the terms and conditions precedes promises or entering into contracts. Moreover, the Qur'ān makes clear that fulfilling the obligations of a contract or a promise is mandatory. In short, the Qur'ān makes trust and trustworthiness, as well as keeping faith with contracts and promises, obligatory and has rendered them inviolable, except in the event of an explicitly permissible justification.⁶⁶ In addition, there are numerous prophetic sayings that supplement the qur'ānic verses on trust. For example, it is reported that the Prophet was asked: "Who is a believer?" He replied: "A believer is a person to whom people can trust their person and possession."⁶⁷ It is also reported that he said: "The person who is not trustworthy has no faith, and the person who breaks his promise has no religion." Also, "Keeping promises is a sign of faith", and "There are three [behavioural traits] if found in a person, then he is a hypocrite even if he fasts, prays, performs big and small pilgrimages, and declares 'I am a Muslim': When he speaks, he lies; when he promises, he breeches; and when trusted, he betrays."⁶⁸

The rule of law governs the behaviour of state rulers no less stringently than those of individuals. As two Western legal experts⁶⁹ observe: "Islam is the direct rule of God. His Law, the Shari' a, is the sole criterion of behavior", and "the authority of the temporal ruler is both derived and defined by this law". Under the rule of law, "the ruler is by no means a free agent in the determination of the public interest", and the decisions that the ruler makes "must not be arbitrary, but rather the result of conscientious reasoning on the basis of the general principles of the Shari' a as enunciated in the authoritative texts".⁷⁰ The same legal experts also assert that, based on their consideration of Islamic legal texts, the commands of faithfully

observing contracts and covenants “apply to the ruler acting in a public capacity” just as severely as to individuals.

Just as the ruler has no special prerogative or exemptions as regards the substantive law, so he has none regarding the application of the law through the courts. Ideally, the jurisdiction of the Qadi [Muslim judge], the only person qualified to apply the Shari’a, is comprehensive and exclusive. The principle that no one can be judge in his own cause is firmly established in the legal texts, and when personally involved, the ruler should submit to the jurisdiction of the ordinary Qadis’ courts. The ruler that breaks faith cannot shelter behind any claim of sovereignty from the dictates of the law.⁷¹

The same principles of governance under which a ruler or a state should function also apply to firms. Iqbal and the present writer, in a joint study,⁷² argue that within the Islamic framework a firm can be viewed as a ‘nexus of contracts’ whose objective is to minimise transaction costs and maximise profits and returns to investors subject to constraints that these objectives do not violate the property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honours all implicit or explicit contractual obligations. Since the firm’s behaviour is shaped by that of its managers, it becomes their fiduciary duty to manage the firm as a trust for all stakeholders in ensuring that the behaviour of the firm conforms to the rules and norms specified by the law.⁷³

Even from the above rather cursory consideration, it should become clear that, once fully implemented, the Islamic institutional framework would support rapid financial development and encourage financial integration and globalisation which, in turn, would promote risk sharing. The institutions ordained by Islam reduce uncertainty and ambiguity to ensure predictable behaviour. Islam also prescribes rules regarding income and wealth sharing to promote income-consumption smoothing. Arguably, sharing of economic risks in the society is of great concern to Islam. This is evidenced by the strong position taken by the Qur’ān on distributive justice through *zakāh*, an obligatory 2.5 per cent of wealth, as well as additional exhortation for voluntary economic assistance to those less able; all of which are insurance against income risk. However, these institutions are exceptional by their absence in many, if not all, Muslim countries.⁷⁴ In the case of the Middle Eastern and North African (MENA) region, for example, Abed and Davoodi⁷⁵ found that the rates of growth since the 1970s have not only been lower than those of developing countries as a whole, but that they have been twice as volatile as the developing countries’ average. They attribute this poor performance to: high population growth and low productivity; lagging political and institutional reforms; large and costly public sectors; inefficient and inequitable educational systems; underdeveloped financial markets; high trade restrictiveness; and inappropriate exchange rate policies. A number of Muslim countries, in and out of the MENA

region, have recently implemented macroeconomic and structural reform policies and have adopted international best-practice standards and codes. As a result, the economic performance of these countries has improved markedly, also helped by an increase in oil revenues. While adoption, implementation, and development of Islamic institutions may be slow, implementation of international best-practice of transparency and accountability plus development of an independent and effective judiciary and the reform of the legal system – to protect property, creditor, and investor rights and enforce contracts – and promotion of financial sector development would increase investment, employment, and income leading to reduction in poverty.

Islamic finance has experienced rapid growth, especially over the last decade. Its growth is astonishing, given that its analytic underpinnings, in modern economic and financial terms, were explained just two decades ago.⁷⁶ There is no accurate estimate of the size of the market at present, but it is certain that it is nowhere near its potential. Just as is the case with financial globalisation, Islamic finance has realised only an insignificant fraction of its risk-sharing capacity; of the 15 basic modes of available transactions, only a few have been used widely and even then only a few instruments have been innovated based on these transaction modes. Nearly three decades ago, beginning with Ross,⁷⁷ theory of finance showed that a basic instrument can be *spanned* into a large number.⁷⁸ The wide range of instrument innovations of the ‘new finance’ since then has demonstrated the validity of this idea. Undoubtedly, the process of instrument design within the field of Islamic finance will gather momentum once it attracts the needed expertise. At the moment, this is the most important challenge of Islamic finance.⁷⁹ The lack of expertise has been the reason why, so far, financial engineering in designing new instruments has focused on fast tracking a reverse-engineering process of redesigning some conventional vehicles. Not only the process of instrument design based on the approved transactions modes has to accelerate, but also inventions of new instruments paralleling Shiller’s⁸⁰ ideas on ‘macro-markets’ should start; and here the potential is great. For example, virtually all government-deficit financing in Muslim countries is debt-based. To remedy this, Nadeem-UI-Haque and the present writer⁸¹ proposed an equity instrument to be sold by governments with its rate of return indexed to the rate of return to domestic, Islamic countries, and international-Islamic equity markets, each with specified weights. The analytic arguments underpinning this proposal were explained by Choudhry and myself.⁸² The reasons governments would want to raise funds are to supply social overhead capital, defence, health, and education. If the private sector was either unwilling or unable, it would fall on governments to undertake the needed investments and cover the related expenditure with usual government revenue. The shortfall would be covered by floating the equity instrument which would be, in essence, an instrument backed by assets represented by either earlier bundles of social overhead capital

already completed or in train, e.g., roads, dams, hospitals, and the like. Since these are lumpy investments and their public goods nature provides a higher social return than investments undertaken by the private sector, the rate of return to be paid must be at least as high as the rate of return to be paid by the private sector when raising equity in the stock market. But, since domestic markets may experience volatilities to which government finance should not be exposed, Nadeem-UI-Haque and myself suggested adding two other markets – the index of returns to all Islamic countries' stock returns and the index of returns to Islamic equity funds in the West – to the index of returns to the domestic equity market. There are obvious advantages to this instrument; one being a vehicle for integration of equity markets across the world while another would be globalisation of this instrument forcing governments to compete for funds domestically, regionally, and globally, leading to efficiency gains.

How likely is it that conventional and Islamic finance converge as they both go through the globalisation process? The answer would be quite likely if global finance would rely more extensively on equity or equity-like flows, on the one hand, and invent/innovate a wider spectrum of risk-sharing instruments, on the other. The same process of innovations in Islamic finance would allow an asymptotic convergence between the two. Five decades ago, Modigliani and Miller⁸³ showed that, in the absence of frictions, firms' financial structure would be indifferent between debt and equity. In the real world, there are a number of frictions that bias financial structures in favour of debt and debt-based contracts. The two most important are tax and information. The tax treatment of equity returns and interest in industrial countries, which dominate the world of finance and the present structure of capital flows, is heavily biased against equities. Informational problems (information asymmetry and the related problems of moral hazard and adverse selection) also bias financial transactions in favour of debt or debt-based contracts. Legal-financial systems in advanced countries are also structured, tilting in favour of debt and debt-based transactions. However, as financial market developments progress, legal and institutional developments across the world accelerate, and information technology advances, the informational problems diminish. Whether tax and legal treatment of equity versus debt will become less biased is a policy question. What is clear is that as informational problems decline, it will become increasingly difficult to maintain legal, institutional, and tax policy impediments to level the playing field between equity and debt. Consequently, it is not unreasonable to expect a process of decreasing dominance of the financial system by debt and debt-based instruments, which has not been without costs, including severe financial crises. This dominance has been a major part of the financial scene globally for so long that it is difficult to note that there was a period in the evolution of finance when equity and partnership were the dominant mode of transaction in the Middle Ages. There has been some recent research suggesting that financial globalisation is not

irreversible. Rajan and Zingales⁸⁴ argue that there have been periods in history, specifically 1870–1913, when the degree of global financial integration was no less than the current degree. Yet, as a result of world wars, stock market crashes, and a worldwide depression, not only the global integration stopped, it did not resume until recently.⁸⁵ Same catastrophic factors can explain an even earlier episode of reversal of financial integration in the Middle Ages.

Before the beginning of the twentieth century, economic historians of the Middle Ages all but ignored the importance of trade and financial relations between Europe and the rest of the world, which were crucial to the economic development of the West before the fifteenth century.⁸⁶ Abu-Lughod⁸⁷ contends that this was due to the belief held by the Eurocentric scholarship that globalised trade became relevant only after the ‘rise of the West’ in the late fifteenth century. According to Abu-Lughod,⁸⁸ an advanced globalised system of trade “already existed by the second half of the thirteenth century, one that included almost all regions (only the ‘New World’ was missing). However, it was a world-system that Europe had only recently joined and in which it played only a peripheral role.” Abu-Lughod maps growing global trade flows between 737 and 1478, demonstrating that trade flows first centred in Mesopotamia and spread rapidly over the next eight centuries throughout the then-known world to become global.⁸⁹ Beginning with Postan,⁹⁰ economic historians have indicated that these trade flows were supported by a financial system sustained by an expanding risk-sharing credit structure based on the *commenda* and *maona* concepts of medieval Europe. *Commenda* is identical to *muḍārabah*, and *maona* partnerships are either *mushārah* or *muḍārabah*, depending on the nature of activity undertaken by the partners.⁹¹ Postan’s paper, based on his investigations in the vast commercial archives of the Middle Ages in England, was path-breaking.

There is little doubt that the institutions of *commenda* and *maona* originated in the Islamic world.⁹² These institutions, along with financial instruments, such as *hawālah*⁹³ and *sufṭajah*,⁹⁴ were transmitted to Europe and to other regions by Jewish scholars and merchants throughout the Jewish Diaspora,⁹⁵ and via Spain through trade and scholastic borrowing from Islamic sources. Professor Goitein (d. 1985) of Princeton University painstakingly researched the documents known as the Geniza⁹⁶ records and reached the following conclusions:⁹⁷

- trade in the Middle Ages was both extensive and intensive, financed by risk-sharing partnerships;
- partnership was used in industrial, commercial, and in public administration projects;
- the Mediterranean and Indian trade, as revealed by the Cairo Geniza, was largely not based on cash benefits or legal guarantees, but on the human qualities of mutual trust and friendship; and

- even a cursory examination of the Geniza material proves that lending money for interest was not only shunned religiously, but was also of limited significance economically.

Studying both the Geniza records as well as sources of Islamic jurisprudence (*fiqh*), Udovitch reaches the following conclusions:

- there is remarkable symmetry between the Hanafite legal formulations of the late eighth century and the documented commercial practices of the eleventh- and twelfth-century Geniza merchants;⁹⁸
- he reaffirms Goitein's conclusion that researching "the extensive commercial records of the Geniza, we found comparatively little evidence of usurious transactions".⁹⁹

Moreover, research by medieval historians demonstrates the extensive use of risk-sharing partnerships.¹⁰⁰ While risk-sharing techniques continued to prevail in Europe until the mid seventeenth century, beginning in the mid sixteenth century, the institution of interest-based debt-financing also began to be used more widely and extensively throughout Europe.¹⁰¹

As mentioned earlier, risk-sharing finance is trust-intensive, and trade financing during the Middle Ages was based on risk sharing which, in turn, was based on mutual trust.¹⁰² Recent research indicates that catastrophic and traumatic experience contributes to the breakdown of trust in a community and among its members.¹⁰³ If so, the Middle Ages certainly witnessed enormous, continuous, and extensive traumas, including four crusades, three Mongol invasions, numerous wars in Europe, which are only a few of the traumatic experiences of the age. In addition to these events was the Bubonic plague of the mid fifteenth century that spread rapidly throughout the then-known world along well-established and intensively travelled trade routes.¹⁰⁴

It is well known that the full-scale adoption of a fixed-interest-based financial system, with a fractional reserve banking sector at its core, has a major deficiency: the system is inherently fragile.¹⁰⁵ Toward the end of the 1970s and early 1980s, the existence of financial intermediaries, in general, and banks, in particular, was justified due to their ability to reduce transaction and monitoring costs as well as to manage risk. However, minimal attention was paid to reasons why banks operated on the basis of fixed, predetermined interest-rate-based contracts, i.e., on a fixed-interest basis, that rendered the system fragile and unstable, requiring a lender of last resort to regulate it. Generally, interest-rate theories explain the rate as an equilibrating mechanism between supply of and demand for finance, which is a rate that prevails in the market as a spot price and not as a price determined ex

ante and fixed, tied to the principal and the period covered by the debt contract. In an important paper, Bhattacharya argued that:

[...] with risk-neutral preferences, when the choice of risk level is unobservable, then any sacrifice of higher mean asset payoff constitutes an inefficient choice. The classical model of intermediaries existing to save on transactions/monitoring costs in asset choice does not explain why their liability structure should not be all equity.¹⁰⁶

The fragility of a financial system operating on the basis of fixed, predetermined interest rate was underlined by Stiglitz¹⁰⁷ who argued that interest rates are not like a conventional price. The findings of the new field of ‘information economics’ strengthened the arguments of Minsky¹⁰⁸ and others that a debt-based financial system with the fractional reserve banking – operating with a fixed, predetermined interest-rate mechanism at its core – is inherently fragile and prone to periodic instability. Stiglitz’s findings underlined Minsky’s arguments that, as returns to banks decline, unable to raise interest rates on their loans, they enter a liability-management mode by increasing interest rates on their deposits. As this vicious circle continues to pick up momentum, the liability management transforms into Ponzi financing and eventually bank runs develop.¹⁰⁹ The last two decades of the twentieth century witnessed a number of global bouts with financial instability and debt crises with devastating consequences for a large segment of humanity, thus raising consciousness regarding vulnerability and fragility of the financial systems which are based, at their core, on fixed-price debt contracts. As previously emphasised, legal and institutional developments, along with good governance and adoption of standards of best practice in transparency and accountability at the level of individuals, firms, and state, buttressed by information technology advances, will mitigate the informational problems leading to lesser reliance on debt-based contracts.

Summary and Conclusions

This article has been written as a theoretical consideration of the Islamic economic paradigm from an institutional perspective. It is important to note that there is in actuality no country in which the institutional structure discussed in this article has been implemented. A major reason is that research needed to specify the nature of the Islamic economics is still in a formative stage. While this article has outlined briefly a possible vision of Islamic economics, it is not a paradigm in the true sense of the term. Consensus has to emerge on a conception and vision of Islamic economics by a critical mass of practitioners before the vision and conception can be called a paradigm. Thereafter, significant investment of capital and effort will

be needed to educate the public in order to reduce the cognitive difference between theory and practice.

This article has also addressed a question regarding the future of financial globalisation, and of Islamic finance: will conventional finance, at the heart of the current financial globalisation, and Islamic finance converge? The article began by considering the recent development and the future of financial globalisation. There is evidence that financial globalisation has not been as helpful as expected, given the potential of its benefits for growth of investment, employment, and income as well as for reduction of income inequality and poverty. The article argues that, ultimately, the success of globalisation will depend on the spread and degree of risk sharing around the world. The greater the momentum, the deeper the markets, and wider the spectrum of risk-sharing instruments, then the greater will be shared ownership and participation by a larger number of people in finance. Faster, deeper, wider financial development has a symbiotic relationship with globalisation as the feedback process between the two strengthens both. Evidence suggests that, thus far, the degree of risk sharing achieved by globalisation is insignificant. The article presented reasons that explain why the degree of risk sharing and expected welfare gains from financial integration have been small:

- as of yet, instruments have not been developed sufficiently to allow greater risk-sharing, and
- many countries still need to achieve threshold levels of financial, legal, and institutional development required to allow greater risk-sharing.

It is believed that the process of liberalisation of economies, adoption of best international standards, development of good legal/institutional framework and practice is gathering momentum in many countries, as is the pace of innovation of financial instruments. The article suggests that parallel progress and challenges also characterise Islamic finance. While it has experienced a phenomenal success in the last two decades, Islamic finance has still a long way to go to achieve its objective of maximum risk-sharing. The article argued that the institutional structures ordained, within which Islamic finance is to operate, are those that promote good state and corporate governance, trust, protection of rights and contract enforcement. It was suggested that, in the case of Islamic finance, the progress achieved to date is a negligible fraction of the potential. The reasons are identical to those offered in financial globalisation. It is suggested that financial, legal, institutional developments, and greater pace of instrumentalisation of basic modes of transactions permitted, would accelerate progress of Islamic finance. As it would appear that Islamic finance and financial globalisation share a common objective of achieving maximum risk-sharing, it is not too unrealistic to expect convergence. It was also

argued that legal and institutional developments as well as further advances in information technology will reduce informational problems and lead to growing trust which is essential for risk sharing. The result will be the dominance of equity in financial structures and relationships. The article presented historical evidence of a globalisation period, in the Middle Ages, when partnerships and equity participation were the dominant mode of finance. The breakdown of trust as a result of repeated wars and catastrophes as well as financial innovations, particularly securitisation of government debt in the late Middle Ages, created the right milieu for the dominance of debt and debt finance which has lasted to the present day. Recent data appear to suggest that global finance may be experiencing early stage of return of dominance of equity and widespread risk-sharing through the growth of Islamic financial techniques as well as greater innovation of equity-based instruments of risk sharing within the conventional finance. And therein lie the seeds of convergence.

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93. Literally, a transfer or change from a locality to another or from a person to another or from a situation to another; legally, a contract through which a debtor is released from a debt by another person who becomes responsible for it.
94. Bill of exchange, a loan of money in order to avoid the risk of transport. A lends an amount to B in order that he may pay it to him or C in another place. In *ḥawālah* the obligation of B to A is already in existence. In *suftajah*, the obligation of B to A is created on purpose by a payment which A makes to B.
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TAKĀFUL: CONCEPT, HISTORY, DEVELOPMENT, AND FUTURE CHALLENGES OF ITS INDUSTRY

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Abstract: Mutual help and guarantee have been the ordinary practice of tribal Arabs even before the advent of Islam in Arabia. A similar but refined concept was reinforced by the Qur'ān to be adopted by Muslims. It was widely applied in their daily lives. When the Muslims extended their trade by sea to the Far East, the concept of mutual assistance became more prominent and organised to protect their ships, merchandise and even lives from all sorts of dangers and mishaps. The practice by these merchants to put aside a sum of money before setting sail to the Far East for trade as a fund to compensate any loss incurred by any of them became the most prominent practice that led to the birth of what is today known as marine insurance. To circumvent some of the *sharī'ah* non-compliant practices of mainstream insurance is the introduction of the concept of donating part of the participants' contribution which forms the special fund to compensate losses. From then on, the *takāful* operators started to emerge, first in Sudan and later in other parts of the Muslim world. Several models have been formulated, namely *muḍārabah*, modified *muḍārabah*, *wakālah* and *wakālah-waqf*. The success of the *takāful* companies around the world has also been strongly influenced by the recent upsurge in the petroleum price that has led to the unprecedented increase in sovereign and private wealth. The recent emergence of 're-*takāful*' companies add up further to the rapid growth in *takāful* operators and funds. Despite the success stories, there are a number of serious challenges facing *takāful* and 're-*takāful*' operators which are worth noting.

Introduction

Takāful is derived from its Arabic root *kafala* which literally means 'to guarantee'. In terms of usage and implication, the term *kafālah* denotes the agreement by one party to indemnify another for any liability that has been pre-agreed upon.

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The *takāful* industry is only 30 years old, the first company being established in 1979 in Sudan. After about two decades, it has proven to be the fastest growing sector of the insurance market with an unprecedented double digit rate of sustainable growth for several consecutive years.¹ Muhammad bin Ibrahim, the Assistant Governor of Bank Negara Malaysia, Malaysia's central bank, stated:

Based on the 2007 Oliver Wyman Report, the potential premium for *takāful* worldwide, is at least US\$20 billion. The report also estimates that up to 20 per cent of the *takāful* revenues originated from non-Muslim customers. [...] Currently there are more than 250 *takāful* operators worldwide.²

The participation of established conventional players in the United Kingdom, the United States, and Germany in establishing both the *takāful* and 're-*takāful*' companies within their group is indeed a crucial contributor to the growth of *takāful* industry worldwide.

In addition, the global demand for *takāful* products continues to grow as a consequence of the phenomenal growth of various components in the Islamic financial system especially the Islamic banking and capital market sectors. This is evidenced by the tremendous growth in Islamic financing and mortgages in the Islamic banking sector and increasing popularity of *ṣukūk* issuance in the Islamic capital market.³

The industry is further supported by progress in the regulatory sphere in the last two years. The Islamic Financial Services Board (IFSB), in collaboration with the International Association of Insurance Supervisors, is actively involved in the development of standards applicable to *takāful*. They are also looking at the corporate governance standard to cover key issues in the *takāful* business including rights and obligations of stakeholders in *takāful* operations.⁴

Conventional insurance companies operate on the basis of a guarantee to the policy holders that they will undertake to compensate them against any loss incurred as per their contract. In this sense there is no material difference between the practices of a conventional insurer to those of the *takāful* operators. Both are dealing with indemnifying their customers and paying out compensation to the losses incurred by the customers. What then are the real differences between conventional insurance and *takāful* that have led to the separate, dramatic development of the *takāful* industry the world over in the last three to four decades? Are these differences based on the concept and principles or are they simply operational?

Unlike Islamic banking that basically meanders away from usury or *ribā* in order to make the products and operations *sharī'ah*-compliant, *takāful* can easily avoid *ribā* by not investing in *ribā*-based instruments that are now available in the Islamic capital and money markets. What else are the main differences between conventional insurance and *takāful*? In order to fully appreciate what *takāful* entails

and how it operates to become *sharī'ah*-compliant, we need to understand the underlying principles that make *takāful* not only *sharī'ah*-compliant but operational as a business concern as well.

Before we examine the *sharī'ah*-principles on *takāful*, it is helpful to understand some of the ancient Arab practices that were akin to the *takāful* operations today. This article will expound these principles and practices, how they were endorsed by the Prophet Muḥammad himself, and then supported by the Qur'ān. We shall also illustrate the concepts and principles employed by modern *takāful* operators in order to operationalise their models. Finally, the article takes a brief look at some of the issues and challenges that still plague these models and the industry as a whole.

Pre-Islamic Practices of *Kafālah*

The concept of *kafālah* has been in vogue well before the advent of Islam. It is generally known that the ancient Arabs practised a strong tribal system which took great pride in lineage and ancestry. There was no compromise when the good name of the ancestors were being ridiculed or defamed. If a member of the tribe committed murder, for instance, it could lead to one of two consequences. Either a tribal war broke out to avenge the death of the tribal member, or settlement was reached by paying 'blood money'. The money that was used to compensate the loss of life came from the tribal fund which was collected from donations by the members. Once the donation was collected, no refund was allowed. The fund was used mainly to settle compensation in tribal disputes. It could also be collected when a dispute had occurred or whenever the fund was depleted. This practice is known as *al-'āqilah*. This cooperation on the part of the whole group and community to mutually share the burden of any of its members reflects the spirit of mutuality in *takāful*. The payment of blood money was an obvious example of mutual insurance, wherein the whole community stood guarantee against the loss to any of its members. This communal enterprise was social in character but economic in consequence.⁵ According to one study, "[t]he underlying principle in mutual insurance is that the individual members are themselves the insurers as well as the insured".⁶

The Principle of Mutuality and Islam

In the pre-Islamic period, payment of blood money by the family or tribe of the killer as compensation to the family or tribe of the killed was commonplace. The individual killer was generally responsible for the payment of the compensation. However, the common practice was for his family or tribe to pay the compensation. As the members of each tribe were closely related and united to face the common dangers of desert life, they developed an extreme sense of loyalty to their tribe.

Each tribe tried to protect and safeguard the life and property of its members. Gradually, this group loyalty and the inter-dependence of its members developed into mutuality and manifested itself in the form of collective responsibility of the tribe to pay compensation for the killing of a member of another tribe by one of its own members. The payment could be in the form of cash or kind, such as camels. The principle of compensation in cash or kind had four outstanding benefits for the people of Arabia:

- it reduced bloodshed and blood-feuds in the country;
- it replaced individual responsibility with the ultimate collective responsibility of the tribe for the actions of its members, and thus helped achieve social security for individual members of each tribe;
- it reduced the financial burden of the individual by transferring it to the group; and
- it developed a spirit of cooperation and brotherhood among the members as reflected in mutuality to share the individual burden amongst the group.⁷

The Practice After the Advent of Islam

With the advent of Islam, the same practice was continued due to its benefits – as is evident from certain injunctions in the Qur’ān.⁸ Qur’ānic evidence clearly supports the practice of paying compensation in terms of ‘blood money’ (*al-diyyah*) although the law of equality allows revenge only to the same extent. Equality is mainly intended to mitigate the horrors of the pre-Islamic custom of retaliation and revenge. In order to meet the strict claims of justice, equality is prescribed, with a strong recommendation for mercy and forgiveness.

Islam also mitigated the horrors of the pre-Islamic retaliation in wounds and injuries by prescribing the law of equality in all such cases.⁹ Again forgiveness and mercy, instead of retaliation, is strongly recommended in order to avoid bloodshed in the community. *Al-diyyah* was also reinforced by the Prophet who permitted it as compensation for human life, stating that the value or quantum must be agreed upon and the money must come from the family of the party that committed the killing.

The same provision was included in the first Islamic constitution of Medina. Through the practice of *al-diyyah*, the money was supposed to be paid mutually by the *al-‘āqilah* (the close relatives of the killer) to the heir of the deceased (victim).¹⁰ In view of the support by the tribe, the murderer was exempted from criminal prosecution even though the relatives were unable to pay.

These injunctions are further supported by a famous *ḥadīth*, narrated by Abū Hurayrah,¹¹ which in essence calls for uplifting the hardships of others instead of

pressing charges, although the law of equality allows such revenge as per qur'ānic stipulations.

Moreover, 'Umar b. al-Khaṭṭāb, the second caliph of Islam (r. 634–44), directed all districts of the state to list the name of the Muslim brothers-in-arms and the people who owed each other to contribute blood money in the event of any manslaughter committed by anyone of their own tribe.

By the end of the eighth century CE, the Muslims had developed marine science, marine navigation, and had built a strong naval unit in the Mediterranean. According to Philip Hitti, 'Abd al-Raḥmān III (r. 912–61), the famous Spanish Umayyad ruler, was the founder of the Muslim navy in Al-Andalus. He appointed his first Chamberlain, Tammām, as its commander. Tammām thus became the first Muslim admiral in Europe. Also under 'Abd al-Raḥmān III, this Arab navy became the most powerful in the Western Mediterranean. The fact remains, however, that Spain, under Islam reached economic and cultural heights unattained before, and its capital vied with Constantinople and Baghdad as a world centre of grandeur, affluence and enlightenment. Arab writers even styled Cordova the 'bride of all Andalus' and an Anglo-Saxon nun referred to it the 'Jewel of the world'.¹²

It was during these voyages that the merchants felt the need for insurance to cover their losses through the perils of the sea. Based on the principle of 'helping one another' they contributed to a fund prior to starting their voyage and used it to compensate any of them who incurred losses. This was the start of marine insurance which of course has been much modified today.

The principle that these Muslim merchants employed as is enjoined by the Qur'ān is based on the verse that reads, "Help ye one another unto righteousness and pious duty. Help not one another unto sin and transgression, but keep your duty to Allah."¹³ This principle of helping one another is amply demonstrated by the practice of *al-'āqilah* of the pre-Islamic period and hence it became acceptable to Islam.

The Concept of *Takāful*

We can discern from the above account of the pre-Islamic practices that *takāful* is based on a mutual intention of protecting one another against common dangers. This is possible if the members of the group feel for themselves as much as they feel for the others. So much so, if any one of them is inflicted with any harm or danger, the whole group feels the pain. In this way, the whole group or community will feel obliged and responsible to help one another so that the burden is not shouldered by any one person but by each and every member. If anyone is inflicted with harm the whole group or community feels it so. By working as a group in facing the risks or dangers, the burden becomes much lighter. The bigger the size of the group the lighter is the burden or liability.

Such a feeling of responsibility is being reinforced by the Islamic teachings as found in the Qur'ān, as already reviewed. The Prophet, too, made several very well-known statements on the responsibility of Muslims to help each other:

- “Allah will always help His servant for as long as he helps his brother [in need]”,¹⁴
- “The believers are like the body; when one of its parts is afflicted with pain, the rest of the body will also be affected”,¹⁵
- “One true believer (*mu'min*) and another true believer (*mu'min*) are like a building whereby every part in it strengthens the other part,”¹⁶
- “By my life, which is in Allah’s power, nobody will enter Paradise if he does not protect his neighbour who is in distress”.¹⁷

Based on the above, the principles of *takāful* may be summarised as follows:

- policy holders cooperate among themselves for their common good;
- every policy holder pays his subscription to help those that need assistance;
- losses are divided and liabilities spread according to the community pooling system;
- uncertainty is eliminated in respect of subscription and compensation;
- advantage is not derived at the cost of others.

Essentially *takāful* is a cooperative insurance whereby members who face the same risk or danger of incurring losses willingly contribute a certain sum of money which will be used to compensate those members of the group who incur such losses. As in the case of ancient Arab tribal custom, every member of the tribe faced the same danger of being harmed by another warring tribe.

In the case of the modern motor policy, for instance, everyone who drives a vehicle on the road faces the risk of an accident. The most logical step to take is to invite these people who face the common danger to form a group and contribute a sum of money which can be used to compensate any of the members who incur losses due to an accident. The same principle is applied to marine, fire, etc.

Differences Between *Takāful* and Conventional Insurance

In conventional insurance, the company sells a policy to the insured who pays a premium for the risk he agrees to be indemnified against by the company or insurer. The policy will not only determine the kind of risk that is covered but also the kinds of risks that are excluded, the period of coverage for the indemnity, the limit of compensation that the insured will get, and sometimes the level of damage or

loss that the company will not be responsible for. When the insured has incurred a loss that arises from an event that is defined by the policy, the company will pay or cover the losses incurred. If nothing happens during the period under cover, the company takes all the money or premium that has been paid up front.

It is clear from the conventional practice that the contract is one of sale and purchase. The company sells the policy to the insured at a price which is the premium. The company then basically takes chances that it will indemnify the insured up to some limit based on the premium that has been paid. However, the insured does not get any benefit except an undertaking as stated in the policy that the company will take care of his losses when the risk materialises. If the risk does not materialise during the period under cover, the company takes all the premium and the insured gets nothing.

Based on the above practice, the Muslim jurists unanimously concluded that while the objective of the insurance is good, the manner it is conducted is not *sharī'ah*-compliant. The first objection is the presence of the element of chance taken by the company. Of course this is done on the basis of some historical knowledge about the probability of an event happening which follows the law of large numbers. However, a game of chance necessarily creates an ambiguous situation. There is no certainty in the outcome of the contract. Ambiguity in contract is not acceptable in Islam as it could subject either of the two parties to injustice. Ambiguity of this type is called *gharar* which could vitiate the contract when it is excessive.

The second objection is the element of *maysir* or gambling that arises out of the chance phenomenon that exists in the contract. The insured takes a chance to protect himself from the risk he is facing. He is prepared to lose the premium if the risk does not materialise. But if the risk materialises, he will get much more than the premium he has paid. This means one party getting something more than he paid for based on chance, which is akin to gambling and thus prohibited by the *sharī'ah*.

The third element is *ribā* or usury that is present in the form of returns from the investment of the insurance fund. Since most of the investments are placed in interest-based instruments hence it is prohibited by the *sharī'ah*.

These are the three main objections raised by the Muslim jurists which make it necessary for the jurists to formulate *sharī'ah*-compliant models. The main reason is that insurance is a necessity and benefits the community. Based on a well-known *ḥadīth*, narrated by 'Āmir b. Sa'd b. Abī Waqqāṣ, it is clear that it is better to leave behind wealth that would enable one's loved ones to lead a good life than to leave them with nothing to depend on. In this *ḥadīth* 'Āmir's father Sa'd reported that he was taken seriously ill in the year of the Prophet's final pilgrimage and the Prophet visited him to enquire about his health. Sa'd told him about his worries in case he should die. Sa'd enquired from the Prophet whether he should give two-thirds of

his property to charity. In reply, the Prophet told him that it would be better to leave his inheritors wealthy rather than to leave them in poverty and beg from others.¹⁸

Similarly, another famous *ḥadīth*, narrated by Anas b. Mālik, reports that the Prophet once told a Bedouin Arab who left his camel untied trusting to the will of God to tie the camel first then leave it to God.¹⁹ This reinforces the need to take every precaution to secure one's property instead of just leave it to chance and hope that God will protect it. We should not leave the fate of our children or property to chance. Rather, we should work hard to secure them and only then should we leave their safety to the will of Allah.

Takāful Operations

Takāful operators must conduct their business in a *sharī'ah*-compliant way by avoiding the three prohibited elements above that make the operations void. The easiest part is to avoid *ribā*, by investing the *takāful* fund in non-interest-bearing instruments. The question is how to avoid the first two, i.e. *gharar* or ambiguity and uncertainty and *maysir* or gambling. If we refer to the qur'ānic injunction quoted above²⁰ on the principle of *ta'āwun* (cooperation) which is that people should help one another in righteousness and piety, we can invite people, especially those who face the same danger or take the same risk to come together and form a group that is willing to help one another. In other words, if anyone among them incurs a loss caused by an event that has been agreed upon, all the members of the group agree to help the unfortunate individual. Based on this understanding, a fund can be created from the contributions of each member on the basis of donation or *tabarru'*. This is probably the most important concept that has been applied in all *takāful* models.

Based on the principles of *ta'āwun* and *tabarru'*, the company is then simply the operator that invites people who face the same risk to form that group. The company is not selling a policy as such and does not indulge in the prohibited elements of *gharar* and *maysir*. Rather, the company is an operator that makes arrangements for the group to come together and agree not only to contribute to the fund but also at the same time agree to donate at least part of the fund to any member of the group who has become victim of any peril or mishap that has been identified earlier.

This is exactly what the ancient Arab tribal system did. So did the Muslim merchants of the eighth century who collected a sum of money as a donation to be used as compensation to any of them who faced mishap and incurred losses. There is complete transparency in this case so as to avoid all ambiguities or chances. Thus the company does not own the fund but the ownership of the fund remains with the policy holders or participants as they are called by the *takāful* industry.

In this sense, the company is not taking the risk, but it is the group of participants who bear the risk and are mutually covering each other. The company is only a

trustee acting on behalf of the participants to manage the operation of the *takāful* business. As such, the company does not have any right to the *takāful* benefits. However, as an operator or manager of the *takāful* business, the company is the entrepreneur or *muḍārib* whilst the participants are the provider of capital or *rabb al-māl* as in the case of the *muḍārabah* concept. In this sense, the profits made from the business can be shared by both parties at a pre-agreed ratio.

Based on the above concept, there are at least two ways that the company can operate as a business. The first is to employ the *muḍārabah* or profit sharing model. The second is to employ the *wakālah* or agency model. There are other models such as the modified *muḍārabah* model and *wakālah-waqf* model which are variants of the two basic models.

The *Muḍārabah* Model

The *muḍārabah* model consists of two parties, namely the provider of capital or *rabb al-māl* on the one hand, and the entrepreneur or *muḍārib* who provides the management expertise and entrepreneurial acumen to the business, on the other. These two parties will share the profits after deducting all the expenses to conduct the business at a pre-agreed ratio. However, in case of a loss, it is only the provider of capital who assumes the losses. The entrepreneur does not assume any liability in case of a loss because he has already provided the expertise without any payment.

The *muḍārabah* or profit sharing model as employed by the *takāful* operators is where the company operates as an entrepreneur or *muḍārib*, utilising its expertise in the general management of the company, underwriting the policies and investing the funds. General management also includes functions such as product development, marketing, human resource, corporate planning, compliance and governance, etc. The contributions paid by the participants are deemed to belong to the participants, and hence they as a group are considered to be the provider of capital or *rabb al-māl* in the *muḍārabah* model. The profit arising out of the whole operation after deducting the expenses incurred to conduct the business is to be divided between the company and the participants at a pre-agreed ratio. In some cases, the cost of doing business is deducted from the share of the profits of the entrepreneur.

The question is that the management and staff of the company are salary earners and hence are not in sync with the concept of entrepreneur in the *muḍārabah* model. It should be clarified that they are paid out of the shareholders' fund and not out of the income of the business. Hence, they represent the entrepreneur in the *muḍārabah* model. Alternatively, the management expenses are being deducted from the share of gross profits to the shareholders. In other words, the total profit from investment and underwriting surplus is being shared according to the pre-agreed ratio. It is from the share of the profit to the shareholders that the management expenses are

being deducted. In this way, whether the management expenses are being borne by the shareholders from the shareholders' fund or from the share of the profit, the consequence is the same.

With this conception, the company then has the right not only to a share of the profits from the investment income of the *takāful* fund accumulated from the participants' contributions, but also to share in management of the business.

In any *takāful* operation, whether the company employs the *muḍārabah* or *wakālah* model, there are basically three funds, namely the shareholders' fund, the *takāful* fund comprising the Participants' Account, and *tabarru'* or donation or the Participants' Special Account (PSA). Whilst the shareholders' fund literally belongs to the shareholders, the *takāful* funds actually come from the participants' contributions and hence belong to the participants. The allocation of the participants' contributions into these two funds is done based on actuarial studies. For products with higher risk or claims ratio, a higher proportion of the contribution will be placed in the *tabarru'* fund to ensure that there are enough funds to cover the claims. It is only when the product has a lower risk or claims ratio that a higher proportion of the contribution will be allocated to the *takāful* fund.

Given these three funds, there should be two main sources of income to the *takāful* company, namely the investment income and the underwriting surplus. The investment income from the shareholders' fund will obviously go back to the shareholders. Logically, as an entrepreneur, the company has the right to a share in the investment income from the Participants' Account and *tabarru'* funds or the Participants' Special Account. What seems to be contentious is the underwriting surplus.

One view is that the surplus from the underwriting activity cannot be shared by the company because it is a donation by the participant to pay out the claims. There is another view that the underwriting activity is done by the company with all its expertise and hence should be able to have a share of it as a provider of that expertise.

However, the general view seems to be that the surplus should not be paid out to the participants either, since they have already donated the amount for the purpose of paying out the claims. Under the principle of *tabarru'* or donation, the donor has completely given away his right to the property or wealth that he has donated and therefore cannot receive any benefit from it.

The question may be raised as to how he can receive the claim payment to the loss that he incurs in the process. The concept here is that every individual participant pledges to help others with his own donation. His donation is meant for others and not for himself. With a large number of participants, it is possible that he does not receive his money back, but whatever he receives will be the donations made by others.

General *Takāful* Business

For conventional insurance, there are basically two categories namely the general and life. The same is true in *takāful* where there is the general, but instead of life it is called family *takāful*. The general *takāful* business deals mainly with specific contingencies such as fire, accident and theft. General *takāful* normally covers a specific short period of one year and is to be renewed annually to ensure its validity.

In the case of the general *takāful* business under the *muḍārabah* model, the company shares the profits from investments as well as from the underwriting surplus. However, all the administrative and management expenses are deducted from the company's share of the profits and surplus. In the case of the modified *muḍārabah* model for general *takāful*, the commissions to intermediaries and management expenses are paid from the *takāful* fund. The company shares the profit and the underwriting surplus with the participants.

Family *Takāful* Business

A life insurance contract insures the life of a person. Once it is sold, the company is liable to pay only upon the policy holder's death. Since the majority of jurists do not approve that life insurance as defined here is *sharī'ah*-compliant, the *takāful* companies use the term family *takāful* instead. Family *takāful*, unlike life insurance, does not insure the life of the person who buys the policy. Instead, it is meant to provide a lump sum payment to the family of the deceased, to help them survive for some time without much sacrifice in life style.

For the family *takāful* business under the *muḍārabah* model, the company does not share the underwriting surplus but returns it to the participants to be accumulated to build the fund. The company only shares the investment profits and deducts all administrative and management expenses from the shareholders' share of the profits from investment.

Under the modified *muḍārabah* model, the company not only shares the investment income from both the Participants' Accounts and the Participants' Special Accounts but also deducts the Commission and Management Expenses from the Participant's Special Accounts. Of course the share of the profits for the company under the modified *muḍārabah* model is smaller compared to those of the *muḍārabah* model.

The *Wakālah* Model

The *wakālah* model is currently the most commonly used model in most countries. Although the *takāful* companies which were established in the 1980s employed the *muḍārabah* or the modified *muḍārabah* models, the newly established companies in the last three or four years have chosen to employ the *wakālah* model.

Wakālah, which literally means ‘agency’, employs the *sharī‘ah* principle of providing a service for a fee or *ujr*. In a *wakālah* model, the *takāful* operator acts as the agent on behalf of the participants. The operator is paid a pre-agreed management fee for the services rendered in respect of underwriting, management and investment of the fund. The operator does not share in the underwriting surplus. This is mainly because the contributions by the participants allocated to the Participants’ Special Accounts are based on *tabarru‘* or voluntary donation which according to the *sharī‘ah* cannot benefit the contributor anymore. The proceeds from the underwriting surplus are being ploughed back into the fund.

In underwriting, the *takāful* operator acts as an agent on behalf of the participants to manage the *takāful* fund. Any liabilities for risks underwritten are borne by the fund and any surplus arising from there belongs exclusively to the participants. The operator is not liable for any deficit of the fund. The operator is being paid a management fee termed as a *wakālah* fee which is usually a percentage of the contributions paid by the participants. This is normally deducted upfront from the contributions.

As for the management of the investment activities of the fund, the operator is also paid a *wakālah* fee based on an agreed percentage. Alternatively, the operator may take a share of the profit if it considers the service provided as part of the expert service to manage the fund. When the fund is still very small, the company may opt to do it in-house. Obviously, when the fund has grown very big, the operator may need to outsource the responsibility of managing the fund to an outside party. This approach would certainly attract additional costs to the company, otherwise.

General *Takāful* Business

According to this variant, the contributions from participants in the general *takāful* business under the *wakālah* model are put into the General Risk Investment Account (GRIA) which is also known as the General Fund. Upon receipt of the contributions from the participants, the company charges a *wakālah* fee for managing this fund. Part of the contributions in GRIA are then placed in the *Ta‘āwunī* Account Pool (TAP) that has front-and-back-end charges as allocations for benefits/reserves, claims, servicing, management expenses and commission (Expense Fund, Risk Fund and Special Fund). The TAP is essentially another name for the *tabarru‘* fund that is used for the payment of claims. Any surpluses in TAP will be put back into the GRIA. The company will charge a Surplus Administration Fee for this activity. The balance of the surplus is put back into the GRIA. Profit received from investment activities is returned to GRIA after deducting an Investment Performance Fee. The net surplus shall be shared at some predetermined ratio between participant and company.

Family *Takāful* Business

Family *takāful* business under the *wakālah* model allocates contributions from participants into two separate accounts, namely the Personal Investment Account (PIA) and Personal Investment Risk Account (PRIA) at a ratio based on the various products offered. PRIA is for protection whilst PIA is for protection and investment. The company charges a *wakālah* fee for managing the family fund. The fee varies from product to product. Part of the contributions in PRIA and PIA will be put into the *Ta'āwunī*, or Cooperative, Account Pool (TAP) mentioned earlier. Any surplus in TAP is put back into the respective PRIA and PIA. The company charges a Surplus Administration Fee for this activity. The balance is put back into PRIA and PIA respectively. Profit from investment activities are returned to PRIA and PIA after deducting an Investment Performance Fee. The net surplus is shared at a ratio of 50:50 or better between the participants and the company.

The *Wakālah-Waqf* Model

The *wakālah-waqf* model was started in South Africa and later copied by Pakistan's first *takāful* company. The main reason why the *waqf* element was introduced into an otherwise pure *wakālah* model is because of the nature of the *tabarru'* fund which has a very specific use, namely to pay claims. The term *tabarru'* itself implies that the participant who contributes has given up his right to any claim on his contribution. This concept is akin to the concept of *waqf* whereby once a person declares to give away a certain property for *waqf* he has severed all ties to the property. Immediately the property belongs to Allah and hence a trustee has to be set up to administer the property. The same is true in this *wakālah-waqf* model. Once the participant declares that he has given away part of his contribution as *tabarru'* a trustee has to be established, in which case it is the *takāful* operator.

The main difference between the *wakālah* model and the *wakālah-waqf* model is the existence of the *waqf* fund. The *waqf* fund is to be used solely to pay out claims. To start the fund, the company has to pay the seed money. The fund will then be built over time through contributions made by the participants. If at any time, the fund is insufficient to cover the claims, the company will have to extend an interest-free loan which will be paid back when the fund can afford.

The participants will pay the *takāful* operator the contributions, based on the product taken up by the participants from among the General business. The contributions are credited to the General *Takāful* Fund as *tabarru'* in the Participants' Special Account. Any person will be acknowledged as a member of the *waqf* fund if he signs the proposal form, contributes to the *waqf* fund and subscribes to the policy documents.

The *Waqf* Fund shall work to achieve the following objectives:

- To pay compensation to its members in the event of losses, mishap or damage.
- To extend benefits to its members strictly in accordance with the *Waqf* Deed.
- To donate to charities approved by the *Shari'ah* Supervisory Board.

The *Waqf* Fund will lay down the rules for distribution of its funds to the beneficiaries and will decide how much compensation should be given to a subscriber or member. The *waqf* will become owner of all contributions and has the right to act as a legal entity as per its terms for investment, compensations and dealings with the surplus amounts.

From among the above models, the most common is now the *wakālah* model and some of its variants, which are being employed by almost all the new *takāful* operators. The *muḍārabah* model and its variants will soon be left out as it is more advantageous for the operators to employ the *wakālah* model. The obvious attraction is in the *wakālah* fee that the company gets upfront without having to do anything else. As in the *muḍārabah* model, the surplus may neither be shared by the participants nor by the shareholders.

The other advantage is the possibility of sharing some of the profits that have been earned through investment or even underwriting. In the above case, the company earns from both sources as a performance fee. This is indeed possible and *shari'ah*-compliant, depending on how they are viewed.

Future Challenges and Recommendations

Despite the past accomplishments and strong momentum for future growth, there are at least three challenges that need to be addressed:

- The limited size and capacity. Despite relatively rapid growth, the industry is still very small compared to the conventional insurance market. In 2006, participants' contributions stood at US\$2 billion, accounting for only 1 per cent of the US\$3.7 trillion global insurance premiums. The *takāful* assets are estimated to be around US\$20 billion, in contrast to the Islamic banking assets of US\$500 billion. The *takāful* sector grows at a relatively slower pace than the *sukūk* market which is growing at about 40 per cent. *Takāful* players are relatively small with the largest *takāful* company having total assets of only US\$3 billion. Being young and new, many *takāful* operators also lack capacity, capabilities and expertise to manage businesses with large and complex risks.²¹

- The low penetration rate. Although Muslims account for at least 22 per cent of the world's population, *takāful* contribution in Muslim countries constitutes only 1 per cent of the total global insurance premium. This shows the potential for a strong demand for *takāful* products and services within the Muslim world if only they view *takāful* protection as an important tool for risk mitigation.²²
- The lack of 're-*takāful*' support and capacity. Adequate support from strong 're-*takāful*' companies is vital for the *takāful* sector in risk mitigation, capital relief provision, and building of essential technical capabilities in managing risks. Currently there are about 10 to 15 're-*takāful*' companies available to support over 250 *takāful* operators worldwide.²³ Until now, most *takāful* and even the 're-*takāful*' operators have to depend on conventional reinsurers. This does not augur well with the need to cater for the unique principles of *takāful* products.

A number of strategies can be considered for planning and implementation:

- There is a strong need to build a more globalised *takāful* industry through greater connectivity across jurisdictions. *Takāful* operators need to give sufficient emphasis on cross-border linkages at regional and international levels. This will not only widen the market but more importantly bring exposure to the different challenges to build strength and competitiveness.
- Efforts towards concerted branding for *takāful* have to be initiated and developed. By concerted branding we could enhance the appeal of *takāful* to the global community. The *takāful* principles of mutuality, transparency and cooperation could be further popularised to spearhead unique products for the global community.
- We have to position the *sharī'ah* as an enabler for greater linkages of *takāful* markets globally. Research and training in the *sharī'ah* and *sharī'ah*-related issues and fields may be one approach to spread the influence of the *sharī'ah* and *takāful* in all markets that *takāful* can serve. Acute shortage of human talent cannot be ignored at all.
- *Takāful*, as is the case with any business that deals with a huge number of clients, must be well-equipped with infrastructure that could help expedite processes and improve accuracy to mitigate risks in these areas. It is not only the physical infrastructures including IT that are needed, but also the regulatory framework must be further strengthened.
- *Takāful* should not be looked at merely as a business concern but should also locate areas where socio-economic assistance is definitely needed. Corporate Social Responsibility could be employed as a means of reaching out to assist in the community improvement.

To conclude, the future of *takāful* is not bleak at all. Indeed it is very bright. Within a short span of 30 years or so, *takāful* has become a growing force in financial circles. However, it requires not just the operators, but also the combined efforts of all the relevant parties – the regulators, market participants, *sharī'ah*-experts and the international community at large – to play their roles.

Notes

1. Keynote Address by Muhammad bin Ibrahim at the International *Takāful* Summit, “Global Takāful Industry: Moving to the Next Level of Excellence”, Jumeirah Carlton Hotel, London, 16 July 2008.
2. *Ibid.*, 1.
3. *Ibid.*, 2.
4. *Ibid.*
5. Muhammad Muslehuddin, *Insurance and Islamic Law* (Lahore: Islamic Publications, 1969), 15.
6. James Biggs Porter, William Feilden Craies, and T.W. Morgan, *The Laws of Insurance. Fire, Life, Accident, and Guarantee, Embodying Cases in the English, Scotch, Irish, American, Australian, and Canadian Courts* (London: Sweet and Maxwell, 1933, 8th ed.), 47.
7. Afzalur Rahman, *Economic Doctrines of Islam*, 4 vols (London: The Muslim Schools Trust, 1979), 4:65–9.
8. Qur’ān 2:178. See also *ibid.*, 4:91.
9. *Ibid.*, 5:48.
10. M.M. Billah, *Applied Islamic Law of Trade and Finance* (Petaling Jaya: Sweet and Maxwell Asia, 2007, 3rd ed.), 125–200.
11. *Ṣaḥīḥ Muslim*, “Kitāb al-Birr”, *ḥadīth* no. 59.
12. Philip K. Hitti, *Makers of Arab History* (London: Macmillan, 1969), 69–71.
13. Qur’ān 5:2 (tr. Yusuf Ali).
14. Narrated by Imām Aḥmad Ibn Ḥanbal and Imām Abū Dāūd.
15. Narrated by Imām al-Bukhārī and Imām Muslim.
16. Narrated by Imām al-Bukhārī and Imām Muslim.
17. Narrated by Imām Aḥmad Ibn Ḥanbal.
18. Narrated by Imām Aḥmad Ibn Ḥanbal; see also *Ṣaḥīḥ Muslim*, “Kitāb al-Birr”, *ḥadīth* no. 984.
19. *Ṣaḥīḥ Muslim*, “Kitāb al-Birr”, *ḥadīth* no. 59.
20. Qur’ān 5:2.
21. Muhammad bin Ibrahim, “Global Takāful Industry”, 2.
22. *Ibid.*, 3.
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ISLAMIC BANKING AND FINANCE IN THE 21ST CENTURY

SELECTED ISSUES IN HUMAN CAPITAL DEVELOPMENT

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Abstract: Islamic Banking and Finance (IBF), both in theory and practice, has made great strides over the last 40 years. However, it is not spared from criticism, much of it relating to issues of 'Islamicity' and 'originality' of mainly IBF practice. One major reason underlying these issues relates to the quality of human resources related to IBF. This article first presents some of the tensions that exist in contemporary IBF. These tensions include debates within the theoretical discourse regarding preferred instruments in IBF. The article also highlights some problems that occur due to the divergence between the theory of IBF and with its practice, leading to a general perception that IBF merely duplicates conventional finance rather than offering any true alternative. The article argues that to resolve these tensions, greater emphasis must be placed on creating qualified human capital at all levels of the IBF discipline and industry. In addition, IBF would be better served if Islam and its *shari'ah* were viewed as a civilisational framework, rather than a narrow *fiqh*/law focus. Having a civilisational understanding of Islam, its *shari'ah* and the Islamic heritage on the one hand, as well as a genuine understanding of modern economics and finance on the other, are necessary pre-requisites to enable IBF to play its role in serving the *ummah* more effectively in the twenty-first century. *Genuine* Islamisation of knowledge would produce the human capital desired.

Introduction

Islamic banking and finance (IBF) has become one of the main visible features of Islamic resurgence in the latter part of the twentieth century. It has also become, rightly or wrongly, the main practical manifestation of Islamic economics and of the 'Islamisation of economics/knowledge' project that began in the mid 1970s. The track record of IBF is indeed impressive and deserves to be acknowledged. From the establishment of the first private commercial bank in 1975 in Dubai, there are now about 300 Islamic banks and 90 *takāful* companies in over 75 countries. One

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can also witness the high growth in global *sharī'ah*-compliant assets, estimated at US\$1 trillion with a growth rate of 15–20 per cent per annum.¹

Despite the great strides made, there have also been criticisms of Islamic banking, both at the conceptual, but mainly at the 'practice' level. The main argument goes back to inter-connected issues of 'islamicity' and 'originality' (of products and instruments), preferences of products and instruments (especially between academics and practitioners), qualifications of those involved in the IBF industry, as well as the role and competency of the *sharī'ah* advisory process. While the world is still trying to come to terms with the exact magnitude of the 2008–09 global financial and economic crisis, it has also given an opportunity for the proponents of IBF to put their case forward as an alternative to the dominant capitalist paradigm. Important players have claimed IBF to be the saviour of not only Muslims, but humanity as well. These claims have to be subjected to honest evaluation.

This article will discuss selected issues that involve human capital development in IBF. It will try to address some concerns and debates within the conceptual/theoretical discourse as well as those concerning the conceptual/theoretical–practical relationship. While many issues can be discussed, this article will try to focus on some interconnected ones that have direct concern to the education process as well as content of curriculum that will help take IBF forward.

Tensions in Contemporary IBF

How Islamic is IBF?

A question that annoys many in the field of IBF, especially those in the industry, are the constant doubts concerning the 'islamicity' or authenticity of IBF. Aside from the criticism on *practical* aspects of IBF, academics and scholars involved in Islamic economics, banking and finance, too, have become the target of censure. This is mainly because quite a few academics are also involved in the '*sharī'ah* advisory process', which is seen by critics as merely 'legitimising/justifying' practices being put forward in the market. However, even within the academia, there is great debate about the direction of IBF and the preferences of instruments being used in theory as well as in practice. In the early 1970s, when Islamic economists started writing about Islamic economics, IBF was one area addressed. The writings as a whole put forward a very different IBF than what we see today. The picture was one that had a more 'developmental' approach and goal. However, by the late 1980s this approach, and those from among the academia who promoted this approach, were marginalised and replaced by those who were more 'practitioner friendly'. Also, many Islamic economists who may have been initially involved in the IBF industry,

were 'replaced' by jurists and accountants, who were seen to be more 'qualified' and who understood the needs of the industry better than the 'theoretical' economists.

One controversial area regarding the practice of IBF that has come under scrutiny is the role of members of the '*sharī'ah* advisory boards' that govern individual Islamic banks and their views regarding Islamic banking today. Even at the relatively 'popular' level, London-based writer Carla Power in an overly critical article presents the following observation that has become an increasing trend in society:

But how truly Islamic is the Islamic finance these men promote? To their critics, many are nothing more than rent-a-sheikhs, willing to give the spiritual nod to just about any financial product for the right price. ... One recent study from the AAOFI (Accounting and Auditing Organization for Islamic Financial Institutions) concluded that 85 percent of bonds marketed as sharia-compliant were illegitimate. And the fees many of these scholars take in – at times, six figures for a single decision – only add to such critiques.²

Central to this questioning of 'authority' in IBF practice is the issue of who should sit on these advisory boards, what their qualifications should be and what should the scope of their duties be. In the case of Malaysia, while there is no explicit requirement for Islamic law/*fiqh* qualifications, the convention is that '*sharī'ah* advisors' should be trained in Islamic law. While not questioning the sincerity of these scholars, the issue may be more concerned with the qualifications and exposure of these scholars and hence their ability to give sound *sharī'ah* advice (as opposed to Islamic law advice). We will take this up later.

Modifying Instruments or Going for More Fundamental Institutional Changes

A larger issue is whether Islam and the modern economy can be reconciled at all. Is it enough to create banking products that mimic those of traditional finance but also meet the letter of Islamic law? Or must the goals of the financial system itself be reworked fundamentally?³

One major criticism of Islamic banking has been that it is modelled after the interest-based (especially commercial) banking system. Hence, the role and function of banks have primarily been retained while focus has been on creating '*sharī'ah*-compliant instruments' (seen by the critics as more expensive duplicates) to replace the interest-based instruments of conventional banks. Critics as early as 1986 like Ziauddin Sardar blame what they saw as 'patchwork economics' stemming from the misplaced 'Islamisation of knowledge' agenda.⁴ Sardar argued that since this agenda takes the modern discipline as the reference point and wants to 'seek the relevance of Islam to it',⁵ this can only result in patchwork and 'bad imitations'. This criticism could have some truth to it if one was to take the 'simplistic and shallow' understanding of 'Islamisation of knowledge' that seems to have prevailed among

some proponents of Islamic banking, and consequently practitioners of Islamic banking and finance.

What we mean by this simplistic and shallow understanding of ‘Islamisation of knowledge’ is emphasis on narrow areas of economics, in this case banking and finance instruments, without giving due emphasis on foundational issues. Failure to give attention to these foundational issues that would include discussion of a philosophy of Islamic economics and finance could easily lead writers to accept the banking institution as is, without understanding the history and foundations of modern banking itself. These critics thought it necessary for Islamic economists to have asked even more fundamental questions like whether there was a need for banks as we know them today, as an answer to solve problems in Muslim societies today. Hence, according to these critics, what has been attempted is to mould conventional banks into Islamic shape by ‘purging them of interest’ and replacing it with profit–loss sharing arrangements.

From the experience of Islamic banking over the last 20 years or so, we now see that this has actually not happened. Instead of equity instruments like *murābahah* and *mushārakah*, Islamic (commercial) banks have actually focused almost exclusively on debt instruments such as *murābahah* and *bay‘ mu‘ajjal* or *bay‘ bi-thaman ‘ājil* that critics say seem to be very similar in operation to conventional practices, and hence familiar to practitioners. While generally accepted by almost all scholars as being an acceptable Islamic contract, Islamic economists initially argued against these debt instruments being given too much prominence by Islamic banks, seeing relatively less developmental impact. While Sardar criticised Islamic economists for not asking the ‘right’ questions, practitioners sidelined Islamic economists for criticising them. All the while, the problem lay in the approach of accepting the banking institutions as they were and trying to mould them into Islamic shape by ‘Islamising’ the instruments. Only now, rather than equity instruments, some Islamic bankers have succeeded in focusing almost exclusively on debt instruments with the backing of ‘*sharī‘ah* advisory boards’ made up almost exclusively of *fiqh* trained scholars. Whether we agree with Sardar or not, the point to note is that Islamisation efforts, *if not inclusive of foundational, methodological and epistemological concerns relevant to economics and finance*, will end up making Islamic economics a branch of western economics and may not live up to the claims that IBF will be the saviour of humankind against crises like we are facing now.⁶

IBF in Theory vs IBF in Practice

The tensions that existed continue to exist today between the ideals of IBF initiated by Islamic economists in the 1960s and early 1970s, with the practice of IBF spearheaded by bankers, with the support of some jurists and economists. It will continue to be an important area of debate and criticism. As mentioned previously,

while the early Islamic economists saw IBF as an extension of Islamic economics, and hence, having developmental goals, practitioners with the support of some jurists saw IBF as primarily a commercial enterprise as in modern banking and finance, and hence, replicating its practices. Unfortunately, ‘*sharī‘ah* compliance’ has increasingly come to mean the minimum legal standards that are permissible, rather than aiming to determine ‘preferred’ options that would have a greater socio-economic impact on society as a whole in relation to developmental goals such as poverty eradication, job creation, entrepreneurial development and greater sharing and distribution of benefits (and losses).

Even if we accept the less preferred options of debt-based instruments (like BBA and *bay‘ al-‘inah*-based contracts in Malaysia) the theory–practice divide is further aggravated when the practice of debt-based IBF does not necessarily follow the requirements of the theory of debt-based IBF. A recent High Court judgment in Malaysia⁷ gave a verdict that stated explicitly that the “BBA as practiced in Malaysia was not a bona-fide sale” and for all practical purposes was more like a loan contract. On appeal (the written judgment is still pending), the presiding judge found that the High Court judge above had erred in his judgment, since the “BBA is a sale contract and not a loan”. A simple reading of this decision indicates that both judgments seem to be talking about different things: the appeal court was referring to the *theory of BBA*, while the High Court was referring to the *practice of BBA in Malaysia*. Why is there a departure between theory and practice and how were the practices ‘justified’ by the *sharī‘ah* boards? This has brought into question the whole process of *sharī‘ah* advisement and the qualifications of members of these boards. While we may not agree with the accusation of the ‘rent-a-sheikh’ view, we can certainly see shortcomings in the present *sharī‘ah* advisement process and in the limitations of the knowledge exposure of the parties involved, maybe even including the learned judges on matters relating to the BBA contract.

The IBF Advisement Process: Breaking Free from Equating the Sharī‘ah with Law

The Islamisation of the banking and finance industry has been a great success story for showing the world that Islam and the *sharī‘ah* can contribute positively to solving modern finance needs. However, there seems to be resistance to ‘true or holistic Islamisation of economics/finance’ from within the circle of some Muslim scholars, who are mainly trained in *fiqh* (mistakenly narrowed to mean law). Many of the banking products are designed by bankers who are mainly trained in conventional finance or some other conventional area, but whose knowledge in Islamic heritage and Islamic economics/finance may be limited or even non-existent. They rely on *sharī‘ah* (misread legal/law) scholars trained in *fiqh* and to a lesser extent in *uṣūl al-fiqh*/jurisprudence to give verdicts on these sometimes rather complicated

financial products. Islam and its *sharī'ah* are reduced to the legal dimension rather than seeing them within a greater civilisational framework.

These scholars with due respect to them, are still in 'legal' mode, i.e. focused exclusively on legal reasoning. They are greatly in demand to make *ijtihād* on contemporary economics/finance issues and to produce alternative *sharī'ah*-compliant instruments. While their sincerity is not questioned, the 'originality' of the products and their implications for society sometimes are.⁸ Besides the 'duplication' criticism, there is a much deeper soul searching that needs to be done by all involved. Is it possible for us to truly develop genuine Islamic alternatives if we are not trained in economics/finance as well as the heritage? Is it possible to look at instruments from the purely legal reasoning angle dealing with contracts, without also knowing the economic and social implications of those instruments and how development as a whole is served?⁹ Can we truly claim that the instruments that are being put forward are genuinely 'serving public interest' if we do not give the required attention to ethical (and not just legal) issues in the views that we make? Should there not be a preference for more ethically preferred choices in IBF? Why are we satisfied to just have the 'minimum legal requirement' as the standard that we want to follow?

While bankers and practitioners make no claims to being Islamic experts, in most cases, they determine the direction of the product and product development. On the other hand, the legal experts whose knowledge is limited to Islamic law of contracts are asked to evaluate these products and give an opinion. Certainly it is unfair to ask these scholars to go beyond their fields of expertise. Hence, while the instruments may be '*fiqh* or legally compliant', they may not meet the requirement of being '*sharī'ah* compliant' in the true sense, since the *sharī'ah* is much wider than law and consists of 'guidance' (including laws, values, norms, principles etc.). Limiting knowledge of the *sharī'ah* and the *turāth* (heritage) to mere *fiqh* discussions and reasoning may not do justice to Islamic economics, banking and finance. In the case of economics, banking and finance, we are talking about a social science, maybe a part of Ibn Khaldun's '*Ilm al-'Umrān*' (lit. 'Science of Civilisation') that tries to understand, analyse and describe human interaction and choices made in areas of allocation of resources, distribution, exchange and finance (among others). In the last category, it will also involve the creation of instruments, but should not only be limited to this.

Similarly, if we talk of the methodology that needs to be adopted, the discipline of *uṣūl al-fiqh* (understood as more legal reasoning) has to be distinguished from *uṣūl al-iqtisād*, the latter being a much broader area of 'the foundations/methodology of Islamic economics'. Rather than only limited to the legal dimension of the heritage and its methodology, *uṣūl al-iqtisād* would include the Islamic worldview, *uṣūl al-'ilm* (sources or foundations of knowledge), *fiqh* and *uṣūl al-fiqh*, *uṣūl al-dīn*,

history, analytical techniques and many other areas of knowledge that would enable holistic decisions to be made, decisions that will enable the 'more preferred choices to prevail and decisions that will take into consideration a wider end-result that represents public interest and civilisational goals of Islam and its *sharī'ah*'.¹⁰ Hence the knowledge of the heritage required in order to develop contemporary Islamic economics, banking and finance must be more than just the narrowly '*mis-defined*' *sharī'ah* (legal) sciences. One of the greatest maladies to befall the Muslims is this 'corruption' of original rich meanings of terms and concepts in the Islamic worldview to narrow meanings.¹¹

As far as modern economics is concerned, meaningful Islamisation cannot occur without some level of 'critical' understanding of the functioning of the modern economy, its system and constituent elements. We state 'critical' because the modern system has to be evaluated from an Islamic framework or perspective. Knowledge in this category would include areas such as economic history (both of thought and practice), statistics (including today's econometrics), theory (both macroeconomics and microeconomics) and economic sociology (which may include other social sciences). One must also be prepared to include elements of sociology, logic, psychology and philosophy in its connection to economics. In the context of developing Islamic economics, it would be necessary for us to 'master' these areas of knowledge, but always with reference to the Islamic perspective. In terms of economics, banking and finance, this would mean understanding contemporary advances in these areas *critically*.

Meaningful Islamisation implies that the Islamic economist or the Islamiser of contemporary economics, banking and finance must know what is acceptable, what needs modification (what to be done and how to do it), what is to be rejected (what and why) and to be able to relate these to contemporary realities as well. It is certainly a tall order and one that does not seem possible if we continue to move in the present way contemporary Islamic banking products are being developed. While the products are developed and presented by mainly western-trained economists/bankers, *sharī'ah* scholars are asked to evaluate them. The latter are not necessarily familiar with the running of the economics and finance sectors and their knowledge in areas of philosophy/methodology (with reference to *uṣūl al-iqtiṣād*) leaves a lot to be desired. If people are questioning present-day products, it is not necessarily only for their legal validity but also for their ethical implications. It is a valid question to ask whether the present two parties involved in the creation of Islamic financial instruments (conventional bankers and *sharī'ah*/legal scholars) should be left alone or some other type of boards need to be set up to act as checks to the *sharī'ah* boards!

If one interprets this as a call for the inclusion of Islamic economists, a point of caution is called for. Even among the Islamic economists, we have to be honest about our ability to truly Islamise economics. While many economics/Islamic

economics programmes do offer courses in the heritage, these are usually in *fiqh* and to a lesser extent in *uṣūl al-fiqh*. In addition, these courses are taught in ways that are ‘unconnected’ to economics/ finance. The level of discourse in methodology and philosophy of science leaves a lot to be desired in these programmes. Islamic economists themselves keep referring to the heritage in terms of *fiqh* and law. This brings us to the issue of the human capital challenges faced.

Genuine IBF Needs Genuine Islamisation: The Role of Education and Training

Compulsory (Farḍ al-‘Ayn) Knowledge in IBF: Islamic Heritage and Modern Economics/Finance

The main lesson gained from 30 years of IBF is that no creative synthesis between the Islamic heritage and modern economics, banking and finance to create an Islamised body of knowledge in the form of textbooks can be produced unless we are able to create a new breed of scholars and practitioners. Right now, despite much progress, the gap is still there. The gap is there not because no one has pointed out what needs to be done. The gap is still there because short-term gains that can make IBF ‘seem to be successful’ are taking precedence over a longer-term view on what we want IBF to achieve. These longer-term goals cannot be seen without an understanding of both the heritage and modern economics and finance *and their philosophical foundations*. Genuine Islamisation of knowledge efforts will have to provide this dimension in the educational curriculum.

At present, many modern western-trained Muslim social scientists are not able to appreciate the philosophical and methodological issues underlying their own disciplines, let alone having any meaningful exposure to the Islamic legacy. Their training has created, in many cases, *mediocre* scholars who may fail to understand the foundations of their disciplines, not to mention any ambition of ‘mastering’ their disciplines as demanded by the ‘Islamisation of knowledge’ agenda. This sad state of affairs is – slowly but surely – changing for the better, with more scholars realising that foundations of western disciplines and exposure to Islamic heritage are necessary for any attempt at genuine Islamisation of knowledge and in developing genuine IBF.

In other cases, their training may have created ‘masters’ of modern disciplines, who have also, maybe unconsciously, become entrapped in the existing frameworks of those disciplines, i.e. they may not approach issues from a genuinely Islamic perspective. It may be pertinent to keep in mind that although many Muslim academics may also have advanced degrees in specific areas of modern disciplines, their knowledge of Islam, its worldview, of Islamic philosophy and methodology

relevant to their disciplines and of the 'Islamisation of knowledge' may greatly differ from one academic to another. In extreme cases, the latter may even be next to non-existent.

The above scenarios are not surprising since most economics and finance programmes in western universities today hardly discuss philosophical and methodological issues in economics. The underlying assumptions of mainstream neoclassical-Keynesian economics (such as those associated with the rational economic man and his maximisation goal) are accepted as 'given', while most – if not all – attention is placed on mastering the latest quantitative techniques (now available in software packages) and applying these to 'analyse data'. In addition, mainstream neoclassical methodology and its 'scientific methods' (model building with a primarily predictive goal) are accepted as objective and correct, with an overwhelming attention paid to technical procedures and application of quantitative techniques to solve mathematical equations, without ever questioning the philosophical underpinnings and ideological foundations of these methods and techniques and the theories they are used to promote. Critically evaluating these philosophical foundations is what genuine Islamisation of knowledge is all about, and it would seem the logical area to allocate resources, both financial and human. If nothing more, we should at least learn from the developments in the west where an increasing number of economists and philosophers of science are questioning the entire framework on which the dominant paradigm of neoclassical economics rests.¹²

Scholars keen on the Islamisation of economics and finance would certainly benefit from reading the material coming out from scholars and graduate students in western universities, who in many respects are much more advanced and profound in their critique of mainstream neoclassical economics. IBF needs to devote more resources to creating a new type of scholar who will be able to be genuinely innovative, keeping in mind the developmental and civilisational goals of contemporary Muslim societies. The scope of knowledge that will be required to meet these challenges must be widened, while areas that are considered to be irrelevant like history and philosophy need to be part of the curriculum that is emphasised.

Contemporary Islamic economists should also be willing to learn from history, both of Muslims and of Western Europe. Our early scholars who came across writings of the Greeks for example were very selective on what they reviewed, worked from 'Islamic perspectives' i.e. with understanding of the Islamic worldview and hence, were very careful and successful in Islamising knowledge. Also, many scholars chose to write works on classification of knowledge, so as to place new bodies of knowledge within an overall schema. If we look at the history of western economic thought, it is very clear that methodological and philosophical concerns were discussed, debated, and developed from the time economics was a part of theology and moral philosophy during the period of the scholastics in medieval

Europe during the thirteenth to fourteenth centuries and also very clear in the writings of the mercantilists and physiocrats of the fifteenth to sixteenth centuries.¹³ Debates on methodology clearly affected the writings of the political economists of their time. Many major writers in the western economic tradition also wrote on methodological issues such as John Stuart Mill.

Until there is a similar realisation of foundational, including methodological issues among contemporary Islamic economists – as there has been in our own tradition in the past, and in western scholarship during the developmental stages of western economics, and again over the last 30 years in the West – we may continue developing IBF along the same path. There is a need to make a long-term commitment to knowledge and scholarship now. This could enable IBF to genuinely take up the challenge of being the alternative to the dominant paradigm and to genuinely contribute to achieving the civilisational goals of Islam as we face the challenges of the twenty-first century.

Notes

1. “Islamic Banking & Finance at the Crossroads of Global Financial Crisis: The Way Forward”, Keynote Address by Dato’ Mohd Razif Abdul Kadir, Deputy Governor, Bank Negara Malaysia at the IIUM Institute of Islamic Banking and Finance, 20 March 2009, Kuala Lumpur. For a detailed elaboration on the development of IBF, please see Hossein Askari, Zamir Iqbal, and Abbas Mirakhor, *New Issues in Islamic Finance and Economics: Progress and Challenges* (Singapore: John Wiley and Sons, 2009), especially Chapter 1.
2. “Faith in the Markets”, *Foreign Policy* (January–February 2009), available online at http://www.foreignpolicy.com/story/cms.php?story_id=4596 (accessed on 2 June 2009).
3. Ibid.
4. See Ziauddin Sardar, *Islamic Futures* (London: Mansell Publishing, 1986). Sardar was one of the earliest critics of Ismail Faruqi’s Workplan on Islamization of Knowledge. While harsh, and in places overly so, a few of these criticisms were actually incorporated in modified versions of the workplan and in later works that developed on the IOK agenda. See Mohamed Aslam Haneef, *A Critical Survey of Islamization of Knowledge* (Kuala Lumpur: International Islamic University Press, 2009, 2nd ed.).
5. This is taken from step 5 in Ismail Faruqi’s *Islamization of Knowledge: Problem, Principles and the Workplan* (Herndon VA: IIIT, 1982).
6. While this is seen as counter-productive by critics like Sardar, some scholars like Monzer Kahf, are of the view that Islamic economics becomes a part of the science of economics just as Marxist or capitalist economics. It is to be studied within the area of economic systems but based on the assumptions of Islamic axioms, values and ethics, just as Marxist and capitalist economics are studied within their own paradigms. While this is not the place to evaluate this position, the present writer may not fully agree with this view as it may be wrong to equate the nature and scope of Islamic economics with its contemporary western secular counterpart. See Monzer Kahf, “Islamic Economics: Notes on Definition and Methodology”, *Review of Islamic Economics* 13 (2003), 23–48.
7. See Datuk Abdul Wahab Patail, High Court Malaysia, Commercial Division, 18th July 2008. Judgment on various suits brought by a few Islamic banks against clients. Suit No: D4-22A-067-2003, Suit No: D4-22A-215-2004, Suit No: D4-22A-1-2004, Suit No: D4-22A-185-2005, Suit No: D4-22A-399-2005, Originating Summons No: D4-22A-395-2005,

Writ No: D4-22A-166-2006, Writ No: D4-22A-167-2006, Writ No: D4-22A-178-2006, Suit No: D4-22A-192-2006, Writ No: D4-22A-203-2006, Writ No: D4-22A-204-2006.

8. See Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets* (Kuala Lumpur: Dinamas Publishing, 2005) which represents newspaper and magazine articles written by the author over the period 1994–2005. Most of the examples used refer to Malaysia, but many are also reflective of the issues/problems in IBF generally. In the book, the author raises his concerns in terms of the ‘originality’ of IBF and how its proponents have to ensure that the confidence of consumers towards IBF is maintained by ensuring that the IBF industry does not become a mere ‘duplication’ industry, i.e. one that justifies the conventional framework.
9. On this issue, M.N. Siddiqi pointed out the importance of understanding the ‘macro-*fiqh*’ dimensions of IBF on the economy and society as a whole as opposed to the ‘micro-*fiqh*’ qualifications of most legal scholars. See his “*Shari’ah*, Economics and the Progress of Islamic Finance: The Role of *Shari’ah* Experts”, *IIUM Journal of Economics and Management* 15, no. 1 (2007).
10. On the discussion of *uṣūl al-iqtisād* see Mohamed Aslam Haneef and Hafas Furqani, “*Uṣūl al-Iqtisād*: The Missing Dimension in Contemporary Islamic Economics”, *Readings in Islamic Economics and Finance* (Sintok: Universiti Utara Malaysia, 2007).
11. See Syed Muhammad Naquib al-Attas, *Prolegomena to the Metaphysics of Islam* (Kuala Lumpur: International Institute of Islamic Thought and Civilization [ISTAC], 1995).
12. In the last three decades there has been a growing disenchantment with the dominant paradigm of mainstream economics. Alternative views are being put forward and heterodox views are having a renewed life. See for example the Heterodox Economics portal at www.hetecon.com and the Post- Autistic Economics website at www.paecon.net.
13. While numerous books on the history of western economic thought can be found, one monumental work that should be read by all Islamic economists eager to study the interface between economic reasoning and western thinking in general, is Karl Pribram’s *A History of Economic Reasoning* (Baltimore: Johns Hopkins University Press, 1983).

ISLAMIC FINANCE

A BULWARK AGAINST CONTAGION IN THE GLOBAL BANKING SYSTEM

*Amer Al-Roubaie**

Abstract: The objective of this article is to shed some light on the performance of Islamic financial institutions in view of the current global financial crisis. Islamic financial activities and products are conducted in compliance with the *sharī'ah* and, therefore, they are less vulnerable to changes in monetary variables than conventional financial products. Due to the prohibition of interest and because of ethical and moral constraints, Islamic banks are restricted from investment in speculative transactions which lessens default risk and enhances effectiveness of liquidity management. Islamic modes of investment contribute to society's wellbeing through the creation of wealth and employment to ensure economic stability and human development. In Islam, knowledge, information and work are the main ingredients for success (*falāh*). In an information-intensive world, honesty, accountability and transparency are vital for market performance and business activities. The global financial crisis has caused instability in financial markets weakening confidence in the global economic system as well as increasing uncertainty about future macroeconomic trends.

Introduction

Seldom do crises create shock waves that impact the economies of so many countries as the one currently sweeping across financial institutions worldwide. The present crisis is a product of human misconduct and inadequate regulatory standards by central banking and monetary authorities. So far, the magnitude of the crisis is estimated to have erased about US\$50 trillion in financial assets worldwide. In the Muslim world, although it is difficult to estimate the losses, the Gulf Arabs alone are said to have lost US\$2 trillion. For example, in Dubai almost 40 per cent of the work in the construction sector has been put on hold throwing thousands of people out of work. The fear prevails that the impact of the global financial crisis will have severe consequences far beyond the economic and financial sectors to

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include the social, political and environmental spheres. In particular, the developing countries will suffer a great deal due to the fall in commodity prices on which their export economies are based. The terms of trade of many nations are expected to deteriorate causing a combination of balance of payments disequilibrium, exchange rate devaluation, budget deficits, higher prices and unemployment.

The crisis has developed on the capability of international financial institutions to provide loans, particularly to poor countries. The consequences of the crisis could have a destabilising effect by increasing social intolerance and political instability. Minimising the risk of economic imbalances, Muslim countries must increase cooperation and strengthen the confidence in financial markets. The capitalist economic system, currently practised in a number of Muslim countries, seems to have suffered a deadly blow, and, therefore, the time has come to reengineer the economic structure and restore confidence in the financial institutions. As an alternative, the Islamic financial system could provide greater financial stability by introducing ethical guidelines to ensure social justice and promote economic growth. Interest payments on bank loans could increase speculation about future economic trends causing negative impact on investment decisions and business transactions.

Currently, the global financial system rests on *ribā* (usury) transactions driven by profit motivation with little attention paid to economic incentives and social safety nets. Capitalism advocates individual freedom and judgment in decision making which causes corruption, mismanagement, fraud and market imperfections. The financial crisis is a product of mismanagement, lack of regulatory measures, poor supervision, inefficiency and speculation. As a result, millions of people have lost their savings with little prospect for recovery.

The causes of the current crisis involve the biggest economy in the world, the United States market. The collapse of the US real estate market followed by mortgage-backed securities markets were among the important factors that were responsible for the current crisis in the global financial markets.

The aim of this article is to shed some light on the Islamic financial system under the current conditions of global financial crisis. During the last few decades, Islamic banking and finance has become popular among investors both in the Muslim world and globally. Being in compliance with the *sharī'ah*, or the Islamic legal system, Islamic financial products exhibit ethical and moral guidelines. This chapter examines the causes and consequences of the global financial crisis from an Islamic perspective with a view demonstrating that Islamic financial institutions could provide an alternative to conventional finance. Literature on Islamic banking and finance in recent years has focused on both micro and macro dimensions of the Islamic financial system. These discourses have increased our understanding of the opportunities and challenges in the wake of the global financial crisis facing

Islamic financial institutions which hold out the future prospect of an alternative to the capitalist financial system.

The Global Financial System and the Crisis of Capitalism

The magnitude of the global financial crisis has shed doubt on the capability of the capitalistic financial system to keep pace with the recent changes driven by globalisation. Liberalisation of finance and trade, the emergence of information and telecommunication technologies, and rapid capital mobility has increased the flows of trade, capital and finance across countries. This, in turn, increased the risk of global linkages by subjecting financial institutions, both locally and internationally to a high degree of instability. The global financial system is highly interconnected through international trade transactions and multinational business. However, both Western countries and multinational corporations exercise a substantial influence over trade movement, capital flows and financial markets. In practice, the global financial system currently exhibits a free market philosophy based on market freedom and individual decisions with regard to financial transactions and monetary trends. Since its inception in 1944, the International Monetary Fund (IMF) has been a key player in formulating policies and making decisions governing the global financial markets. The structural adjustment programme of the IMF has adopted free market values as guidelines for lending policies, especially in developing countries. Granting of loans is tied to market freedom and low levels of government interference in economic and financial activities. Such policies have forced many countries to withdraw incentives and support local producers from multinational corporations.

Financial institutions, directly affected by the current crisis have pulled the global economy into recession. Many countries, especially non-industrialised countries, are suffering from balance of payments disequilibrium and shortages of liquidity to meet their import requirements. International trade transactions are directly linked to financial flows and foreign direct investment (FDI), and, therefore, a high degree of financial instability causes an adverse effect on economic growth. A recent report by the World Trade Organization (WTO) estimates that the global gross domestic product (GDP) is expected to shrink by 9 per cent in 2009. Slow growth in the global economy reduces aggregate demand resulting in a ripple effect across countries. Without adequate liquidity, the financial system will struggle to meet global financial transactions to service trade and finance. Without a bail out by Western governments a large number of financial institutions would have gone bankrupt. The freedom of the enterprise and individual investors serves only capital owners and profiteers and not necessarily investors. Competition to gain control of the market led to mismanagement, abuse and violation of business ethics. This, however, represents

an opportunity for Islamic banks to take advantage of the current financial crisis, both locally and globally, to increase the ambit of their financial services worldwide.

The capitalist nature of global financial institutions characterised by oligopolistic market structure generates monetary transactions in the interest of maximising profits. These institutions operate in the short-term pecuniary interest of senior management with little attention paid to the long-term interest of stockholders, let alone the general public. Owing to absence of imperfection of regulation and supervision by government agencies, financial institutions were able to manipulate financial markets in order to gain profit at the expense of long-term interests of the rest of the society. Western governments undertaking to bail out these institutions have burdened themselves with large budget deficits causing constraints on expenditures to alleviate poverty, reduce unemployment, and promote economic growth. The capitalist economic system seems to have reached its limit and, therefore, the role of an unaffected free-market economy will no longer be able to provide practical solutions to modern problems. Policies advocated by international institutions, including the IMF driven by the 'Washington Consensus', have failed to sustain stability in international financial markets.

Finance and financial institutions are at the heart of modern economies reflecting the sensitivity of macroeconomic variables to changes in financial institutions. Furthermore, the crisis will have severe repercussion effects including job losses, social intolerance, economic dislocation and political instability. Similarly, the emergence of such trends will give rise to international tensions by weakening the global financial institutions causing trade, liquidity, capital flows and economic growth to decline.

The extent of the financial crisis and its global implications underscores the importance of international institutional reforms to restore confidence in the global economy. Good governance encompassing structural reform is a must for financial market stability. In the new structure, all countries must be represented including Muslim states. Despite their financial endowment, characterised by their accumulation of petrodollars, Muslim countries have been marginalised by not taking any active role in global financial markets. Increasing interdependencies among financial markets within economies and globally requires involvement of all nations, especially oil producing countries. Recent escalation in oil prices, although short-lived, increased these countries' shares in global liquidity causing trade imbalances and balance of payments disequilibrium in many oil-importing economies.¹

The United States Banking System

The global financial crisis is a result of mismanagement and unethical practices by big financial institutions, speculators and policy makers in the United States. Due

to the low level of regulatory measures and supervision by monetary authorities, banks in the United States were lending money on easy terms with inadequate credit checks on borrowers and with inflated appraisals of the quality of collateral on secured loans.

By doing so, easy credit has encouraged excessive consumption through borrowing, i.e., for years, the average American has been over-leveraged living on credit due to the generous offers and easy lending policies by banks. Such policies have created an artificial economy with an amount of money far exceeding the productivity of both the individual and the economy. Down payments on homes were close to nothing which encouraged those with no standing credit to acquire easy loans most of which were diverted to buying consumer goods and luxury products. It is rather difficult for any society to sustain such lavish consumption by having so many people living beyond their means. In contrast, moderation in consumption is the main principle for living in a Muslim society, i.e., in Islam living within one's mean is the right choice for development. In other words, excessive borrowing and overspending make the society more vulnerable to economic and financial downturn. In the view of David Testa, chief executive of Gatehouse Bank, which began operations in April as the fifth Islamic bank in Britain,

[i]nvestors traumatized by the credit crisis could seek comfort from the stricter rules imposed on lending by Islamic law, which bans some of the structures and financing methods that quickly unraveled during the US mortgage crisis.²

A bubble economy driven by irrational exuberance and greed led consumers to believe that prices of housing and stocks would always rise and the fear that markets may fail unthinkable. The economic system driven by capitalism seems to have run out of steam by its inability to sustain growth. In the view of the Philadelphia-based journalist Dave Lindorff,

[t]he truth is that we are not threatened by communism, by drug lords, or by Muslim Jihadists in any serious way. Rather, we have become our own worst enemy. The honest truth is that the US is technically bankrupt and in a state of chronic decline, and yet the nation persists in spending a trillion dollars a year on war and preparations for war, as though America were in mortal danger from foreign enemies.³

Islam is against such lavish spending if the economy is non-productive to support high consumption. Monopoly and excessive control over resources is not allowed in Islam to facilitate giving access to all individuals in society to share resources through work, management, knowledge and organisation. Earning profits is possible through work and trade resulting from real economic activities.

Owing to the size of the US financial system and its linkages to global financial markets, the financial crisis in the United States has generated a spill-over

effect across the financial institutions and markets worldwide. Avoiding further deterioration in the global economy and minimising the risk of financial failure, especially in developing countries, requires greater cooperation among nations. The existing financial institutions, including the IMF and World Bank, are no longer in a position to manage international liquidity and maintain global financial stability. The global financial crisis will have destabilising effects on local economies both in industrialised and non-industrialised countries.

It is the unchecked greed of capitalism that generated the crisis. Hedge fund managers and rogue CEOs, practising irresponsible acts to maximise personal wealth, contributed to the crisis currently sweeping across the world. Among the most pernicious practices involved the dissemination of extremely risky derivatives. Use of derivatives like credit default swaps, also described as ‘weapons of financial mass destruction’, represent transactions involving an increase in capital measured in dollars but not in real assets. The main purpose behind credit default swaps is to increase bank income. A loan or bond may be issued by the bank to a second party covered by an insurance contract to protect sellers from expected losses. These credit default swaps do not represent real securities in the sense that “they’re not transparent, aren’t traded on any exchange, aren’t subject to present securities laws, and aren’t regulated”.⁴ The motive behind such financial transactions is for big financial institutions to generate income. Investing in a credit default swap involves an insurance contract between two parties which provides protection against losses for both parties. According to one observer,

[c]redit default swaps are not standardized instruments. In fact, they technically aren’t true securities in the classic sense of the word in that they’re not transparent, aren’t traded on any exchange, aren’t subject to present securities laws, and aren’t regulated. They are, however, at risk – all \$62 trillion of them.⁵

The Islamic Financial System

Islamic Finance is a component of the Islamic economic system driven by the principle of the *sharī‘ah*. Islamic finance exhibits humanistic features designed to promote social justice, endorsing equity and protecting individual right and freedom in the market place. Economic activities in Islam underscore the importance of individual right to ownership, making decisions, freedom of choice and cooperation. In an Islamic state, the *sharī‘ah* provides legal and ethical guidelines which strengthen market activities and minimise risks of failures. In this regard, the Islamic financial system aims at serving man through the creation of employment opportunities, increasing production of goods and services and sustaining development. Unlike capitalism, interest of the individual in Islam is served through the welfare of the

Muslim community at large (*ummah*). For example, Adam Smith, the father of capitalism, postulates that the prosperity of a nation is a product of individual rational behaviour to make profit. More specifically, the work of the individual through the 'hidden hand' is responsible for the success of society. In Islam, such a proposition is rejected due to man's personal greed and lack of sufficient knowledge to make decisions. In other words, individual welfare is a derivative of society's welfare. Resources are not supposed to be allocated for the service of a few in society; rather, to be shared by all individuals. This implies that the interest of the individual will be served through the collective work of the whole community. However, recent research in economics has shown that "people cannot always pursue their long-term personal interest. From time to time, they must also rely on other people and take into account other people's interests as well as their own."⁶

As a discipline, Islamic finance is relatively new compared to the existing financial systems including capitalism and socialism. The conventional financial system comprises secular and theoretical concepts the return on which is measured in interest payment. In contrast, Islamic finance exhibits religious features comprising prohibition of *ribā*, ethical investment practice, economic incentive and social welfare. The Islamic financial system promotes Islamic ideals and promotes balance between man's religious needs and worldly requirements, i.e., return on Islamic investment is not necessarily measured in individual profits but by contribution to society. In addition, the concept of brotherhood in Islam is about cooperation and not competition. Gain from investment must be shared by all members of the *ummah* in accordance with the principles of equity instead of being concentrated in a few hands.

The social dimension of Islamic banking constitutes elements of fairness and equity to alleviate poverty and create wealth. In Islam, individuals are entrusted with the task of allocating resources efficiently to maximise returns and promote individual welfare. Human development – not output – is the main objective of the Islamic economy. Knowledge, information, health, food, shelter and the environment are the ultimate targets of the Islamic economic system. These are among the core fundamentals for promoting a just society. Islamic finance contributes to building such a society through the adaptation of various modes of financial and investment instruments capable of delivering with high efficiency and accountability. Thus, Islamic banking policies, in relation to lending and granting loans to customers, require careful review to ensure that investment is in compliance with the *sharī'ah*. The *sharī'ah* board, an independent body of religious scholars, usually supervises bank activities by providing final approval of decisions to be sure that they comply with the Islamic legal system. This practice instils legitimacy into investment activities to meet the socio-economic needs and contribute to the development of the society.

Interest-free banking maintains no interest payments on non-productive investment implying that money creation must be linked to production of physical assets. Various modes of investment practised by Islamic banks involve business participation and partnership among investors in which both profit and losses are agreeable to all parties. In non-interest-free banking, bank transactions mainly take the form of interest income paid either to depositors or charges on lending to individuals and institutions. Owing to the creation of physical production and employment through bank lending using the Islamic mode of financing, the risk is usually minimised. However, unlike conventional banks, there is no guarantee that capital owners get their capital back or the share of the profit on their investment. It is rather a fair practice that in business both profit and loss should be taken into consideration. In addition, Islamic finance provides incentives for capital providers to earn higher returns on their investments compared to the interest payments by conventional banks. In addition, the potential success of Islamic enterprises is likely higher owing to the involvement of partners, especially in the case of *mushārakah* (joint venture). Islamic financial products, although having recently sputtered, grew rapidly in recent years, owing to their acceptance, particularly by non-Muslims, as an alternative to conventional finance. Assets of Islamic banks have exceeded US\$1 trillion reflecting the competitive advantage of Islamic financial products. Diversification of Islamic products includes issuing of Islamic bonds (*ṣukūk*), project finance, equity financing and wealth management have helped Islamic banks to broaden their investment base and gain competitiveness. There is no doubt that financial globalisation has given greater circulations of Islamic financial products worldwide and has been able to attract foreign investors from non-Muslim countries. In a recent issue of the *International Herald Tribune* it was pointed out that,

[w]hile conventional banks worldwide are nursing losses of more than US\$ 400 billion from the credit crisis, Islamic banks are virtually unscathed. And they are playing up the contrast to scalded shareholders, bondholders and borrowers and fearful depositors.⁷

Rapid growth in financial globalisation, in recent years, has provided the Islamic banking industry with greater incentive to expand and take advantage of globalisation. There are several Islamic financial products sold worldwide by Islamic banks in non-Muslim countries or by Islamic windows through foreign banks. What is still lacking in banking operations by Islamic banks is the adaptation of a unified approach to standardise financial services. Also, Islamic banks must become creative and innovative to develop new financial products to gain comparative advantage over international banks. Building confidence and establishing rules including international regulatory standards prescribed by the Basel I and Basel II Accords allow Islamic banks to get acceptance worldwide. Such standards

also provide investors with assurance about the viability of Islamic banks as an alternative to conventional banks.

The Human Dimension of Islamic Banks

The Islamic banking system carries duties and responsibilities similar to conventional banks, but they are constrained by the *sharī'ah* principles. Among other things, Islamic banks are not to charge interest on their transactions. The objective of Islamic banks is to serve the community by providing the necessary funding for stimulating economic growth and enhancing the social welfare. As financial intermediaries, these banks contribute to the economy by channelling savings into productive investment. Unlike conventional banks, Islamic banks impose strict guidelines on granting loans to ensure compliance with the *sharī'ah*. The risk of doing business, though it exists, is expected to be less in Islamic financial markets owing to non-interest payment. Liabilities of Islamic banks are allocated for productive investment to meet the society's economic challenges. In addition, management of funds is subject to restrictions imposed by the socio-economic interest of the Islamic economy. Earnings of Islamic banks depend on profit generated from investment, and, therefore, regulatory measures on lending policies become an integral part of investment decisions. Mohsin Khan and Abbas Mirakhor explain:

Due to the fact that the return to liabilities will be a direct function of the return to asset portfolios and also because assets are created in response to investment opportunities in the real sector, the return to financing is removed from the cost side and relegated to the profit side, thus allowing the rate of return to financing to be determined by productivity in the real sector. Thus, in the Islamic system there is a much tighter link between the rates of return in the real and financial sectors than in the capitalist system.⁸

This implies that the financial sector in the Islamic economy is related to the productivity of the economy which constitutes less volatile trends compared to financial markets in capitalism. Speculative investment is usually linked to future trends driven by the expected rate of return, mainly interest rates. This makes the financial system highly sensitive to changes in interest rates. In the Islamic economy, the linkage between financial markets and real sectors reduces economic and financial fluctuations owing to the fact that the rate of return on investment is linked to the performance of investment. For example, under the *muḍārabah* (profit sharing) system, the bank accepts deposits and uses them in partnership with investors. A contract is required for defining the terms and conditions between the two parties including the sharing of the profit. Depositors are paid a percentage of the total profit earned by the bank usually in the form of dividends. In this regard, money is paid to depositors only if profit is realised, which is in contrast to conventional

banks where interest is paid in spite of profit or losses incurred by the bank. Thus, speculations about future trends in interest could have direct effect on the real sector affecting employment, inflation, income and growth, i.e. the economy is sensitive to changes in financial markets. Under such circumstances, the Islamic financial system promotes financial and economic stability due to the prohibition of interest.

At present, there are more than 300 Islamic banks in many countries worldwide. Total assets of these banks vary in size depending on each country's financial endowments and government backing of Islamic financial institutions. The growth in demand for financial products is expected to increase in the coming decades owing to the increase in Muslim population and rapid expansion of Islamic banks outside the Muslim world. Today, Muslims are more interested in their heritage and culture driven by the Islamic principles. Experience with development during the last several decades has not been satisfactory to induce growth and improve human development. Models, theories, ideas and systems imported from other civilisations could only provide knowledge and information but cannot be a substitute of indigenous knowledge. It is not possible to isolate socio-economic development in Muslim societies from traditional values and religious teachings.

The Islamic worldview contains a set of elements exhibiting ethical, moral, social, political, financial and economic values which are different from those practised in other societies. Core Islamic principles, notably prohibition of *ribā*, cannot be modified to meet the challenges of the modern age. These challenges, however, are products of human errors and judgment based on worldly views and not attributed to religious teaching. Secularisation of Muslim societies has led to the penetration of non-Muslim theoretical, scientific, cultural, social, educational, economic and financial elements which are associated with growth and performance of Muslim societies. Life in Islam is more than just production of goods and services to satisfy man's material needs; it is also about enhancing his ethical values and obtaining spiritual fulfilment. It is within this framework that Islamic banking and finance must be practised in order to contribute to the development of Muslim societies.⁹

The Islamic financial system underscores the importance of financial discipline to avoid losses and promote market stability. An Islamic bank acts as an agent on behalf of depositors to invest their money and secure earning profits. In contrast, management of conventional banks represents owners who are interested in maximising profits. Discipline in the Islamic economy is guided by ethical considerations driven by the teaching of the *sharī'ah*. Investment through Islamic banks requires creation of economic activities using the society's real resources. In this respect, the ultimate objective of Islamic banks is to enable society to become more productive. In the Islamic economy, capital is a product of production itself and should not be treated as a separate factor of production earning interest. It is the effort of the entrepreneur that uses capital goods to create value by managing,

organising and supervising the enterprise. Islamic finance operates on the basis of profit/loss (P/L) reflecting the fact that in real life both profit and risk must be accounted for. Excluding risk from investment activities means providing protection for capital-owners at the expense of the rest of the society.

By operating on the basis of profit loss sharing (PLS) principle, the Islamic banking system exhibits greater financial and economic stability. Market risk is largely explained in relation to interest variation absent from the Islamic economy. Western economies are sensitive to financial variables, mainly interest rates, which usually spill over into the rest of the economy impacting income, prices, government revenues and expenditures, and employment. Earnings income in the Islamic economy must be created through work using factors inputs including labour and land. Money is useful if it is converted into physical capital through business activities. Capital providers earn a fixed share in the profit of the enterprise if the project is successful in earning profits.¹⁰

Sharī'ah* Compliance and the Prohibition of *Ribā

Being driven by religious codes and ethical principles, the Islamic financial institutions act as an economic agent on behalf the community. Depositors in Islamic banks are shareholders entitled to dividends obtained from profits and not income earned from interest. In other words, ownership of Islamic banks belongs to a large number of people and not to individuals or private enterprises. In an Islamic state, this implies that Islamic banks are owned by the community which makes decisions that serve the entire community instead of a few owners. Decisions and policies by Islamic banks support investment for promoting human development and meeting people's basic needs, involving investment not only in physical production, but also in knowledge creation, information dissemination, health care, water and environmental management. This implies that the Islamic financial institutions represent an integral element of the whole society and, therefore, their interest will be linked to the development of the society. In addition, Islamic banks collect the *zakāh* – the obligatory Muslim 'alms tax', one of the 'five pillars' of Islam – and give to charities for helping members with disabilities, the poor and the needy. The prohibition of interest in Islam is due to social and economic considerations to promote justice and prevent discrimination.¹¹

Islam provides comprehensive guidelines regulating how life is organised. Islamic banks bear great responsibility for promoting development in a Muslim society. Islamic banks are financial agents working on behalf of the public as partners sharing profits and incurring losses. In this respect, as shareholders, depositors of Islamic banks in principle authorise the bank to invest their money on their behalf in compliance with the *sharī'ah*. When an individual saves, his saving gives rise

to creation of an asset or a debt. But, as a rule, he has no power to decide which it will be. Conventional banks are lenders providing loans for investors in return for interest. Unfair and unjustified trading is rejected by Islam owing to the prohibition of harmful and non-productive activities in the Islamic economy. Risk is part of life and not taking risk violates *sharī'ah* principles. However, investors must be aware of risk and act to minimise the risk. For investors, risk is an opportunity to make profit and also a problem related to potential losses. In the Islamic economy, the financial system operates on the basis of profit-and-loss sharing (PLS) by sharing both profit and risk among partners. In contrast, conventional finance does not subscribe to such investment principles by eliminating risk from depositors. In other words, capital owners are exempted from risk taking by earning guaranteed income in interest payment. This gives rise to redistribution of resources in favour of capital owners at the expense of investors.

In an Islamic economy, the task of the banking system is to ensure wealth creation to sustain living. Consumption largely depends on income earned from work and not borrowed money. The celebrated medieval Muslim scholar Abū Hāmid al-Ghazālī (d. 1111) was of the view that knowledge and action are the two important features of an individual in society.¹² In modern economies, mismanagement or misuse of money can have devastating impacts on human development causing poverty, social problems and political intolerance. Meeting the basic needs becomes essential for social equilibrium. Banks are supposed to contribute to socio-economic stability by allocating investment resources for meeting the society's basic needs. Bad governance and unethical practices by corporations have been among the main characteristics which governed the corporate world under capitalism. Without ethical guidelines, the society can no longer afford to promote justice and equity.

Islam makes it clear that *ribā* is prohibited, and, therefore, all financial transactions in the Islamic economy must refrain from dealing with *ribā*. It refers to the access amount above the principals charged by individuals or financial institutions. Although the prohibition of *ribā* has been interpreted differently by Islamic scholars and various schools of Islamic jurisprudence (*fiqh*), the most important argument, perhaps, is its violation of the principles of social justice. All forms of injustices, exploitations and inequalities violate the *sharī'ah* teachings and, therefore, Islam condemns those who practise *ribā*. Historically, the prohibition of interest goes to the era before Islam where the Old Testament considered usury as a sin that must be avoided. However, in modern economics, interest represents a cost of borrowing money. Interest impacts the level of economic activities by influencing investment, income and employment. Higher interest rates will have an adverse impact on investment expenditure by discouraging people from investment in productive activities. Central banks usually interfere to manipulate the economy by reducing interest rates and provide incentives for investment in the economy.

In addition, in countries where national debt accounts for a high percentage of GDP, serving the debt through interest payments has brought the economies of these countries close to collapse. In the last two decades, Argentina, Mexico, Russia, the least developed and some Asian countries suffered from shortages of liquidity for serving their debt. A yearly transfer of billions of dollars from poor to rich countries to service interest payments implies that the poor people are feeding the rich. This implies that a large share of output produced in developing countries is used to serve the debt instead of being used as investment to alleviate poverty and promote human development. Globally, high debt reduces a nation's capacity to import which, in turn, spurs global recessions by reducing demand for goods and services traded in global markets. Under such circumstances, conventional banks become exploitative by linking lending and investment to interest rates. This is, in contrast, to non-interest banking systems, which disallow interest payment on investments in order to preserve market competition and provide equal opportunity to all individuals. Market imperfections usually discriminate against the poor, non-owners of capital, unprivileged groups, minorities and women. Thus, following the *shari'ah* guidelines could restore equity and justice by imposing ethical and moral restrictions on business activities to preserve human rights and increase *falāh*, which is the Islamic term for 'success' (especially from self-improvement), 'happiness' and 'well-being'. According to Ziauddin Ahmad,

[i]t has been pointed out that interest based on debt financing is a major factor in causing economic instability in capitalist economies. It is easy to see, for example, how the interest based system intensifies business recessions. As soon as banks find that business concerns are beginning to incur losses, they reduce assistance and call back loans, as a result of which some firms have to close down. This increases unemployment resulting in future reduction in demand, and the infection spreads. Islamic banks, on the other hand, are prepared to share in losses which reduce the severity of business recession and enable the productive enterprises to tide over the difficult periods without a shut down. Islamic banking has, therefore, to be regarded as a promoter of stability rather than a conduit of instability.¹³

The Concept of Money and Investment in Islam

Investment in the Islamic economy must meet society's objectives to satisfy people's basic needs. In Islam, production of luxury comes after the essentials are met to combat poverty and preserve man's divinity. Monopoly and concentration of wealth in the hands of a few are against the Islamic justice system. It is through work that man is supposed to earn income and accumulate wealth and not through earning income from investment in interest. Investment in Islam comprises both risk taking

and earning profit. In other words, earning profits alone cannot be justified unless suppliers of capital agree to accept losses. The tendency to accept risk has redistribution effects by preventing wealth from being concentrated in a few wealthy individuals. In contrast, earning interest has opposite effects on income distribution where owners of capital enjoy earning income for no risk being taken. This is perhaps one of the justifications of prohibiting *ribā* in Islam. Productive investment requires creation of physical assets which add value to society's output.

Economic activities involve allocation of resources including labour to ensure job creation and induce rapid economic growth. The Islamic banking system facilitates such activities by providing loans that guarantee productive investment for maximising the society's material wealth. Unlike conventional banks, Islamic banks do not necessarily maximise profits; rather, social welfare is their ultimate objective. Thus having money change hands without creation of an asset is not acceptable from an Islamic point of view. The Islamic economic system advocates building a society aiming at achieving *falāḥ* or success in both this life and the hereafter. According to Hasanuzzaman, "[f]alāḥ as an all-embracing concept provides a motivation to behave properly".¹⁴

The role of money in the Islamic economy is to stimulate market demand in order to sustain employment and growth. The Qur'ān condemns those who hoard money because of the negative effects of hoarding on circulation and, hence, on production. In modern economies, circulation of money plays a stimulating role in economic activities providing incentives for investment and demand for production. Money usually enlarges the economy's capacity to produce goods and services leading to employment of resources including labour. In conventional finance, money is treated as a commodity bought and sold at a specified interest payment. Here, interest is a price for the use of money paid either to the depositors or borrowers. In other words, the return on investment is measured in the amount of interest paid which also represents the profit of an entrepreneur. Since interest is prohibited according to the *sharī'ah*, money can only be useful if reinvested in the creation of real assets. That is to say, money cannot create wealth without creating assets. The latest financial crisis in the west is a product of this kind of transaction where banks driven by earning money opted for investing in the paper rather than in the real economy. This, in turn, has inflated the market by creating huge financial debt that was not possible to serve. Easy lending policies and lack of transparency led banks to offer large sums of money to people with little or no collateral. Lax credit terms provided by lending institutions opened the door for borrowers to divert funds to consumer purposes instead of retaining home or equity investment in productive sectors of the real economy.¹⁵

An increase in the amount of money above the optimum needed for buying the output produced causes inflation instead of increasing output. In recent years, in Gulf

countries, increases in oil prices led to increases in liquidity causing demand for goods and services to increase sharply. Along with speculation, rising demand led prices to go up impacting the value of money and the cost of living. In small economies, the productive capacity of the economy is limited and, therefore, increases in the quantity of money will affect prices more than stimulating production.

Islamic investment is equity financing based on pooling money obtained through depositors used mainly for the creation of real economic activities. Under such circumstances, banks must be extra careful in making loans to minimise risk and protect depositors' money. Lending by banks requires careful assessments to make sure that any investment contributes to the interest of both depositors and society. Default on payment of principal is likely to be reduced under equity financing owing to the fact that losses are shared by all partners. In Islam, income from trade is allowed owing to the labour contents in its production whereas income from interest is prohibited because it is not related to engagement of labour. In trade, market transactions usually include physical products traded among buyers and sellers, the reward of which is profit. Payment of interest does not involve usage of labour but only time which covers the period until the principal is paid back. Here the reward is not paid for any good or service being created in the economy. Furthermore, in trade there is a risk to be considered which comes in the form of potential loss of capital or other circumstances that are beyond the power of investors. According to one scholar,

[e]very economy, sooner or later, is likely to reach a point where it becomes unprofitable to extend or undertake new investment without reducing the rate of interest to a very low level approaching zero. This is most likely to be experienced in the modern rich and industrialized countries where the opportunities for investment gradually become scarce. And as marginal efficiency of capital comes down to the level of the rate of interest, future production of capital assets is not undertaken. Under these circumstances, it is absolutely necessary to lower the rate of interest (probably to zero) in order to stimulate investment, otherwise the country will be impoverished.¹⁶

In response to the global crisis, Islamic finance provides greater protection. As Umer Chapra argues, Islamic finance minimises the impact of crisis:

It introduces greater discipline into the financial system by requiring the financier to share in the risk. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and processes, and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby, ensuring that he evaluates the risk more carefully.¹⁷

In conventional banks suppliers of capital earn profits but without taking risk. In contrast, investors who are willing to take risk will be left at the mercy of the market earning little or no profit at all. Suppliers of capital usually get fixed return in interest payments. The entrepreneur usually does most of the work including providing managerial and organisational skills. Such investment practices create inequalities by favouring those with capital leading to concentration of wealth in the hands of a few. In developing countries, including Muslim nations, interest rates could discourage investment in high priority projects even though these projects might be of high value to socio-economic development of the society. In the case of borrowing, interest rates represent costs which investors must pay before making profit. Producers usually pass the increase in cost to consumers causing prices to go up:

The right approach, therefore, will be to study modern banking separating out the good things in the system and finding ways and means to benefit from it without involving interest. We can adopt such useful and good things like the organizational, managerial and structural side of banking while leaving the evils of the system, like the unsocial and harmful practices of interest, speculative dealings and profiteering to others.¹⁸

As an alternative to interest, investment in the Islamic economy constitutes several forms of investment including *muḍārabah*, *mushārah*, *murābahah* (sale of goods at a price, which includes a profit margin agreed to by both parties), *bayʿ al-salam* (contract of deferred delivery), *istisnāʿ* (a contract of exchange with deferred delivery, applied to specified made-to-order items), and *ijārah* (selling benefit or use or service for a fixed price or wage) among others. Islam is against interest payment encouraging in return investment in trade and business activities. In other words, loans granted by the banking system must be invested in the real sectors creating goods and services. Such will lessen the impact of speculations and cyclical fluctuations in financial markets on the rest of the economy. The current financial crisis is spilling over into the local economies both locally and globally. These modes of financing provide mechanisms for allocation of resources on the basis of profit and loss sharing principles. As an intermediary, the Islamic banking system provides depositors with several choices to invest their money. However, most investment according to the Islamic modes of finance requires both capital and labour to be shared by all parties involved in investment, and, therefore, risk will be shared by everybody in the partnership. Unlike conventional finance where the return on investment is known in advance, in Islamic finance, profit will only be known after completion of the project and realisation of profit. On the other hand, the risk in Islamic banks is expected to be less than in conventional banking owing to the partnership between capital providers, or depositors and investors. Investment in the Islamic economy is based on equity financing by pooling depositors' funds to finance

projects. Most modes of financing in Islamic financial markets and institutions exhibit short-term financing, mainly *murābahah*, *ijārah* and *muḍārabah* financing, which makes risk in Islamic financial institutions more diversified instead of being subject to interest payments alone.

In the Islamic economy, the voluntary sector plays an important role in stimulating aggregate demand and enhancing growth potential. Unlike the conventional economy, Muslims voluntarily spend in the forms of *zakāh*, *awqāf* (inalienable religious endowment; plur. of *waqf*), charity, and spending in the way of Allāh to build mosques, hospitals and schools. Such expenditures help the economy to generate linkages and stimulate demand.

Money in the Islamic economy is a means to facilitate transactions. The role of money is to serve as a medium of exchange and unit of account but not as a store of value. The Qur'ān, for example, rejects hoarding to ensure that money remains in circulation serving the economy. In modern economics, interest is paid for those who are willing to sacrifice present consumption with future consumption by saving their money. The income paid to savers cannot be justified owing to the fact that the money was earned for no work being done and, in addition, it brings no added value to the economy's output. Without employment of resources, investment in the Islamic economy cannot be justified.¹⁹ Even depositing money in a bank may not justify that investment will be taking place because the individual saver has no say in what his/her money will be used for.

Conclusion and Recommendations

In this article, an overview of the relationship between Islamic finance and the global financial crisis has been introduced. The Islamic banking services system, despite its young history, has grown rapidly in recent years reflecting rising market demand both in Muslim and non-Muslim countries. Operations and activities of Islamic financial institutions follow religious guidelines imposed by the *sharī'ah* teachings. Islam advocates individual freedom and promotes social justice to ensure social *ḥalāl*. Violation of these principles amounts to immoral and unethical practices which usually create imbalances within society. The Islamic financial system is an integral element of the Islamic way of life which exhibits individual rights, social and economic justice, prohibition of *ribā* and environmental degradation. The social orientation of Islamic investment highlights the importance of allocation of resources in favour of the public interest instead of individual monopolistic control over resources.

The global financial crisis has brought a lack of confidence in the global financial system under capitalism. Market freedom has strengthened the position of monopolies and individual control over financial institutions to enrich a few

people and corporations at the expense of society. Owing to lack of supervision and weak government regulations, the banking system was able to manipulate the financial system and divert huge sums of money to serve special interest groups. In contrast, limited freedom under the *sharī'ah* principles has imposed ethical and moral constraints on financial activities in the Islamic financial system. It is the service of the community that must come first under the Islamic financial system by facilitating growth through the creation of real output. Investors share not only profits but they also share the risk. In the Islamic economy, investment adds economic value measured in terms of increase in output and employment opportunities. Keeping money in the bank generates income without work providing capital owners secured profits. Islam rejects the payment of a predetermined fixed amount on bank deposits because of its violation of the principles of justice. Thus, providing credit according to the Islamic *sharī'ah* must be linked to sustaining socio-economic development and enhancing human well-beings. Sharing profits and losses benefits both borrowers and lenders through risk reduction and equity in income distribution. In Islamic finance, lenders and borrowers are partners working for their own interest.

There are still several challenges facing Islamic banking and finance that need to be overcome in order to increase global competitiveness. The time perhaps is suitable for these institutions to strengthen their global position by providing alternative financial services driven by innovation and development of new products. The global financial crisis is a product of institutions driven by serving the interest of owners of capital with little or no attention paid to human development. Investment according to Islamic finance is human centred the benefit of which will be to the entire society. In addition, being in compliance with the *sharī'ah*, investment has to be guided by ethical principles.

Notes

1. For details about the impact of higher oil prices on global liquidity see Amer Al-Roubaie, "The Impact of Higher Oil Prices on Global Liquidity", *Al-Shajarah: The Journal of the International Institute of Islamic Thought and Civilization* [ISTAC, Kuala Lumpur] 13, no. 12 (2008), 142–78.
2. *International Herald Tribune*, 18 August 2008.
3. See Dave Lindorff, "The Ugly Truth: The American Economy is Not Coming Back", *Counterpunch* (30 January–1 February 2009), available online at <http://www.counterpunch.org/lindorff01302009.html> (accessed on 4 August 2009).
4. See "The Real Reason for the Global Financial Crisis: The Story No One's Talking About", *The Market Oracle*, 18 September 2008, available online at <http://www.marketoracle.co.uk/Article6335.html> (accessed on 4 August 2009).
5. *Ibid.*
6. Roger Leroy Miller, *Economics Today* (Boston: Addison-Wesley, 2009, 15th ed.), 9–10.
7. *International Herald Tribune*, 18 August 2008.

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THE ROLE OF ADJUSTABLE-RATE SUBPRIME MORTGAGES AND CREDIT DEFAULT SWAPS IN THE GLOBAL FINANCIAL CRISIS

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Abstract: This study focuses on three key areas where excessive risk taking created systemic vulnerabilities and thus contributed to the current crisis. The first was the awarding of high-risk adjustable-rate subprime mortgages to people with limited abilities to pay them back. The second was using the same high-risk mortgages as collateral for new borrowings in the form of mortgage-backed securities (MBSs) and 'collateralised debt obligations' (CDOs). If the subprime mortgages defaulted, the securities funded by those mortgages would also default. The third area where excessive risk taking took place was in the trading in credit default swaps, essentially unregulated insurance on debt. Trading in 'naked' credit default swaps, in particular, added considerably more risk to an overleveraged system by significantly magnifying potential liabilities especially for providers of insurance who did not hedge their sales.

Introduction

The current financial crisis has adversely affected output, employment, income, pensions, savings and the quality of life. Many people have become jobless and many families homeless. Consumer spending – a key driver of economic activity – slowed down. As one observer has it:

Between 1 January and 11 October 2008, owners of stocks in U.S. corporations had suffered about \$8 trillion in losses, as their holdings declined in value from \$20 trillion to \$12 trillion. Pensions invested in share market lost approximately a third of their value. Losses in other countries have averaged about 40%.¹

The global banking system has recorded write-downs of more than US\$2 trillion.² The crisis exposed a range of weaknesses within the regulatory framework of the financial system. There is a need for better crisis management and for restructuring the regulatory framework governing trading in the financial system.

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As the current crisis started in the United States, any analysis of what led up to it and how it can be avoided in the future must begin, although not necessarily end, in America. Factors that contributed to the current crisis included excess liquidity in the US financial system, resulting in excessively low interest rates,³ delay by the then Chairman of the Federal Reserve, Alan Greenspan, in containing growing bubbles in the credit and housing markets, the US government policy of promoting house ownership among those who could ill afford it, legislative changes that led to lax lending standards and predatory lending practices, failure by some brokers to alert borrowers to the high risks of adjustable rate mortgages, excessive lending by financial institutions, excessive borrowing by consumers, businesses and governments, misleading or inaccurate assessments of the quality of securities by rating agencies, conflicts of interest,⁴ high levels of personal, corporate and government debt, misalignment of the interests of company executives and shareholders, absence of legislation separating investment and commercial banking, and excessive speculation, particularly in the form of trading in 'naked' credit default swaps (CDS). Risk also increased dramatically as a result of excessive leveraging (borrowing).

One important issue that needs to be addressed is whether debt can with justice serve as collateral for other debt. A substantial degree of risk exists about the quality of collateral in the form of debt. The collapse in the values of financial assets (mortgage-backed securities) was caused directly by the collapse in the value of the collateral backing them, subprime mortgages. This supports the view that it is risky to borrow against weak collateral such as subprime mortgages.

Deregulation

'Regular' means 'stable' and 'predictable'. Compliance with good regulations makes life more secure. Regulation draws the line between the permitted and the prohibited, between what is acceptable and what is unacceptable. Good regulation reduces uncertainty and promotes predictable behaviour in social interaction. Some feel that there should be few restraints on freedom. Since rules restrict freedom, regulations should be kept to the minimum. It is clear, however, that without regulations, inclusive of laws, humanity would fall into confusion, anarchy, and chaos.

Since 1993 commercial banks in America have provided only 20 per cent of all net lending, with the balance being provided by the 'over-the-counter' (OTC) or 'shadow' banking system.⁵ The OTC financial derivatives market is currently valued at approximately US\$600 trillion. Interest rate swaps amount to US\$400 trillion, credit default swaps make up approximately US\$62 trillion, and equity derivatives amount to US\$8 trillion.⁶ The total amount of debt in the world, by contrast, is about US\$39 trillion. Global GDP is approximately US\$55 trillion.⁷

Deregulation added a great deal of uncertainty to an already opaque OTC market. In 1999, under pressure from representatives of the financial industry, President Bill Clinton repealed the Glass–Steagall Act, originally passed in 1933. “In retrospect,” Paul Krugman observed, “this was surely a move in the wrong direction.”⁸ The Act separated less risky commercial banking, from the higher risk, unregulated investment banking. Prior to its repeal, the Act prohibited investment banks from taking deposits and making housing loans. Deposits in investment banks, unlike deposits in commercial banks, were not insured by the government. Commercial banks, unlike investment banks, could not sell insurance or borrow by selling bonds. Under the Act, investment banks were not able to borrow emergency funds from the newly established Federal Reserve, using its so-called ‘discount window’, a facility available to commercial banks. In 2000, former president Bill Clinton signed into law the Commodity Futures Modernization Act, which effectively prevented the Commodity Futures Trading Commission (CFTC) from asserting any authority over the ‘shadow’ over-the-counter banking system. The Financial Industry Regulatory Authority (Finra) left the over-the-counter market unregulated on the grounds that “bankers could be trusted to regulate themselves”. The argument that freedom is necessary for innovation carried the day. Privately owned credit rating agencies such as Standard and Poor’s – paid by the same financial institutions they rate – failed to alert federal regulators to systemic risks developing in the industry. A number of rating agencies assigned an AAA rating, signifying investment grade, to securities that were collateralised to a substantial degree by risky subprime mortgages.

The OTC or ‘over-the-counter’ banking system is made up mainly of hedge funds, pension funds, insurance companies, and investment banks. The OTC or ‘shadow banking’ system performs functions similar to those of the conventional banking system yet remains largely unregulated. The absence of regulation in the informal, over-the-counter financial derivatives market, where trading parties deal directly with one another without any financial intermediaries such as clearing-houses or exchanges, allowed excessive risk taking to take place on a large scale. Taking on far too much debt in relation to shareholder funds overleveraged many companies. Bosses were paid for making their companies bigger, not necessarily better. Mergers and acquisitions were paid for in large part by borrowed money. Financial institutions took on excessive risks and, in the absence of regulations, made commitments they were eventually unable to meet.

Financial derivatives, securities whose value depends on the value of another asset, generate enormous profits on Wall Street but remain opaque to investors. This opaqueness, due in part to the inherent complexity of these instruments, dramatically increased uncertainty. Leading financial derivatives expert Satyajit Dass observed:

It is not clear why increasingly complex and opaque products are needed other than to increase risk and leverage as well as circumvent investment restrictions, bank capital rules, securities and tax legislation [...]. The unpalatable reality that few, self interested industry participants are prepared to admit is that much of what passes for financial innovation is specifically designed to conceal risk, obfuscate investors and reduce transparency. The process is entirely deliberate. Efficiency and transparency is not consistent with the high profit margins on Wall Street and the City. Financial products need to be opaque and priced inefficiently to produce excessive profits.⁹

In the OTC market, no third party, such as a clearinghouse or an exchange, regulates transactions between counterparties. There were no minimum capital, margin or reporting requirements. There were no limits on the positions insurance companies, hedge funds, mutual funds, and investment banks could take. No lender of last resort was available. There was no way to know the extent of exposure to liabilities, or the degree of leverage (debt), taken on by financial institutions. It was not possible to know whether parties that entered contracts could honour them if and when called upon to do so. Excessive deregulation¹⁰ increased uncertainty. Warren Buffett described financial derivatives, traded in the OTC market, as “financial weapons of mass destruction”.¹¹

High-Interest Adjustable-Rate Subprime Mortgages

Between 1997 and 2006, prices of many properties in the US almost doubled. Due in part to rising house prices, beginning in 2001, an increasing number of ‘subprime mortgages’ were extended to lower income Americans. Many bought houses with the intention of reselling them at higher prices. According to one observer,

[b]etween 2000 and 2007, underwriters of subprime mortgage-backed securities – primarily Wall Street and European investment banks – poured \$2.1 trillion into the (subprime) business.¹²

Subprime mortgages were first mooted in the 1980s, but until 1994 they comprised only 5 per cent of all housing mortgages.¹³ Because of poor or undocumented credit history of the borrowers, and the higher risk of non-repayment, interest rates on ‘subprime’ mortgages are higher than on ‘prime’ mortgages. A subprime mortgage is therefore more expensive to the borrower than a ‘prime’ mortgage. For the same reason, it is also more profitable to the lender.

Mortgage companies lent money on a large scale, with houses serving as collateral. Lenders waived down-payment requirements. Some mortgages required payment of interest only. Other mortgages gave borrowers the option to pay even less than the interest owing, resulting in ‘negative amortisation’, where the total

amount owed increased with time. There was poor or inaccurate risk assessment. Subprime customers did not need to show proof of job or income and often did not document having any assets. They were known as *ninjas*: no income no job applicants. Quantity of loans took precedence over quality. Lax lending practices significantly increased the uncertainty surrounding the borrowers' ability to pay back subprime loans. It would prove even more risky to use 'receivables' in the form of mortgage payments as collateral for new borrowing.

Pay practices (commissions) rewarded brokers for selling a particularly risky type of loan, the adjustable rate mortgage (ARM). A distinguishing feature of this mortgage is that the interest rate on it is variable over the lifetime of the loan. The adjustable rate mortgages enable lenders to pass risk – the risk of sudden and large increases in interest rates – on to borrowers. Typically, adjustable rate mortgages begin by offering low rates of interest. 'Teaser' rates, even lower than the initial rates, are regularly offered in the very short term (up to one year), to provide an additional incentive to people to borrow.¹⁴ Such terms make the mortgages appear inexpensive, at least in the short term. Mortgages that were cheap in the short run, however, turned out to be expensive in the long run. After one, three or five years, however, the interest rates on the adjustable rate mortgages are 'reset', often at *significantly higher* rates. By February 2007, there were 7.5 million subprime mortgages outstanding in the United States.¹⁵ Eighty per cent of these were adjustable rate mortgages.¹⁶ Ironically, subprime mortgages were extended even to people who qualified for prime mortgages.

A number of ordinary borrowers did not understand the terms of their mortgages. They were particularly vulnerable to predatory lending practices. Some failed to exercise due diligence and read the fine print. Many assumed that housing prices would keep rising indefinitely. Few expected a collapse in housing prices. The pattern was one of a classic boom and bust.

Due to rising interest rates and overbuilding, the housing boom in the United States began to slow in the fall of 2005. After reaching a 50-year low of 1 per cent in 2004, with inflationary pressures rising in the share, housing and credit markets, interest rates started increasing from June 2004. They reached a 27-year high of 5.25 per cent in 2007, bursting the housing bubble. This triggered a freeze in lending. Rising unemployment compounded the problems for many borrowers. As interest rates rose, the rates on adjustable rate mortgages were 'reset' at higher levels. A growing number of house buyers who purchased houses using these mortgages could not, after initial easy payment terms expired, meet the much higher monthly mortgage payments, experiencing 'payment shock'. Many fell behind and defaulted on their mortgage payments. Due to falling house prices, they could not refinance their mortgages. In many cases, the value of the loan exceeded the value of the house, leaving homeowners with negative equity. Many borrowers simply walked

away from their homes. At the end of 2008, more than 8 million homeowners, one in five mortgage holders, owed more than their house was worth.¹⁷ Foreclosures increased sharply, adding to the existing glut of houses, further depressing their prices. In 2007, 1.3 million US properties were foreclosed, an increase of 79 per cent from 2006.¹⁸ In 2008, 2.4 million properties were foreclosed in the US. The number of properties projected to foreclose in 2009 is in excess of 3 million.

The adjustable rate mortgages cannot be justified for two reasons. Not only because *high* interest rates are (sooner or later) charged on such mortgages, but also because the rates on such mortgages are variable and therefore unknown to both parties. A change in interest rates effectively changes the terms of the contract. Neither the borrower nor the lender knows in advance what rate he or she will have to pay or receive later. This allows a high degree of risk about the future cost (interest) of the loan to enter into the transaction.

Should interest rates rise dramatically, lenders stand to make a windfall, but borrowers face a heavier burden. Millions of families lost their homes due to foreclosures after being unable to pay much higher monthly mortgage payments on their adjustable rate mortgages, which became effective after their mortgages were ‘reset’ at prevailing rates, which turned out to be significantly higher than the original rates. When interest rates on an adjustable rate mortgage increased, the monthly payments in many cases *doubled or more than doubled*.

Securitisation

Securitisation is a way of borrowing by selling securities backed by assets in the form of receivables, such as subprime mortgages. Securitisation started in the mid 1980s. It has been carried out mainly by government-sponsored enterprises such as Freddie Mac (Federal Home Loan Mortgage Corporation) and Fannie Mae (Federal National Mortgage Association),¹⁹ investment banks and hedge funds.

Mortgages extended by finance companies – the originators – were first sold to ‘special purpose vehicles’ (SPVs), sponsored by private investment banks or hedge funds, or ‘government-sponsored enterprises’ (GSOs) such as Freddie Mac or Fannie Mae. The SPVs and GSOs then issued bonds (effectively borrowed more capital) collateralised by the ‘pooled’ mortgages. Bonds collateralised by mortgages are known as mortgage bonds or mortgage-backed securities (MBSs). With the funds obtained by selling mortgages, mortgage-originating companies were able to extend additional mortgages. With the sale of mortgage bonds, Freddie and Fannie were able to raise additional funds to buy still more mortgages and issue more mortgage bonds. The demand for mortgage-backed securities was strong. From 1996 to 2007, the amount of MBSs issued nearly tripled to US\$7.3 trillion.²⁰ Before being taken over by the US government, Freddie and Fannie between them had guaranteed or

underwritten US\$4.8 trillion of mortgages, with the rest being underwritten by private institutions.²¹

Freddie and Fannie typically sold the 'mortgage bonds' to investment banks, which resold many of the MBSs to institutional investors, either directly or in a repackaged form, where they were 'pooled' once again with other loans of varying quality, to form highly structured securities known as 'collateralised debt obligations'. CDOs are similar to MBSs, except that while the portfolios for MBSs are invariably made up of mortgages, the portfolios of CDOs typically include not only mortgage bonds but also real estate loans, auto loans, students loans, leases, credit card receivables, corporate bonds, and even parts of previously issued CDOs. Nevertheless, residential mortgages made up approximately 40 per cent of the collateral of CDOs, with subprime and second mortgages making up the bulk of these. A typical CDO is collateralised and funded by between 20 to 500 loans.²²

While hardly any CDOs were issued in 1995, by 2006 the amount of capital raised by selling CDOs reached US\$500 billion.²³ Securitised debt surpassed bank lending for the first time in 1998.²⁴ Between 1980 and 2008, securitised debt increased 50 fold, compared to a 3.7 fold increase in bank loans. During the same period, approximately US\$8.7 trillion worth of assets worldwide has been funded through securitisation.²⁵ Securitisation contributed to a significant expansion of credit and fuelled the bubble in the housing market.

When borrowers defaulted on subprime mortgages, triggering the credit crunch, the value of the mortgage-backed securities dropped dramatically, in some cases by as much as 90 per cent.²⁶ An overwhelming proportion of CDOs turned out to be toxic (illiquid). No one in the private sector wanted to buy them, especially as it was also becoming clear that insurance 'covering' CDOs in the form of CDSs (credit default swaps), in a large number of cases would not materialise. Insurance companies such as AIG sold CDSs on a large scale without setting aside sufficient reserves, and without hedging their sales by purchases of insurance from other sellers of CDSs. They left themselves vastly exposed to liabilities.

Mortgage companies, government sponsored enterprises, investment banks, commercial banks, hedge funds, and insurance companies on several continents were affected by the collapse in the prices of MBSs and CDOs. Financial institutions in America, Europe, and Asia, found themselves with large amounts of bonds (debt) at significantly marked down values. Few institutions were spared. According to the *Financial Times*, as of February 2009, in the United Kingdom alone "about \$305bn of the CDOs are now in a formal state of default".²⁷ Some institutional investors complained that they were not sufficiently warned about the risks inherent in the complex instruments sold to them by investment banks. Buyers of CDOs have since launched lawsuits alleging misrepresentation, if not outright fraud and

deception.²⁸ A number of subprime lenders “were forced to pay billions of dollars to settle government charges of abusive or predatory lending practices”.²⁹

Credit Default Swaps and the Risks of Unregulated Insurance

The growth in subprime mortgages was fuelled by a massive growth in credit default swaps, in effect unregulated insurance for debt, in the form of MBSs and CDOs.

A credit default swap (CDS) is a contract between two parties, normally arranged over the telephone or by instant messaging, to insure a loan or a bond, typically for a period of five years. Trades were sometimes recorded on scraps of paper.³⁰ A party entering the contract, such as an investment bank, pays an initial payment plus quarterly premiums to the insurer. The seller of a credit default swap agrees to compensate the buyer for the face value of the bond in exchange for the bond (or cash equivalent) in case the issuer of the bond experiences a ‘credit event’, such as a bankruptcy filing, a default on a payment, a restructuring, or a downgrading. Unlike conventional insurance policies, the CDS is marketable. Its price rises and falls with the risk of default by the underlying security. It is relatively inexpensive to insure a CDO that is unlikely to default. The premiums that buyers of insurance have to pay, however, rise with the risk of default. CDSs were excluded from the definition of ‘securities’, and were therefore outside of the jurisdiction of the SEC, the Securities and Exchange Commission. They were not subject to any securities laws, and it was not mandatory to trade them on any exchange or clearinghouse. CDSs were not considered ‘insurance’ either, and thus were not subject to any legislation governing the insurance business. Sellers of CDSs thus were not required to set aside any reserves against potential claims.

The credit default swap has been the single fastest growing financial derivative. The market for CDSs grew from US\$900 billion in 2000 to the notional value of US\$62 trillion at the end of 2008, an amount nearly ten times the US national debt, with a fair value of US\$2 trillion.³¹ Five top US banks, JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley together traded 96 per cent of all credit default swaps.³² In many cases, institutions that invested in MBSs and CDOs bought and sold insurance not only for the securities they possessed but also on securities they did not possess. This type of CDS is known as a ‘naked’ CDS.

Initially, this market [for CDSs] was intended to make hedging a corporate bond position easier. But speculators who don’t hold bonds now dominate the market, using the swaps instead to wager on a company’s health or the prospects of a securities portfolio. In Wall Street parlance, these investors would be characterized as trading the contracts ‘uncovered’ or ‘naked.’³³

Unlike in conventional insurance, *the buyer of a naked swap does not have an interest in protecting the asset being insured* by the swap. On the contrary, the buyer of the naked swap can gain (collect a payout) *only if* the asset for which he bought insurance is destroyed or damaged.

Buying naked swaps resembles 'naked' short selling, where speculators sell shares they neither own nor have borrowed, in the hope of buying them back at a lower price in future, delivering them to the buyers, and pocketing the difference between the (higher) selling price and the (lower) buying price. Naked short selling has been banned in some countries, notably New Zealand.

Buying insurance for an asset that one possesses is understandable, and can be thought of as 'hedging' or protecting against loss. But buying insurance for an asset that belongs to someone other than the party buying the insurance cannot be considered 'hedging', as it is *not* done with the intention of protecting oneself or one's property against loss. On the contrary, if the asset remains safe, the buyer of insurance (who does not own the asset being insured) stands to *lose* money (premium payments). Far from protecting against loss, the intention in buying 'naked' swaps is to *benefit* – from someone else's loss. A person buying insurance should have an interest in the asset being insured. Because buyers of naked swaps do not have an interest in the asset being insured, it is difficult to justify naked swaps as 'insurance'. Accordingly, some have called for a ban on all swaps while others called for a ban only on naked swaps.³⁴

Trading in naked swaps is closer to *betting* than it is to hedging. The party selling naked swaps is *betting* that it will never have to pay compensation for the asset being insured, while the party buying naked swaps is *betting* that the asset will suffer a 'credit event', which will trigger a payout by the counterparty, the insurer.

Buyers of the naked swaps had much to gain if the subprime mortgages backing the insured CDOs defaulted. *Bona fide* buyers of swaps, who owned the securities insured by those swaps, could claim at most the amount they paid for the bonds, unless they bought multiple insurance contracts for the same bonds. Assuming they did not buy multiple contracts, their compensation in case of a payout would be equal to their loss. Overall, they would experience neither gain nor loss. The buyers of naked swaps, however, would experience a large gain in case of a payout, because they would collect the payout without suffering a major loss. The gain by buyers of naked swaps is thus greatly disproportionate to their 'loss', the initial 'investment', in the form of premium payments, as no asset in their possession was damaged or lost.

Trading in 'naked' default swaps explains why the total amount of insurance (CDSs) far exceeded the total value of bonds being insured. According to Market Oracle, the 'naked' swaps comprised 89 per cent of the total of all swaps sold.³⁵ Ordinary swaps amounted to only 11 per cent of the total CDSs. In 2008 the total

notional (face) value of CDSs was US\$55 trillion. Yet the sum of all corporate debt was only US\$6 trillion. In other words, the amount of 'naked' CDSs amounted to US\$49 trillion. For every dollar of legitimate insurance there were 9 dollars' worth of excessive speculation. The excess of US\$49 trillion of naked swaps over the \$US6 trillion of legitimate swaps significantly magnified risks to the financial institutions that sold naked CDSs on a large scale, especially those, such as AIG, that did so without hedging their sales.

Passing liability for default on CDOs backed by subprime mortgages to others by buying default swaps was touted as a 'diversification' of risk. Far from diversifying risk, the proliferation of CDSs has, on the contrary, spread risk farther and wider throughout the global financial system. 'Naked' CDSs add risk that was not there before.

Financial institutions such as the insurer AIG, the biggest seller of the CDSs, were eager to sell this unregulated 'insurance', as initially they made enormous profits from collecting insurance premiums for securities they considered relatively risk-free.³⁶ As of 30 June 2008 AIG had written over US\$440 billion of CDSs on securities collateralised by residential mortgages, which significantly exposed it to the subprime crisis. When its securities were downgraded, AIG was faced with calls for collateral, which it could not meet. In addition, the interests of the shareholders of AIG were misaligned with the interests of executives. The chief of AIG Financial Products, which sold credit default swaps in very large quantities, received a 30 per cent commission from the profits earned by sales of CDSs. While he personally benefited from high commissions, at the same time his actions, together with the negligence of his superiors, bankrupted the world's biggest insurance company.³⁷ The US government rescued AIG four times, using a total of US\$182.5 billion of taxpayer funds.³⁸ Rescue efforts have put enormous demands on the US and other central banks, resulting in higher national debts, printing of money,³⁹ and inflation. Investors in subprime mortgages, such as the major banks, were bailed out using the government tax revenue. Profits remained private, but losses were socialised.⁴⁰

Investment or Speculation?

Securitisation was carried out by government sponsored enterprises (Freddie and Fannie), special purpose vehicles, and investment banks. The main investors in mortgage-backed securities were hedge funds, pension funds, and insurance companies. A large proportion of the funds raised by securitisation from the high-income group was channelled, ironically, to the lower income group, the subprime customers. Subprime loans, however, proved difficult to repay with low-paying jobs, and impossible to repay without any jobs, even more so after people's monthly mortgage payments increased dramatically as a result of increases in interest rates on adjustable

rate mortgages. The subprime crisis illustrated the failure of an unregulated financial system to allocate resources efficiently. What was needed was investment that generates jobs and income, investment that generates real wealth rather than just more indebtedness. Instead of what they needed most – jobs – the lower income group (and even jobless people) were offered *high interest subprime loans*.

As of July 2009 there were 14.5 million officially unemployed people in the United States, approximately 10 per cent of the work force. Real unemployment is likely to be substantially higher than this number. At the same time, there were 4 million unsold houses in the US.⁴¹ If each unsold house on average is worth \$US200,000, there is US\$800 billion of completed houses on the market for which there are no buyers. Assuming they can find jobs to provide them with the necessary income, a number of people would be in a position to buy some of the unsold houses.⁴² The fact that a substantial surplus of unsold houses exists alongside a large surplus of labour demonstrates the inability of a poorly regulated or unregulated economic system to utilise resources fully. Too many products (houses) were produced in one market, and too many resources remained idle in another market, the labour market. Investments by banks, hedge funds, and wealthy individuals did not provide what ordinary people needed most: jobs that provide income to meet basic needs, including the need for affordable housing. There was a shortage of venture capital and a surplus of speculative capital. Instead of channelling funds into investment that generates jobs and real wealth, financial institutions – left to themselves by government authorities – channelled billions of dollars of resources into unproductive, excessively speculative uses, aiming at quick and extraordinary profits while ignoring genuine human needs. Speculation, where wealth is merely transferred rather than created, took precedence over real investment. Clearly, strong incentives for real investment were lacking. It is the responsibility of governing authorities to provide a structure of incentives and disincentives to channel the flow of resources into productive uses, and to make it costly for resources to flow into unproductive, highly speculative uses. Regulation to prevent excessive speculation was lacking. Surplus funds were channelled into the *wrong uses*: excessive speculation on Wall Street rather than real investment on Main Street. This misallocation of resources reflects an unjustified emphasis on finance at the expense of economic activity. Wall Street by right should be at the service of Main Street, not *vice versa*. If any meaningful recovery and correction are to take place, real investment will have to receive priority over excessive speculation and extraordinary profit seeking. For this a change in thinking and operating procedure are required. It is necessary to provide incentives that value work, integrity, honesty and fair trade. Similarly, it is necessary to put in place a structure of disincentives for excessive speculation and extraordinary profit seeking. Society as a whole must

reject the ideology of greed currently driving Wall Street. Change in legislation is required to operationalise the change in thinking.

Wealthy people's money was lent to help poor people in America to buy homes. The reason it didn't work was because subprime borrowers could not pay the higher monthly mortgage payments that became effective when the Federal Reserve raised interest rates, triggering large increases in the monthly payments on adjustable subprime mortgages. Apart from deflating the share market and housing bubbles, higher mortgage payments forced millions of families out of their homes into apartments or homeless shelters. For many, the dream of owning a home turned into a nightmare. Surely there must be better ways to manage economic and financial activity. The regulatory superstructure governing financial and economic activity needs to be built upon ethical foundations.

Conclusions and Recommendations

Adjustable rate mortgages are highly risky to borrowers. Their terms are slanted heavily against borrowers (who bear most of the risk) and in favour of lenders. For this reason, adjustable rate mortgages should be banned altogether. Using weak collateral in the form of receivables from loans for new borrowings needs to be reviewed. A convincing definition needs to be developed for what constitutes acceptable collateral for issuing bonds. Strong collateral should reduce the risk of a collapse in financial asset values that we have seen in the current crisis. It is necessary to regulate trading in credit default swaps; either by means of clearing-houses or exchanges, and to proscribe trading in 'naked' swaps altogether. Price and volume transparency need to be enhanced.

As of 16 September 2009, the US government has "spent, lent or committed US\$12.8 trillion to revive the economy".⁴³ The safeguarding of the public interest requires protecting taxpayers from potentially catastrophic losses. Government rescues of private failure are paid for with taxpayer money, whether through loans, equity acquisitions, or higher prices as a result of the monetisation of losses. The first two add to the national debt while the latter results in inflation. It is necessary to ensure that public funds do not end up going to private bondholders and shareholders. The latter are ultimately responsible for the actions of the management of their company.⁴⁴ The principle 'no bailouts without representation' on boards of directors should be implemented as a matter of policy. Companies should not be allowed to become 'too big to fail'. Anti-monopoly legislation should be vigorously enforced. Government service needs to recruit persons committed to serve the interests of the people. It is necessary to educate public servants on the noble values of public service and prohibit conflicts of interest.

Policies need to be put in place that reward real investment and wealth creation in communities through job creation, and provide strong disincentives for excessive speculation aiming at quick and extraordinary profits. "It is lending which is required if our economy is to be revived; it was gambling that got our financial system into trouble."⁴⁵ Special interest groups, such as financial industry lobbies, have to be reined in by effective regulation and vigorous enforcement.⁴⁶ More importantly, a new way of thinking is required on the part of both corporate and political leaders, a moral and intellectual paradigm that encourages the creation of real wealth and discourages excessive speculation, and uses wealth for the purpose of meeting pressing needs such as the alleviation of poverty, overcoming of illiteracy, elimination of waste, respect for the environment, and a fair distribution of wealth and income.

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'CASH WAQF' AND ISLAMIC MICROFINANCE

UNTAPPED ECONOMIC OPPORTUNITIES

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Abstract: The success of microfinance programmes in alleviating poverty in many countries has spurred the development of faith-based microfinance institutions. Muslims have combined certain elements in Islamic finance and microfinance to create a new programme called 'Islamic microfinance' and use it as a tool to fight poverty in their community. Even though microfinance is proven successful in fighting poverty, current microfinance practised by commercial banks in Malaysia has several shortcomings. Current weaknesses include stringent credit evaluation and missing the real target group, i.e., the poor and the needy. Furthermore, the mode of financing is mostly personal loan using *bay' al-'inah*, whereby the use of the loan is to fulfil personal consumption instead of income-generating activities. Given these shortcomings, the article explores the possibility of using 'cash waqf' as a new source of funding for Islamic microfinance and proposes a new concept and application of Islamic microfinance so that it is truly in line with the Islamic spirit of microfinance. It is hoped that with this new concept and application of Islamic microfinance, the use of microfinance genuinely caters for the needs of the poor as well as generating socio-economic growth of the Muslim *ummah*.

Introduction

Poverty is one of the major problems faced by most of the developing countries. According to the Rural Poverty Report 2001,¹ there are 1.2 billion people who are extremely poor surviving on less than US\$1 a day. Extremely poor people spend more than half of their income to obtain (or produce) staple foods. Most of these people suffer from nutritional deficiencies, and many even suffer from hunger at certain times of the year. Moreover, within this community, one child in five will not live to see his or her fifth birthday.² Considering the importance of resolving the poverty problem, the United Nations announced the Millennium Development Goals. One of its aims is to reduce poverty to half by 2015.

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According to Yunus and Abed,³ microfinance is an effective tool to alleviate poverty. This argument has been proven by many researches⁴ and through the success of several microfinance programmes around the world, such as Grameen Bank in Bangladesh, Bank Rakyat Indonesia in Indonesia, Amanah Ikhtiar Malaysia in Malaysia, CARD in the Philippines, FINCA and ACCION in Latin America, and other microfinance institutions all over the world. Considering the ability of microfinance to eradicate poverty, the United Nations has decided to include it in the list of potential contributions to achieve the Millennium Development Goals set for 2015 to cut by half the number of people living in poverty.

Among the developing countries, Malaysia seems to offer a success story as it demonstrates a commendable record in reducing its poverty level. In 1999, it was reported that 8.5 per cent of the population was beneath the poverty line. However, after only five years, i.e., in 2004, Malaysia managed to reduce the number of those living below the poverty level to only 5.7 per cent. Microfinance is one of the objectives of New Economic Policy (NEP) which was launched by the Malaysian Government to reduce poverty and income disparities in Malaysia. Malaysia offers several models as part of its microfinance programme.

The Malaysian 2005 Census of Establishment and Enterprise Statistics indicated the enormous potential and uptrend of banking contributions within micro-enterprise development in Malaysia.⁵ Although the reports revealed that only 13 per cent of micro-enterprises received financing from Malaysian banks, many banks are optimistic on the growth momentum and believe that the demand for microfinance schemes will continue as micro-enterprises represent a large segment of the growing business markets, operating in all sectors.

Malaysia's English-language daily *The Star* reported on 28 July 2008⁶ that in Malaysia, the outstanding amount of microfinance increased to RM271 million as at end of March 2008, with Agrobank's microcredit products, namely Modal Usahawan (MUST) securing 56.2 per cent of the bank's total financing outstanding, representing 66.8 per cent of the number of accounts for microfinancing in Malaysia.

By July 2008, Public Bank reported receiving more than RM100 million worth of applications for its microfinance package, while the number of applications received and approved for the previous six months increased by more than 40 per cent. Other banks, too, reported that the growth of microfinance is on the upward trend as micro-entrepreneurs provide strong foundations for the growth of small and medium enterprises, as well as strengthening existing ones. Overall, the demand for microfinance products by micro and small enterprises has risen steadily. This is due to the increased awareness of micro and small entrepreneurs of the availability and viability of the microfinance scheme.

In the following, we shall evaluate the current practice of microfinance in Malaysia and explore the possibility of using 'cash *waqf*' as a new source for

funding Islamic microfinance. We shall also propose new concepts and applications for Islamic microfinance, pointing out the 'Islamic spirit' of microfinance. Following an overview of microfinance in Malaysia, we shall provide a brief literature review on conventional and Islamic microfinance. We continue with explaining our methodological approaches and an evaluation of the current practice of microfinance in Malaysia. We shall close with suggesting new concepts and applications for microfinance.

The Development of Microfinance in Malaysia

The largest microfinance institution in Malaysia is Amanah Ikhtiar Malaysia (AIM) which can be seen as the biggest replication of the Grameen Bank model in Southeast Asia. Beside this institution, public institutions such as Agrobank (formerly known as Bank Pertanian) as well as the Credit Guarantee Corporation (CGC) scheme, too, provide lending to small and medium enterprises (SMEs). However, the loan-sizes of these institutions are somewhat above those of conventional microfinance.

Initially, the banking sector in Malaysia did not put much emphasis on microfinance. According to McGuire, Conroy and Thapa,⁷ the Central Bank of Malaysia (Bank Negara Malaysia, BNM), restricted the spread between base and maximum lending rates in the commercial banking system to 4 per cent, less than would be required to cover the extra costs associated with microfinance lending. In the case of some loans guaranteed by CGC the permissible spread was only 2 per cent, reinforcing this effect.

Therefore, getting involved in microfinance activity is difficult for commercial banks as well as other institutions. However, AIM, as a government-linked institution, has been successful in helping the Government alleviate poverty in Malaysia. Grants from the Malaysian Government were some of the factors that made AIM successful in assisting poor people in Malaysia. As of September 2006, AIM had 157,787 members and disbursed a total of RM1.8 billion in loans. AIM's activities have been directed almost entirely, but not exclusively, to the alleviation of poverty among poor Malays. In 1994, AIM had some 6,100 Grameen-like groups in operation with a total membership approaching 30,000 borrowers.

All impact studies conducted on AIM in 1989,⁸ 1990–91,⁹ 1991–93 and 1994–95¹⁰ show that borrowers were able to increase their income after receiving loans from AIM. The latest impact study conducted by AIM in 2005 shows that borrowers would be out of poverty after four loan cycles with an average of RM3,500 per loan. The study also reports that 31 per cent of borrowers hire family members as workers and another 31 per cent of borrowers hire non-family members as workers. Therefore, we can conclude that microcredit is a powerful tool in alleviating poverty and generating employment.

The Role of Bank Negara Malaysia (BNM) in the Growth of Microfinance

In line with the Government's initiatives to support and drive the growth of micro-enterprises and small and medium enterprises by improving their access to financing for productive purposes, BNM, in 1972, established the CGC scheme. The function of CGC is to provide guarantees on funds disbursed to SMEs through financial institutions, especially those SMEs that do not qualify to have access to normal credit facilities due to lack of collateral.

Initially, BNM's policy *vis-à-vis* financial institutions (based on the BNM guidelines issued in 1985) had an adverse impact on the microfinance programmes and indirectly sidelined the emergence and growth of microfinance as a niche market in Malaysia. However, the policy required all banks as well as their board members to provide banking services and facilities that are conducive to a well-balanced economic growth and particularly to the priority sectors at a reasonable cost. All banks adopted prudent credit-scoring standards and followed stringent policies in ensuring that their financial institutions are soundly managed at all times.

In 1986–87, BNM launched its first microfinance scheme, a microcredit popularly known as under 'Loan Fund for Hawkers and Petty Traders (LFHPT)', ranging from RM5,000 to RM10,000. The scheme was flexible, as it did not require the usual investigations on customer background or the search for a guarantor. This scheme received tremendous response from local hawkers and petty traders. However, the scheme had also caused the non-performing loans portfolio of banks to increase up to 40 per cent in the early 1990s. Therefore, in 1993, a new credit policy was introduced by BNM, replacing LFHPT with the Association Special Loan Scheme (ASLS). However, only 291 applications met the commercial bank credit-scoring standard.

Due to the high rate of defaulters on the microcredit scheme, BNM restructured its microfinance lending policy and allowed commercial banks to impose their own credit-scoring standard on new applications and, in 1996, discontinued the microcredit scheme to hawkers and petty traders.

BNM's microfinance policies and schemes in general have not been able to outreach to the 'really' poor borrowers. This failure in the late 1990s is mainly due to the following factors:

- Low demand on banking facilities from low-income borrowers as their salary scale could not meet the monthly repayment requirements.
- Existing bank facilities and services were not bankable, because most of the poorer entrepreneurs were the home cottage industry players, located in rural areas.

- Commercial banks need to cover extra costs that are associated with microfinance lending of which the transactions are small and costly.
- Inadequate human capital to monitor and supervise the scheme.
- The loan approval was too stringent and the scheme operated in an unclear regulatory landscape.
- No promotion, advertising, or support came from the Government.

LFHPT and ASLS microfinance schemes failed to reach poor borrowers as banks only accounted for high repayment rates, thus leaving only non-profit organisations and cooperatives offering microcredit facilities.

An Overview of the Literature on Conventional and Islamic Microfinance

Conventional Microfinance

Research on economic and social impacts of microfinance has been increasing and some studies have even analysed the methodology of assessing the impact of microcredit programmes in selected countries. With regard to the economic and social impact of microfinance programmes, previous studies came to a variety of results. Some studies found positive economic/social impacts from the programmes, whereas others highlighted negative impacts. Afrane,¹¹ for instance, studied the impact of two microfinance interventions in Ghana and South Africa: the Sinapi Alba Trust (SAT) in Ghana and the Semeto Microfinance Development Programme (SOMED) in South Africa, in 1997 and in 1998, respectively. *Ex ante* and *ex post* analysis was adopted for the two case studies. Afrane used four broad impact indicators or domains: economic access to life-enhancing facilities, and social, as well as spiritual and psychological domains. Using data collection from four main survey instruments – questionnaire-interviews, case studies, focus-group discussions, and field observations – the results of this study showed that microfinance interventions have achieved significant improvements in terms of increased business incomes, improved access to life-enhancing facilities, and empowerment of people, particularly women. On the other hand, results on the social and spiritual domains contained mixed positive and negative effects, as compared with the other two domains. The positive impacts included enhanced public respect and acceptance, self-esteem, participation in community activities, monetary contributions to social projects, and empowerment of women. On the other hand, the negative impacts of the microcredit programme included pressure of time, resulting from increased business activities, worsening family-relations, poor church attendance and poor participation in church activities.

As the microcredit programme is aimed at fighting the problem of poverty in underdeveloped and developing countries, some studies are looking at the end-results of the programme by analysing the impact of it on reducing the poverty level. Chowdhury, Gosh, and Wright¹² pointed out the two main findings from their study on Bangladesh: first, microcredit is associated with both lower objective and subjective poverty and, second, the impact of microcredit on poverty is particularly strong for about six years with some levelling off after that point. Another study on Bangladesh, conducted by Amin, Rai, and Topa,¹³ found that while microcredit is successful in reaching out to the poor, it is less successful in reaching out to the vulnerable. These results also suggest that microcredit is unsuccessful in reaching those most prone to destitution, those who are both poor *and* vulnerable.

Coleman¹⁴ conducted a study to investigate the impact of a group-lending programme in Northeast Thailand, addressing the issue of self-selection and endogenous programme placement, thus leading to biased estimations of impact in previous microfinance impact assessment studies. To overcome this problem, Coleman conducted a quasi-experimental impact study and collected detailed data on household and village characteristics. The data was analysed by using Tobit regression and the results show that group-lending has an insignificant impact on physical assets, savings, production, sales, productive expenses, labour time, and on most measures of expenditure on healthcare and education. The only variable on which impact is significant is the reduction on expenditure for men's healthcare. Perhaps, the impact is somewhat more significant and positive on women's high-interest debt because a number of the group members had fallen into a vicious circle of debt from moneylenders in order to repay their village bank-loans. However, the impact is significant and positive on women lending out with interest because some members engaged in arbitrage, borrowing from the village bank at a relatively low interest rate and then lending the money out at a mark-up rate. These results are consistent with those of Adams and von Pischke who noted that "debt is not an effective tool for helping most poor people to enhance their economic condition".¹⁵

Kabeer and Noponen¹⁶ studied the social and economic impact of the PRADAN Self Help Group (SHG) microfinance in Jharkhand, one of poorest states in India. This study used interviews as tools for qualitative research and applied descriptive statistics as the tool for quantitative research. The result of the study showed that PRADAN's SHG-bank linkage model has had a significant and positive impact in improving livelihood base, savings and debt position, as well as the living and consumption standards of the participants. PRADAN participants have been able to secure their primary livelihood source through their own agriculture, supplemented by labour, livestock and non-farm enterprise activities, in comparison to more marginally positioned non-members who must still rely on unskilled labour

activities as their primary source of income. The access to financial services and the strengthening of participants' agricultural activities are associated with less vulnerability in terms of higher savings, less onerous debt and less crisis-related borrowing and more investment in productive activities and fewer months of seasonal migration. They are also associated with significant household welfare gains, especially shelter, food security and education. Despite the positive results, this study also showed that empowerment is not an automatic outcome of targeting women for financial services. While gains in terms of women's knowledge, awareness and skills were clearly discernible, impact in terms of participation in decision-making within the home and in the public domain were far more modest.

With regard to the economic impact of microcredit programmes in Malaysia, a few studies have been undertaken to determine the effectiveness of AIM's microcredit programme on poverty reduction. The first was an impact assessment study conducted in 1988. The objective of the study was to evaluate the effectiveness of AIM in replicating the Grameen Bank microcredit programme in increasing the household income of the poor who were involved in the pilot phase of the programme. The study was based on a sample size of 283 members. The major finding of the study showed that 70 per cent of the AIM members involved in the study experienced a significant increase in their monthly household income, from an average of RM142 per month to RM220 per month.¹⁷ The second internal impact assessment study done by AIM resulted in a similar major finding and concluded that access to microcredit facilitates an increase in the household income of AIM members.¹⁸

In mid 1990, the Socio-Economic Research Unit (SERU) of the Malaysian Prime Minister's Department initiated an impact assessment study on the AIM microcredit scheme. Among the objectives of the study were an evaluation of the AIM credit delivery mechanism to their members, AIM's achievement in poverty reduction, and the cost-effectiveness of AIM's microcredit scheme in alleviating poverty. SERU had opted to take samples from the northern state of Kedah, which at the time was an underdeveloped and agricultural-based region whose population comprised many of the poor employed in the rubber and rice sectors. The study found that AIM, by applying rigorous tests, has ensured that only the poor are eligible to access to the microcredit scheme. In addition, the study also concluded that the monthly household income of its members more than doubled, from an average of RM198 before becoming an AIM member to RM457 with access to the microcredit scheme. With regard to cost-effectiveness, the study concluded that with a total operating cost of RM1,757,019 AIM was able to uplift 249 poor households from the clutches of poverty.¹⁹

The latest impact assessment study conducted internally by AIM was carried out in 2005. The study found that the AIM microcredit scheme was able to increase the

client household income from RM326 prior to joining the programme to RM932 per month after having received a loan from AIM – an increase of 186 per cent!²⁰

In conclusion – even though the results of the previous studies on the economic and social impacts of microcredit or microfinance programmes are mixed – it can be stated that studies which have analysed the impact of those programmes on poverty alleviation found that the microcredit or microfinance schemes did achieve their objectives. Moreover, the studies referred to above have also shown that microcredit or microfinance programmes are not only able to lift poor families out of poverty, but that those programmes have also brought positive improvements in other areas, such as child-education and health, as well as the empowerment of women in household decision-making.

Islamic Microfinance

Islamic microfinance is rooted in a desire for economic growth and prosperity of socio-political systems based on Islamic principles and includes the same principles that have been applied to trade, business, investing and mortgages within Muslim communities. Islamic principles of equal opportunity, advocacy of entrepreneurship, risk-sharing, and disbursement of collateral free loans, as well as the participation of the poor are supportive of microfinance principles.

Recently, Karim, Tarazi, and Reille²¹ reported that the Muslim demand for microfinance products based on *sharī'ah*-compliance has led to the emergence of Islamic microfinance as a new market niche. They furthermore argued that Islamic microfinance has the potential to expand financing to unprecedented levels throughout the Muslim world.

As early as 2002, Ahmed²² conducted a study to provide empirical evidence from three Islamic microfinance institutions (IMFIs) operating in Bangladesh. The study found that IMFIs appear to have performed even better than Grameen Bank, the largest conventional MFI operating in that country. Ahmed²³ states that one possible explanation for this is that perhaps the IMFIs benefit from the social capital derived from Islamic values and principles. The study, however, also states that all three IMFIs reported that the expansion of their activities was held back by lack of funds. Another finding from this study indicates that IMFIs have not yet tapped the sources of funds from Islamic institutions – including *waqf*.

A global survey conducted by the Consultative Group to Assist the Poor (CGAP), an independent policy and research centre based in Washington DC, on Islamic microfinance in 2007 found that the outreach of Islamic finance is very limited.²⁴ According to the survey, IMFIs serve 300,000 clients through 126 institutions operating in 14 countries. The survey found that Bangladesh has the largest Islamic microfinance outreach serving 100,000 clients. However, the survey also found that Bangladesh has also the largest conventional microfinance outreach serving almost

8 million clients, and that Islamic microfinance represents only 1 per cent of the microfinance market. The survey concluded that in all Muslim countries Islamic microfinance still represents a small percentage of the total microfinance outreach. Finally, the CGAP survey found that IMFIs lack product diversification, offering only one or two Islamic financing products and over 70 per cent of the products offered are *murābahah*, a particular kind of *sharī'ah*-compliant sale, where the seller expressly mentions the cost he has incurred on the commodities to be sold and sells it to another person by adding some profit or mark-up thereon which is known to the buyer.

Research Methodology

In Malaysia, there are many financial institutions offering microfinance services, such as commercial banks, cooperatives, credit firms, and money-lending institutions. Figure 1 shows the various financial institutions offering microfinance services. Our study, however, evaluates only microfinance offered by commercial banks. There are nine commercial banks offering microfinance services in Malaysia. These banks are:

- Alliance Rakan
- CIMB Bank
- Public Bank
- AmBank
- United Overseas Bank (UOB) Malaysia
- EONCap Islamic Bank
- Bank Pertanian Malaysia (AgroBank)
- Bank Rakyat
- Bank Simpanan Nasional (BSN)

In this study, we evaluate the features of microfinance offered by all the nine commercial banks, that is, product type, loan size, eligible economic sector, eligible customers, eligibility criteria and documents required.

An Analysis of the Current Practice of Microfinance in Malaysia

Financing Modes

Under their microfinance programmes, Alliance Bank and CIMB Bank offer both Islamic and conventional banking products, while Bank Rakyat and EONCap Islamic Bank offer only Islamic banking products and Public Bank, AmBank, UOB, Agrobank and BSN offer conventional banking products. Our survey revealed a

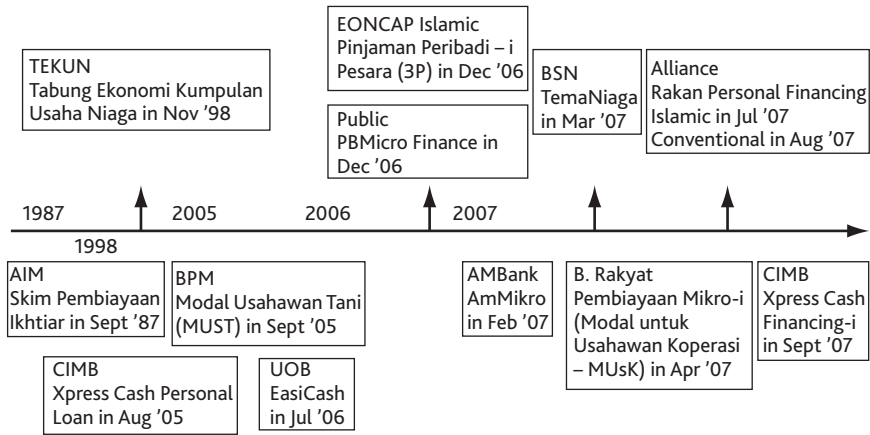


Figure 1 Financial Institutions Offering Microfinance in Malaysia

Source: Bank Negara Malaysia

lack of product innovation and an over-reliance on *bay' al- 'inah* (sale and buy-back agreement) for microfinance schemes in Malaysia. Of the four banks which offer Islamic microfinance products – Alliance Bank, CIMB, EONCap Islamic and Bank Rakyat – only the *bay' al- 'inah* concept has been applied. Financial product developers should not rely too much on *bay' al- 'inah* alone as there are other types of *shari'ah*-compliant instruments which comply with the definition of microfinance, such as *qard al-hasan*.

However, Islamic banking products such as *tawarruq* and *qard al-hasan* are yet to be made available under microfinance schemes. In view of the great demand for Islamic microfinance it is also recommended that financial product developers conduct in-depth research or have strategic alliances with research and academic institutions to develop innovative microfinance products that are in line with the *shari'ah*. One must bear in mind that Islamic law stipulates that microfinancing should be offered free of charge in order to meet contingency needs, and that creditors should not take advantage of poor borrowers, in this context the micro-entrepreneurs. Another principle that should be followed is that there should not be any rewards without taking the risk, which means there is no reward for the capital rendered to micro-entrepreneurs unless it is exposed to business risk.

Loan Sizes

The microfinance scheme currently offered by commercial banks in Malaysia comes in the form of term-financing under personal and business enterprise categories, ranging from a minimum of RM500 to RM50,000, depending on the purpose of

the application. The individual borrower and the board of directors of the applying company or entity must be Malaysian citizens and between 18 and 65 years old. The tenure of facilities is within one month to five years for micro-enterprises and six months to ten years for personal financing, with repayment-options either on a fortnightly or monthly basis.

Eligible Economic Sectors

From the nine banks offering microfinance services, four banks – Alliance Bank, CIMB Bank, United Overseas Bank, and EONCap Islamic Bank – extend loans in all economic sectors. Public Bank, Bank Rakyat, Bank Simpanan Nasional, and AmBank specify that agriculture, retail, services and trade, as well as manufacturing economic sectors are eligible for microfinance services. Bank Pertanian (Agrobank), however, limits its microfinance products to agriculture and agro-based industries only.

Eligible Customers

Personal loans are made available to army pensioners or salaried workers with an earning between RM800 to RM3,000 per month or self-employed individuals with an income not less than RM30,000 per year. Individual borrowers must have a permanent job or plans for a project, a permanent residential address, an open savings account with the loan-granting bank and must have signed up for credit protector insurance. However, the salary scale imposed, for instance, by Alliance Bank, i.e. a minimum of RM2,000 per person, makes it rather difficult for low-income earners to qualify for a micro personal loan which falls under the microfinance scheme.

The Malaysian Poverty Line Index states that a household income below RM1,500 is considered as 'beneath the poverty line', thus making such a household eligible for microfinance. This means that an Alliance Bank personal loan (Islamic as well as conventional) under the microfinance programme *does not* fulfil the definition by the Asian Development Bank (ADB) concerning microcredit. Their salary criteria of having a minimum pay-cheque of RM2,000 per month does not meet the poverty line index and should not be made eligible to enjoy the microfinance benefit established by the Credit Guarantee Corporation. Meanwhile, the CIMB Bank, UOB and EONCap Islamic Bank salary criteria of a minimum of RM800 and RM1,500, respectively, *do* comply with the Malaysian poverty line index, and therefore borrowers should be allowed to be reported under the microfinance sector.

In addition, the Alliance Bank criteria on micro-enterprise turnovers of a maximum of RM1 million per annum definitely *do not* meet the objectives of the microfinance scheme to be made available for poor people. The business criteria should be reviewed in line with microfinance credit standard and not banking credit standard. The Rakan personal financing scheme of Alliance Bank should fall under

the Small and Medium Enterprises financing scheme instead of the microfinance scheme.

Eligibility Criteria and Required Documents

The requirements for micro-enterprises are that they are either sole-proprietors, partnerships or private limited companies, or individuals operating his/her business on a full-time basis for a period of six months to three years, furthermore that they have a permanent business location and a tenant agreement or have a stall or shop-lot, hold a valid company registration and a business licence required by local authorities. The business sectors allowed for the microcredit programme encompass agriculture or agro-based industries, as well as retail, wholesale, manufacture, service, trade or other productive sectors.

Interest Charges

The interest rate charged is as low as the Base Lending Rate plus 1.5 per cent or as high as 15–17 per cent per annum rest²⁵ or a minimum 1.25 per cent per annum to a maximum 3 per cent per month with a rebate of 20 per cent cash refundable for prompt and early payment within the tenure of facilities granted. The flexibility given to this scheme is such as no collateral or individual guarantor is required, plus an exemption from the usual stamp duties. BSN imposed an additional condition according to which a mortgage insurance and a three months deposit are deducted from the total loan and three months' interest is levied for early settlement. However, all borrowers are subjected to CRISS (Central Credit Reference Information System) or CITOS (Credit Tip-Off Service) compliance.

Credit Evaluation Standards

Similar to other normal-term financing schemes, the disbursement of the microfinance facilities is subjected to full evaluation to be conducted by a particular bank upon receiving the full set of documents, such as identity card, proof of business registration/licence/permit, proof of income, utility bills, or a recommendation letter from panel cooperatives and self-help group members, or any additional supporting document as and when required by the disbursement banks. Even though the microfinance scheme is guaranteed by the CGC scheme, the borrowers are subjected to CRISS or CITOS compliance and each bank's credit-scoring standard. The stringent conditions imposed, such as CRISS and CITOS, do not benefit the micro-entrepreneurs as the policy restricts them from applying for various loan facilities.

However, the implementation of microcredit schemes will put more burden on the banking industry, in terms of operational costs. Some banks foresee that the microfinance schemes might increase their loan default position due to the relaxed

condition concerning collateral guarantors. Furthermore, the previous results concerning microfinance activities have shown a deteriorating trend in terms of repayment since microfinance is a high-risk return portfolio. Most banks report that they have adopted stringent and prudent evaluations of lending policies in order to mitigate unexpected losses.

Approval Periods

Our survey revealed that the success of Agrobank's microfinance scheme, for instance, which is mainly intended to cater for the needs of agro-based businesses, is collateral-free. It also offers straightforward and convenient accessibility. Loans are processed and approved within an average of five working days. Loan approval and disbursement are also fast to ensure that the financing needs of the micro- and small enterprises are met in a timely manner. According to Agrobank and Public Bank, loans could actually be processed and disbursed within 24 hours once the relevant terms and conditions are fully met.

Toward New Concepts and Applications of Microfinance

Malaysian banks usually define micro-enterprises as business entities with fewer than five full-time employees and annual sales of less than RM250,000, which is similar to the definition of microfinance brought forward by ADB. Bank Negara Malaysia defines microfinancing as small business loans not exceeding RM50,000 that are made available for micro-enterprises for business purposes only and not for personal loans.

These definitions do not actually fulfil the true spirit of microfinance, which is providing for a small loan in order to help the poorest people out of poverty and, in some cases, to assist them in fulfilling their basic needs. By using the above definitions of microfinance, commercial banks and Bank Negara are not aiming at the *original* target group – the hardcore poor – to offer them access to credit. The *current* definitions of microfinance, instead, include population segments that are not considered as poor to be eligible customers for microfinance products. The 'real' customers, i.e., the real poor, could be deprived from benefiting from the microfinance services if the current definition is applied, because a loan given to someone who is better off means that a poor person, in turn, would be deprived from having such a loan.

Therefore, we would like to offer a different definition of microfinance. Our definition of microfinance is a provision of a wider range of financial services for the purpose of socio-economic development as well as catering for the needs of unfortunate individuals or entrepreneurs who are not able to access the normal banking facilities or who fail to meet the standard of normal credit scoring.

During a period of crisis – such as the current global financial crisis – funds are diverted away from microfinancing purposes in order to give loans to big corporations.²⁶ The preference of banks and financial institutions to do business with big companies could mean that there will be fewer funds channelled for microfinance purposes. Since micro-entrepreneurs have to compete for credit from the commercial banks against the stronger big corporations and since commercial banks are increasingly adopting stricter credit evaluation standards in giving loans to micro-entrepreneurs, we propose the use of ‘cash *waqf*’ as an alternative and an additional source of capital for microfinance to promote the growth of Islamic microfinance in Malaysia in particular, and in Muslim countries in general. According to Amadou Cisse, the Vice President of the Islamic Development Bank, the amount of ‘cash *waqf*’, as well as that of *zakāt* funds throughout the Muslim world reaches hundreds of billions dollars a year, and the capacity for mobilising these resources is huge.²⁷

The institution of *waqf* is said to have originated as early as the time of the Prophet, but it reached particular significance during the Seljuk and Ottoman periods. It entails the use of cash, land, and real estate for charitable purposes. There are certain conditions governing *waqf*, but the objective is to serve the poor and the community. The presence of *waqf* and charities on the liability side of IMFIs is compatible with the social financial intermediation role of MFIs – especially the creation of ‘cash *waqf*’ as a source of income for Islamic microfinance.

Figure 2 shows how cash *waqfs* could be used as a source of funds for Islamic microfinance. Cash *waqfs* can be sourced from potential donors who want to donate their money to help the poor to venture into income-generating activities. The sourcing of this fund can be done by an Islamic microfinance institution (IMFI) which will act as a trustee of this fund. The IMFI will then identify eligible beneficiaries of the cash *waqf* which will be the poor or needy micro-entrepreneurs. Loans given to these micro-entrepreneurs can be based on profit-sharing (*muḍārabah*) or cost-plus (*murābahah*), so that when the micro-entrepreneurs repay their loans, the money can be used to replenish the cash *waqf* pool and in turn become the source of funds for other micro-entrepreneurs.

In the case of extreme poverty, the *qarḍ al-ḥasan* principle can be applied to extend credit to the poor to enable them to fulfil their basic needs. The term *qarḍ al-ḥasan* means beneficial loan, benevolent loan, gratuitous loan, or interest free loan. It is a kind of gratuitous loan given to poor people for a fixed period without charging the payment of interest or profit. The borrower of *qarḍ al-ḥasan* is only required to repay the original amount of the loan. Scholars argue that the administrative fee or service charge for loan transactions is not against Islamic principles. For example, Irfan Ul Haq in his doctoral dissertation entitled “Economic Doctrines of Islam” states that “Banks are permitted to charge a minimum service fee to cover

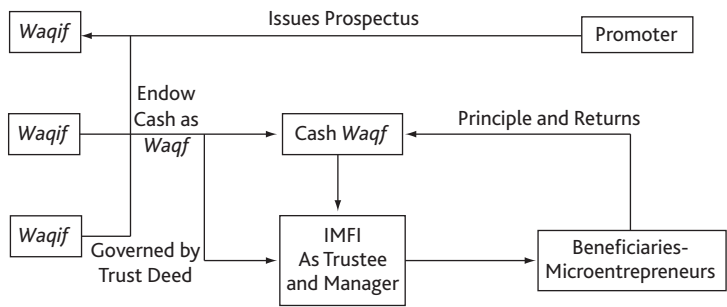


Figure 2 Cash Waqf as a Source of Funding for Islamic Microfinance

Note: English spellings and transliteration of Arabic terms have been maintained.
Source: D.M. Abdullah, “Offshore Trust and *Awqāf*”, paper presented at the “International Seminar on *Awqāf*”, organised by the Department of Awqaf, Zakat, and Hajj (JAWHAR), Johor Bahru, 11–12 August 2008.

the cost of administrative fee.”²⁸ The Islamic Development Bank in Jeddah, for instance, recovers a service charge of 2 per cent to 3 per cent on interest free loans. Therefore, if *qard al-ḥasan* is given by any financial institution, the imposition of a service charge or administrative fee would be permissible.

In other circumstances, if microfinance is given for personal financing, banks should extend credit based on *tawarruq* instead of relying on *bay‘ al-ṭinah*, since an *al-ṭinah* contract is questionable and not accepted by many banks in the Middle East and Europe. With the context of an ‘Islamic transaction’, *al-tawarruq* means buying goods or assets in instalments and then selling them for cash at a lower price to a third party who is not the original seller of the commodity or asset.

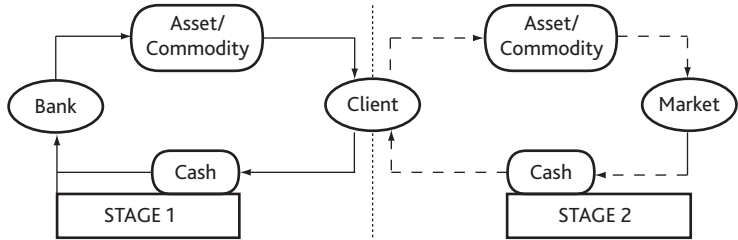


Figure 3 The Concept of *Tawarruq*

Source: Abdul Mumin Abdul Ghani and Ahmad Sufian Che Abdullah, “*Tawarruq*: Inovasi baru produk perbankan Islam dalam pembiayaan peribadi”, paper presented at the “Seminar Perbankan Islam dan Anda: Era Globalisasi”, organised by the Academy of Islamic Studies, University of Malaya, Kuala Lumpur, 27 June 2005.

Figure 3 illustrates how the concept of *tawarruq* operates as a means to obtain a personal loan through two stages. In stage 1, a client who wishes to obtain a personal loan (of, for example, RM10,000) goes to a financial institution. The financial institution will sell its asset, whether physical or financial, at a mark-up using the *murābahah* principle (for example, at RM15,000) on an instalment basis. In stage 2, the client, who is now the owner of the asset, will sell the asset to any interested party on a cash basis at the market price (let's say, at RM10,000). This process involves a transaction of real assets and is thus acceptable in terms of an 'Islamic transaction'.

Conclusion and Recommendations

In this article, we have aimed at critically examining the current practice of microfinance in Malaysia. We evaluated the features of microfinance offered by all the nine commercial banks, i.e. product type, loan size, eligible economic sectors, eligible customers, eligibility criteria and documents required to support loan application. Our study found several shortcomings in the current practice of microfinance in Malaysia. These weaknesses are, among other things, stringent credit evaluation standards, and missing the real target group, i.e., the poor and the needy. In addition, the mode of financing is mostly personal loan, using *bay' al-ʿinah*, whereby the use of the loan is to fulfil personal consumption instead of income-generating activities. Given these shortcomings, the article suggests the possibility of using cash-*waqf* as a new source of funding for Islamic microfinance and proposes new concepts and applications of Islamic microfinance, thereby putting it in line with the true Islamic spirit of microfinance. Furthermore, the article also proposes the use of other modes of financing such as *mudārabah* and *murābahah*, as well as *qard al-ḥasan* and *tawarruq* in extending credit to the poor.

As reported by CGAP in their survey of Islamic microfinance in 2007,²⁹ the outreach of Islamic microfinance is very limited and represents only a small percentage of the total microfinance outreach in all Muslim countries. With this new concept and application of Islamic microfinance, it will be able to further enhance the growth of microfinance to reach millions of poor Muslims, whether in Malaysia, other Muslim countries, or among Muslim minorities in non-Muslim countries. In addition, with this new concept and application of Islamic microfinance, we are convinced that the use of microfinance would genuinely cater for the needs of the poor and the needy and as a means to combat poverty as well as generating socio-economic growth in the Muslim world.

Notes

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2. See Michael S. Barr, "Microfinance and Finance Development", *Michigan Journal of International Law* 26 (2005), 271.
 3. Muhammad Yunus and Fazle Abed, "Poverty Matters", in: Sam Daley-Harris, *State of the Microcredit Summit Campaign 2004* (Washington DC: Microcredit Summit Campaign, 2004), 16, available online at <http://www.microcreditsummit.org/pubs/reports/socr/2004/SOCR04.pdf> (accessed on 9 September 2009).
 4. Such as Shahidur Khandker, "Microfinance and Poverty: Evidence Using Panel Data from Bangladesh", *The World Bank Economic Review* 19, no. 2 (2005), 263–86, available online at <http://wber.oxfordjournals.org/cgi/reprint/lhi008v1?ijkey=JALcZTD7a55baue&keytype=ref> (accessed on 7 September 2009); Paul Gertler, David I. Levine, and Enrico Moretti, "Do Microfinance Programs Help Families Insure Consumption Against Illness?" *Health Economics* 18, no. 3 (July 2008), 257–73; A. Park and C. Ren, "Microfinance with Chinese Characteristics", *World Development* 29, no. 1 (January 2001), 39–62.
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 6. Ibid.
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 13. S. Amin, A.S. Rai, and G. Topa, "Does Microcredit Reach the Poor and Vulnerable? Evidence from Northern Bangladesh", *Journal of Development Economics* 70, no. 1 (2003), 59–82.
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 17. Sukor Kasim, *Impact of Banking on Rural Poor in Peninsular Malaysia: Final Report of External Impact Evaluation Study on AIM Active Borrowers, Non-Borrowing Members, Dropouts and Non-Participating Poor* (Penang: Centre for Policy Research, Universiti Sains Malaysia, 2000).
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 23. Ibid.
 24. Karim, Tarazi, and Reille, "Islamic Microfinance".

25. 'Yearly rest', a term used in the banking industry, refers to interest that is calculated once a year based on the outstanding balance at the end of the year.
26. Cf. *Islamic Finance News* 6, no. 2 (January 2009), available online at <http://www.islamicfinance-news.com/> (accessed on 9 September 2009).
27. Mohammed Abbas, "Bankers See Large Profits in Islamic Microfinance", *Reuters*, 5 September 2007, available online at <http://in.reuters.com/article/companyNews/idINL0559309420070905> (accessed on 7 September 2009).
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VIEWPOINTS

Islamic Responses to the Financial and Economic Crises

*Abdul Karim Abdullah**

An economic crisis is the flip side of a financial crisis. A financial crisis, whether on a personal, national or international level, takes place when economic activity – the source of income – slows down or stops.

Economic activity generates income. When production slows down income paid for the use of the factors of production also falls. As the gross domestic product declines so does national income. When there is a recession or a depression the economy needs to be revived – fast.

An increase in efficiency or productivity contributes to higher profits, higher incomes, and a higher standard of living. Low productivity keeps income at low levels. When income increases without a proportionate increase in productivity, however, it is as if a car engine were running at a higher speed – but in the neutral gear. More income is being generated, but there is little corresponding increase in real wealth.

Islam, in turn, appears to offer effective responses to a variety of crises – including financial and economic ones. Some of those responses take the form of ‘commands’, and some the form of ‘prohibitions’. The responses include fiscal and monetary prudence, social justice (Qur’ān 4:135; 5:8; 6:152; 55:9), higher spending, enforcing fair trade, fulfilling contractual obligations (Qur’ān 5:1), being optimistic, curbing excessive speculation, and providing incentives for genuine wealth creation.

Islam counsels fiscal prudence, which is required on an ongoing basis. Governments must have the will to run surplus budgets during good times, and deficit budgets during difficult times. We save *for* the rainy day, and spend *on* the rainy day. The prophet Yusuf accumulated a surplus during the seven good years. The surplus was then used up during the seven lean years (Qur’ān 12:47–8). He applied what we today call ‘counter-cyclical fiscal policy’.

The Qur’an frequently exhorts us to spend out of what God has bestowed on us (Qur’ān 2:177; 2:254; 13:22; 57:7). The best way to overcome a recession or depression is to ‘spend our way out of it’. Spending will ‘prosper thy neighbour’.

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Niggardliness will beggar him. We must remember that one person's expense is another person's income.

Money should circulate not only among the rich, but also among all social classes. A well-known verse in the Qur'ān (59:7) confirms this. This should help narrow the gap between the well to do and the impoverished.

Hoarding, exploitation, profiteering, usury, fraud, price fixing, monopolising markets and gambling are prohibited. Trade enriches and creates prosperity (*falāḥ*). Usury impoverishes and creates misery. Usury is the reverse of charity. In charity we give; with usury, we take.

Muslims are *literally* called to 'success' and 'prosperity' (*falāḥ*) five times a day – during the calls to prayer. Not to be overlooked is the fact that the messenger of God, Muḥammad (pbuh) himself was a successful businessman. He exemplified many sound business practices in his own lifetime. He was well known for his honesty and trustworthiness, even before he was called upon to deliver God's message to humanity.

An Islamic approach requires a suitable regulatory framework. Islam, among other aspects of life, regulates commerce (Qur'ān 2:282). Without law, there would be anarchy. Prior to the current crises, there was excessive de-regulation, especially in the OTC (over-the-counter) market for debt-based securities, a legacy of the free market euphoria of the Thatcher and Reagan years. Islam recommends the 'middle path' – moderation and avoidance of extremes – whether in the direction of freedom or in the direction of authoritarianism.

Another Islamic response is to be optimistic. God has promised a generous reward to those whose intention is to do good. A verse in the Qur'ān (15:56) says that only those who go astray despair of the mercy of God. We must look at life in a cheerful way.

Expectations play a major role in people's decisions. People spend and invest more when they are optimistic. Pessimism has a demoralising effect. It reduces confidence and inhibits initiative. A verse in the Qur'ān (2:268) states that the evil one threatens all and sundry with poverty, but God invites all people to plenty. The current crisis is as much a crisis of confidence as it is a financial and economic crisis. To overcome the crisis, we need to become and remain confident. High morale is essential for success (*falāḥ*).

It is necessary to reward real investment and discourage excessive speculation, which is akin to gambling. As there is a fine line between excessive speculation and legitimate business risk taking, it may not be possible to eliminate excessive speculation completely.

We can apply these and other Islamic responses to overcome the current crises, and prevent or at least mitigate, future crises.

Economic theory and practice need to be based on ethical principles. The inherent instability in the financial and economic architecture stems in part from its disconnectedness from ethical values, such as when financial institutions engage in predatory lending practices. We need to recognise that the meaning of ‘value’ extends beyond its quantitative significance. Value is more than just the price of something. We need to establish and maintain a strong link between economics and ethics. This can be done by infusing economics with universal ethical values, such as the protection of life, religion, knowledge, family, and dignity. The Islamic concept of the ‘common good’ (*maslahah*) likewise needs to be incorporated into our understanding and practice of economics and finance. Too often, private interests conflict with (and even override) the interests of the people or the public interest.

Islam teaches ethics and a strong sense of moral purpose. The role of man on the earth is that of a ‘deputy of God’ (*khalifah*). Our responsibility is to manage the earth in accordance with the knowledge revealed to us by God Most High. We need to comprehend and apply that knowledge. We shall be judged on how well we managed – or mismanaged.

In order to optimise the greater common good, we need to design, implement and maintain effective enforcement mechanisms to limit excessive speculation and encourage *real* investment. In particular, we need to muster the collective will to implement, maintain and fine-tune the required regulatory framework.

'Banking Panics' and Islamic Finance Principles: Lessons from the Current Crisis

*Sanep Ahmad**

Understanding the Current Crisis

Clearly, the recent 'bank panics' and global economic crisis occurred mainly due to the result of debt defaults in subprime mortgages. Firstly, default by home buyers for their loans repayment to the banks and secondly default by banks for their bond repayment in the mortgage bond market. If debt defaults can be avoided in the first place, bank panics and economic crisis will most likely not happen. This means that the origin of the problem is related to bank defaults in the Sub-Prime Model which arises due to poor credit evaluation by banks. Therefore the solution for the current crises should be focused on ways of avoiding debt defaults by borrowers.

Many economists believe that debt defaults that led to the current economic crisis are directly related to regulatory failure. The banks have violated some important principles required by Basel II accord regarding credit standards. These principles can be summarised into two main points as follows:

- *Banks lending and selling.* With the sale of subprime mortgages banks deliberately sold mortgage products to clients who could not afford to pay. Borrowers with poor credit histories, too, were granted housing loans. These types of borrowers would easily default when the mortgages reset. Thus some economists are of the opinion that the crisis was initiated by poor mortgage underwriting. Others do not agree that faulty credit standards have caused the current crisis, stating that the mortgage-backed securities were in fact rated by the rating agencies. The banks and institutional investors simply followed the investment grade ratings provided by the agencies. However, it was further argued that the credit ratings that were assigned to the subprime mortgage-backed securities by the rating agencies were based on significant errors.
- *Lack of transparency.* Greedy banks and borrowers are not transparent enough and are not revealing the real facts. Firstly, banks and mortgage dealers did not disclose the characteristics of the bond to the borrowers, e.g. that the bond is an adjustable-rate mortgage (ARM). An ARM is a costly mortgage and

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would directly affect a borrower's financial status after reset. This very characteristic should have been clearly explained to them so that they understood the cost and effect of buying such bonds. However, it seems that banks were purposely hiding the real characteristics of the bonds from the borrowers, fearing that the potential buyers would not acquire the bond after realising the real characteristics of the bond. Secondly, banks are often not concerned about the quality of the assets purchased by the borrowers. The banks packaged and repackaged the mortgages and sold them as asset-backed securities with a high credit rating and a high return, while the actual credit quality of the underlying asset was not exactly known.

In short, the practice of ARMs, the unscrupulous lenders and the predatory borrowers have been identified as major causes for 'bank panics' and the current economic crisis. These problems would not have occurred had there been a stringent credit regulatory system in place.

Islamic Finance Principles and the Current Economic Crisis

In terms of the *moral and Islamic dimension*, the Sub-Prime Model is clearly a model of financial innovation that is *not* based on the *sharī'ah*. Its mechanism is generally based on the sale of debt (*bay' al-dayn*) which is allowed by Islam with certain conditions. Unfortunately the current practice of sale of debt is not in accordance with *sharī'ah* principles and consists of three elements prohibited by Islam, namely interest (*ribā*), uncertainty/deception (*gharar*) and gambling (*maysir*). However, the existence of these prohibited elements is not the main reason for the current economic crisis. Although, the new subprime mortgages are ARMs, it is not the interest rate which really caused the crisis. The real reason behind this problem was actually the unscrupulous/dishonest mortgage lenders, luring unsuspecting borrowers into a debt trap. Insincere banks did not reveal the real characteristics of the bonds, and on the other hand the greedy borrowers did not sincerely declare their financial positions and were also not really concerned about the characteristics of the bonds.

This means that the problem is not as much related to the system as to a generally prevailing 'moral hazard' issue, namely the predatory and greedy behaviour of lending and borrowing. If both parties would have been honest in their transactions by disclosing all the facts, the current problems faced by banks, borrowers and the whole world could have been prevented. Problems could have been avoided had there been a transparent financial advisory mechanism. Such a mechanism is actually missing in the current conventional financial system.

From the perspective of Islam, this unethical behaviour relates to the issue of mutual consent (*ridā*) and deception (*gharar*) in the contract. The *sharī'ah* requires that both parties in any contract should reveal everything in order to avoid unknown elements (*jahālah*) that may cause dispute in the future. Nothing should be kept secret. If everything is disclosed as required by Islamic ethics, it is unlikely that the mortgage bond market in the Sub-Prime Model could have developed in the first place.

Having *sharī'ah*-compliant products *alone*, however, would not be enough. Although the sale of debt (*bay' al-dayn*) is permissible and can be applied in any transaction of bank products, there must be a regulatory system that would protect the buyer's interest (*maslahah*). Similarly, *ṣukūk* (bond) and *ṣukūk* market are all allowed but only with proper regulatory mechanisms. However, applying only *sharī'ah* principles, such as *muḍārabah*, *mushāarakah* or *ijārah* in any Islamic products such as *ṣukūk ijārah*, *ṣukūk mushāarakah* or *ṣukūk muḍārabah* would not necessarily secure the economy from crisis, because the problems related to risk management would still be there. The question of risk could only be managed by a proper regulatory system. Similarly, the problem of 'moral hazard' needs a proper regulatory mechanism.

What is needed is also the enforcement of the existing Islamic rules along with some fresh guidelines for the major stakeholders, especially the financial institutions. More rules are needed to regulate the Islamic capital markets to ensure the future success of Islamic finance.

Banks should moreover, respect the two pillars of Basel II. These two pillars are firstly, maintenance of regulatory capital calculated for three major components of risk that a bank faces, namely credit risk, operational risk and market risk, and secondly, maintenance of regulatory measures for other residual risks such as systematic risk, pension risk and reputation risk.

The Basel II accord thus implies that banks lend only to those that are credit-worthy. This will ensure that borrowers do not run into financial problems, regardless of whether the system is conventional or Islamic.

Moreover, Islamic financial institutions should create *sharī'ah*-based regulations on credit standards in order to guarantee that Islamic principles are adequately capitalised. Although Basel II is expected to be sufficient, some *sharī'ah* guidance could also be considered:

- Implementing *sharī'ah*-rules regarding debt and debt trading. The rule states that debt disbursement should be based on a debt/equity ratio of 33 per cent and that debts cannot be traded except at par value.
- Promoting asset-backed Islamic mortgages, supported by real quality assets. The *sharī'ah* requires that debts should be guaranteed by valuable assets.

In case that no other asset can be used, the purchased asset can be used as mortgage instead. Islamic mortgages may require that the property changes hands twice. Firstly, the bank buys the house outright and then acts as a landlord, renting the house to the potential buyer. The buyer will pay rent as a contribution towards the purchase of the house. When the last payment is made, the property changes hand to the buyer.

- Providing *sharī'ah*-compliant risk-management solutions to the creditors of Islamic financial products through a comprehensive consumer-protection framework. The exact solution is left to the discretion of the banks.

Islam promotes transparency and avoids unknown elements between parties of contract. In the case of a loan offer, the borrower should be informed regarding the product offered. Similarly, the bank should be informed regarding the borrower's history and mortgage assets. All relevant information should be declared by all parties and without prejudice.

In sum, the core issue of safety in any banking system – regardless of whether it is Islamic or non-Islamic – is in its credit standards and regulatory measures. In this regard, Islamic banking is no different from other banking.

BOOK REVIEWS

Mubin Sheppard – *Tunku: His Life and Times*.

The Authorized Biography of Tunku Abdul Rahman Putra Al-Haj

(Subang Jaya, Selangor: Pelanduk Publications, 2007, 2nd printing), paperback, 234 pp. ISBN: 967-9784-95-9

Christoph Marcinkowski *LAIS Malaysia*

The reissuing of Mubin Sheppard's *Tunku: His Life and Times*, the biography of Malaysia's 'Father of Independence' Tunku Abdul Rahman Putra Al-Haj (1903–1990), by Pelanduk Publications, one of Malaysia's leading publishing houses, could not be timelier as Malaysians and their friends had been celebrating the 50th anniversary of the country's freedom from colonialism. This work by Sheppard, a historian of Malaysian culture and heritage who was a close friend of the Tunku, became a classic after it was published by Pelanduk for the first time – in the present version – in 1995.

Mubin (originally Mervyn) Sheppard will always be remembered as a great friend of Malaysia. He was a British Muslim of Anglo-Irish ancestry, who for a long time had a close relationship with the Tunku. Mubin had a distinguished career serving both the Colonial and the Malaysian Government. He arrived in Kuala Lumpur in 1928 and was employed in the Malayan Civil Service. During World War II, he was fighting in the defence of Malaya, serving as Company Commander in the Federated Malay States Volunteer Force, and was subsequently interned for three and a half years by the Japanese occupiers in Singapore. Sheppard's first post-war appointment in the colonial administration was in 1946, as the first Director of Public Relations Malaya, the predecessor of Malaysia's current Ministry of Information. He later served as British Adviser in two Malay states. In the 1950s, during the fight against the communist insurgents, Sheppard was responsible for the Emergency Food Denial operation which covered the entire Malay Peninsula, playing a very crucial role in combating the terrorists on the logistic front. After *Merdeka*, Malaysia's first leader after independence from Britain, Tunku Abdul Rahman, made Sheppard responsible for setting up the National Archives and, soon after, the National Museum, of which he was in charge until 1963. As a matter of fact, Sheppard had to create the Museum anew, as it had been destroyed accidentally by US airplanes in the final stages of World War II. After his retirement in 1964, Sheppard continued to

serve Malaysia in various capacities, such as editor of the journal of the Malaysian Historical Society, later known as *Malaysia in History*, and editor and honorary secretary of the *Journal of the Malaysian Branch of the Royal Asiatic Society*. He wrote 17 books, mainly about the history and culture of Malaysia, some of which were awarded Malaysian and international prizes. Malaysia's National University, Universiti Kebangsaan Malaysia, UKM, and Universiti Sains Malaysia, USM, both awarded him Honorary Doctorates of Letters. He was awarded the title *Tan Sri* by the Federal Government and that of *Dato'* by the Malaysian states of Selangor and Negeri Sembilan. In Malaysia, he is particularly remembered as founder member of Badan Warisan Malaysia and of Sahabat Warisan Malaysia. Sahabat Warisan Malaysia ('Friends of the Heritage of Malaysia Trust') was a society set up in 1984 to support Badan Warisan Malaysia in its objectives. The Mubin Sheppard Memorial Prize is a culmination of one of its fundraising efforts. In 1995, Sahabat was dissolved and its membership was merged with that of Badan Warisan. His deep love for the history, culture and his fellow Malaysians is reflected in his service as the first Honorary Secretary General of the Muslim Welfare Organisation of Malaysia (PERKIM), which was conceived by his friend, the Tunku. Mubin Sheppard passed away on 11 September 1994. The Mubin Sheppard Memorial Prize was established to stimulate students' awareness of Malaysia's cultural heritage.

The first print of *Tunku: His Life and Times* has had its own history: It dates back to an earlier work by Sheppard on the life of the Tunku in two volumes, *Tunku: A Pictorial Biography, 1903–1957* (Petaling Jaya, Selangor: Pelanduk, 1984) and *Tunku: A Pictorial Biography, 1957–1987* (Petaling Jaya, Selangor: Pelanduk, 1987). The volumes offer a great collection of the Tunku's pictures from various stages of his life – from his childhood and his Cambridge student's life to his political heydays. In order to prepare himself well before embarking on his project, Sheppard compiled hundreds of questions for the Tunku to answer on events of his life. Tunku Abdul Rahman recorded the answers on tape and Pelanduk Publications transcribed them. These transcripts, in turn, were used by Sheppard as his raw material in writing the book. The decision to publish *Tunku: His Life and Times* after the demise of the 'Father of Independence' was planned and agreed upon earlier by the late Mubin Sheppard with the consent of the Tunku. The text contained in the 1995 (and 2007) versions of *Tunku: His Life and Times* has been reproduced accurately from the afore-mentioned two-volume *Tunku: A Pictorial Biography*, with an additional chapter to record the passing of Tunku Abdul Rahman.

Several biographies have been published on the Tunku before and after Sheppard's work, and there might be some truth in the common wisdom that biographies are mostly more interesting in terms of what they do *not* mention than for what they *do*. Sheppard's work, however, is somewhat different – in particular because of the manifold 'nature' of its author: a former senior civil servant in Malaya's colonial

administrative machinery; a sincere convert to Islam, the religion of the majority of former colonial 'subjects'; a close friend to the 'topic' of his endeavour as a writer; and last, but not least, if not above all, a former member of the British ruling class who fell in love with Malaya and decided to stay on in order to accompany Malaysia on her way. Sheppard had thus been able to draw a picture of the Tunku and his times that is much more vivid and telling than what is usually offered on the lives of great statesmen and leaders. Moreover, another reason for the appeal and importance of this biography is the significance of its 'topic', the Tunku, within the history of Malaysia and in comparison with other independence leaders of former colonies, many of which faced subsequently a rather uncertain, if not troublesome future. Compared with this, the Tunku should perhaps also be remembered – by Malaysians and foreigners alike – as the leader and, in a sense, founder, of a stable, prosperous and democratic country which features 50 years after independence (contrary to countless other countries that underwent struggles for freedom from colonialism) a freely-elected government – currently the world's longest-serving – with an alliance – Barisan Nasional, BN – that mirrors Malaysia's ethnic groups, religions, and cultures.

Sheppard's book consists of 18 chapters that evolve around crucial events in Tunku's life. The preface by Sheppard is dated 1 August 1994 and appears thus to have been written only very shortly before his death the following month. Most impressing to this reviewer has been the ability of the author to present to his readers a picture that does not let Tunku appear as 'superhuman', a kind of 'super-hero' – again, contrary to many other of the world's early post-independence leaders of the 1950s, such as Egypt's Nasser. Most of Tunku's achievements as a leader are known to Malaysians and politically interested individuals abroad. What was lacking *before* Sheppard published his biography, however, was a portrait of Tunku Abdul Rahman, the man, a picture that would reveal as much as possible of his upbringing and even personal habits – even those which would be perceived as signs of weakness by certain people. To the mind of this writer, the particular fascination of Tunku consists in his unpretentious, honest and humble, yet steadfast, way of life, whether before or after he went into politics and assumed the leadership of the independence movement of his country. He was born as a prince; a son of a ruling sultan in the Malay state of Kedah and sent to Cambridge to study law, he was often perceived as displaying a typical 'rich kid's' attitude. The book does not only mention that Tunku's ancestry is Siamese from his mother's side (a fact which everyone knows in Malaysia), but also offers deep insights into the setting of Kedah at the turn from the nineteenth to the twentieth century, when it had been still under Siamese suzerainty, and into the various connections between the courts in Bangkok and Kedah. These connections reflected, among many other things, the

facts that members of Kedah's royalty – including the Tunku – often spent a part of their lives in the Siamese capital.

Upon his return from Britain, Tunku Abdul Rahman was posted at various administrative functions in the countryside of Kedah, where he could see for himself the often appalling living-conditions of the locals. His sense for justice destined him to become their champion – without becoming an exaggerated version of 'Robin Hood' – often supporting them in their petitions, even to the extent of making enemies among his peers and superiors. During World War II, he 'rescued' – in fact 'kidnapped' – his incapacitated father, the sultan, from a perhaps ill-fated escape to the strategically important island of Penang, which doubtlessly would have been a desirable bombing target for Japanese airplanes. During the brutal Japanese occupation period he tried to improve the lot of his people by pleading their case to the new rulers, however, never by giving up his dignity, before, towards the end of the war, opposing the occupiers openly. This part of the book, dealing with pre-independence Malaya and Tunku's life *before* his involvement in the independence movement was the most rewarding one to this reviewer. The rest is part of Malaysian national history and has been told by others.

Many of Sheppard's readers – especially non-Malaysians who spent some time in the Malaysian capital – will be interested in the many trivia provided by him on Kuala Lumpur as it looked during the days of the Tunku – prior to the massive transformation that took place subsequently, in particular during the Mahathir era. It had been the Tunku who conceived the idea for the building of the beautiful National Mosque, the National Museum, the arrangements concerning the *Dataran Merdeka* or 'Freedom Square', and the National Monument which commemorates the heroes of Malaysia and the Commonwealth nations who gave their lives for the defence of Malaya against the Japanese invaders and the communist terrorists. All of those buildings have since then become major landmarks of Kuala Lumpur.

In sum, the book offers much more than what is usually to be found in a biography. It grants not only Malaysians but also foreign friends of this country with a deep insight into what it meant to fight for independence in a multi-ethnic, multi-religious context, to unite a nation, and to preserve its freedom from the threat of Communism and against malicious envy from the part of others. Moreover, Tunku Abdul Rahman's particularly humane (and often 'all too human') attributes emerge perhaps best from Sheppard's book: his humbleness in spite of being of royal stock, his aversion to false pride, his sense for reality, and his being true to himself and his own words, features that have often also been attested by men who went different ways, among them Singapore's leader Lee Kuan Yew. It is thus hoped that Tunku Abdul Rahman Putra Al-Haj and Tan Sri Dato' Al-Haj Mubin Sheppard will be remembered not only by Malaysians, but also by all those who have become acquainted with the country, its people, and its diverse cultural heritage.

Fauziah Mohd Taib (ed.) – *Number One Wisma Putra*

(Kuala Lumpur: Institute of Diplomacy and Foreign Relations, IDFR, 2006), hardcover, 311 pp. ISBN: 983-2220-11-4

Christoph Marcinkowski *LAIS Malaysia*

Number One Wisma Putra celebrates more than half a century of service to Malaysia by the country's Foreign Service. Its humble origins date back to July 1956 as External Affairs Ministry of the then Federation of Malaya, before Prime Minister Tunku Abdul Rahman Putra Al-Haj became the first Minister of Foreign Affairs in September 1957 – only ten days after independence from Britain. Today, No. 1 Wisma Putra happens to be the address of the Malaysian Ministry of Foreign Affairs in the country's new administrative capital, Putrajaya, which is only a short drive south of Kuala Lumpur, where the Ministry had its beginnings. As pointed out in the foreword by Malaysia's former Prime Minister, Tun Abdullah Ahmad Badawi, who from 1991 to 1999 served also as the country's foreign minister, 'Wisma Putra' is the popular non-official name for the Ministry, thus fondly remembering its founder Tunku Abdul Rahman, the 'Father of Malaysia's Independence'.

The book has been carefully edited by HE Fauziah Mohamad Taib, who was between 2005 and 2007 the Director General of the Institute of Diplomacy and Foreign Relations (IDFR), and who is since 2008 the Permanent Representative of Malaysia to the Organisation for the Prohibition of Chemical Weapons (OPCW) at The Hague and concurrently accredited as Malaysia's Ambassador to the Netherlands.

The book was already conceived back in 2005 by Malaysia's then foreign minister, Dato' Seri Syed Hamid Albar. He contributed also its first chapter, which is particularly charming as it provides deep insights into the often trying circumstances in which the holder of that office might find himself in his daily work. Altogether, the volume contains seven parts that are divided into 31 chapters – each of them written by a diplomat or senior civil servant of the Ministry. The chapters address in a lucid and often enchanting manner the Ministry's historical foundations, the daily life of Malaysia's ambassadors and diplomatic representatives abroad, and provide portraits of places and people in their host countries. The contributors to this volume reveal their often very personal experiences – such as what it meant to be a Malaysian ambassador in certain war zone countries, for instance in Vietnam in the early 1970s or in Saddam's Iraq during the various wars that were either initiated or provoked by him during his brutal rule. They not only provide valuable insights into the daily lives of those diplomats, but also offer information on the host countries that remain often untold in the media. Among the stories that were most interesting to this reviewer, who has some background in the study of strategic and

Middle Eastern affairs, is the account by Fauziah Mohamad Taib (chapter 28, “The Day the World Changed”, pp. 257–69), who had been Deputy Chief of Mission in Washington DC from 1998 to 2003, on the September 11, 2001 terrorist attacks on the World Trade Center in New York City, seen through her own eyes. Similarly moving are the stories by Dato’ K.N. Nadarajah, Malaysian ambassador to Iraq from 1986 to 1991 (chapter 27, “Gulf Crisis: Evacuation of Malaysians”, pp. 247–55), and especially by Tan Sri Ahmad Fuzi Abdul Razak, previously Director General of IDFR and currently Ambassador-at-Large for Foreign Affairs (chapter 21, “An Encounter with Saddam Hussein”, pp. 193–201). Very valuable, too, are the insights provided by Datin Paduka Dr Rajmah Hussain, who currently serves as Malaysia’s first female ambassador to the United States (chapter 29, “Reflections of a Lady Diplomat”, pp. 271–81). The fact that Sharifah Shifa Al-Attas, IDFR’s Director of Research and Publication (who already has a reputation as one of Malaysia’s most distinguished editors) has been behind the design of the volume’s cover and layout has ensured that this book is also from an aesthetical and artistic point of view such a delight.

In sum, however, *Number One Wisma Putra* is not just a beautiful book that should not be missing on the shelves of those who want to know what it meant to create from scratch an efficient foreign ministry. It will also be treasured by those who want to know more about the key players, their often turbulent experiences and adventures – be it as foreign minister or as ambassadors. It is thus a fitting tribute to and celebration of the achievements and hard work that led to what Wisma Putra is today – a worldwide respected institution with now 102 diplomatic missions around the globe of a country that is also making a steadily increasing impact as a bridge between Asia and the West.

David Levering Lewis – *God’s Crucible: Islam and the Making of Europe, 570–1215*

(New York and London: W.W. Norton, 2009), paperback, xxv + 473 pp.
ISBN 978-0-393-06472-8, US\$17.95

Karim D. Crow *IAIS Malaysia*

God’s Crucible marks Lewis’ historical engagement with the major theme of the impact of Islamic civilisation upon the formation of Europe. Through his synthesis of secondary historical studies in English, French and Spanish Lewis paints a broad historical canvas portraying the rise and spread of Islam in South West Asia, its dramatic extension across North Africa into the Iberian peninsula and beyond under the Umayyad Caliphs, and the complex interaction and vicissitudes of Christian and Muslim powers in Hispania/Andalusia. He ends his narrative with the start of

the *reconquista* at the fateful Battle of Las Navas de Tolosa in 1212, which was fought not far from Toledo in central Spain and which ended with the total victory of the combined forces of three Christian kings of Castile, Aragon, and Navarra over the Almohad caliph Muḥammad III (r. 1199–1213): “the first war fought by Christians and Muslims exclusively *as* Muslims and *as* Christians – a war between civilizations” (p. 378). Lewis clearly has the contemporary ‘clash’ in mind when exploiting this much abused phrase.

Lewis is a distinguished scholar of comparative history (University Professor) now teaching at New York University, twice winner of the Pulitzer Prize for his two-volume biography of W.E.B. Du Bois, and a past president of the Society of American Historians. The range of his competence includes the late-nineteenth-century conflict between British imperialism and Muslim reassertion, a biography of Martin Luther King, and a history of anti-Semitism in France with the Dreyfus affair at its centre. For a historian hitherto concerned chiefly with the modern period, to undertake a detailed synopsis of Islam’s unfolding over its first half-millennium and the amazing presence it established in southwest Europe – without previous training in Arabic or Iberian studies – shows both intellectual curiosity and courage. Fortunately, there now exist enough basic Arabic sources in translation (Ibn Ishāq, Ṭabarī, Masʿūdī [in French trans.], Maqqārī, Ghazālī, Ibn Rushd, Ibn Khaldūn) along with solid surveys and monographs on specific topics and periods, that an American historian may approach the classical age of Islam with a measure of credibility.

It is gratifying to see Lewis insisting on employing ‘Common Era’ (CE) dating – instead of the Christian-derived AD – and recognising that historical objectivity requires one to match significant European dates with their Islamic era *hijrah* equivalents (AH) – thus the Umayyad conquest of Visigothic Hispania occurred in 711 CE = 92 AH (i.e. 78 solar years after the death of the Prophet Muḥammad). In his preliminary ‘Notes on Usage’ Lewis correctly observes (p. xix):

The time is fast approaching when Arabic names and terms, unfamiliar and difficult though they are to people formed by Western culture, should be reproduced in historical works intended for a wide readership avid for information and understanding precisely as they are written in Standard Arabic with their diacritical notations.

But his editors’ preference must have intervened, for he next states: “diacritical marks have been omitted in the transliteration from Arabic” – even while he employs many Latin, Greek and Spanish terms deemed essential for purposes of his *narrative*.

And what a narrative does Lewis pour out of his wide reading and digestion of a rich pastiche of scholarship – a veritable exhilarating jaunt through the centuries at a speedy clip! Intending on serving up a piquant meal ‘for a wide readership’, he dwells in some detail upon certain key events and battles shaping the course of history: from the penetration of Hispania in 711 by Ṭāriq b. Ziyād (governor

of Tangier under Mūsā b. Nuṣayr the Umayyad viceroy of *Ifriqīyah*, what was formerly the Roman province of *Africa*, roughly corresponding to modern Tunisia and the eastern parts of Algeria), the ‘myth’ of the battle of Poitiers (chap. 7), and the “Carolingian *Jihads*” with the fundamental role exerted by the *Song of Roland* in forging the European sense of self and of otherness (chap. 11). One frequently gets the impression that Lewis is trying too hard to make his dense fact-filled prose more digestible and absorbing by choosing adjectives, snappy popular images and idiomatic turns of phrase to lighten up his narrative (p. 370: “The Toledo conveyor belt delivered a volume of translated data that significantly lifted the cultural level of the West”). His narrative is history popularised for the educated ‘western’ readership, and there is a real need for such vulgarisation in our era when voices assert the inevitability of ‘war between civilizations’.

Lewis uncovers nothing new which others have not previously examined. His gift is that of synthesis and presentation wrapped in a stimulating recounting, peppered with his own judgments and hypotheses. Comparing Lewis’ bestselling work with the earlier solid historical study by Norman Daniel, *The Arabs and Mediaeval Europe*,¹ who covered much the same civilisational ground as Lewis does, yet who paid more attention to Central and Western Mediterranean regions besides Andalusia, as well as to the cultural and scientific factors. One regrets Lewis’ inexperience with western Islamic studies, sometimes being misled by his secondary sources to commit elementary errors (which a competent editorial staff could have prevented). We may mention here several errors, not to detract from Lewis’ achievement, but to caution readers they are being treated to a tertiary presentation which may inadvertently distort.

In his second chapter Lewis describes the Zamzam well (in the near vicinity of the *Ka’bah* in the centre of Mecca) as “a few miles outside the city” (p. 31); the Prophet Muḥammad’s youngest daughter Fāṭimah becomes “his eldest daughter” (p. 52), and on the same page the first Caliph Abū Bakr died “from natural causes” – whereas sound Muslim tradition records Abū Bakr died of poison. When recounting the Prophet’s participation in the rebuilding of the *Ka’bah* five years before the start of his mission, Lewis writes (p. 32): “At age thirty-five, we see fairly prominent Meccan Muhammad pitching in physically to help raise the *Ka’bah* walls and spruce up the numerous fetishes and minor deities surrounding the structure.” As far as I am aware, there is absolutely *no* mention of any such ‘sprucing up’ by the merchant Muḥammad of the idols surrounding the *Ka’bah*² in early Arabic sources! What is stressed and often repeated in Muslim sources is Muḥammad’s crucial assistance in resolving the dispute among his clansmen through helping to remount the sacred ‘Black Stone’ into the wall of this venerable structure. This kind of gratuitous projection on Lewis’ part tends to undermine confidence in some of the hypotheses

he proffers over the course of his narrative, displaying his tendency to sacrifice accuracy and attention to detail for the sake of his grand sweeping narrative.

In his important final chapter on the intellectual achievements of al-Andalus and its legacy for the emergence of the European mind (pp. 367–79), entitled “Knowledge Transmitted, Rationalism Repudiated: Ibn Rushd and Mūsā b. Maymūn”, Lewis commits factual and interpretive errors regarding the proper assessment of the centrality of rationality in Islam. Referring to Muslim philosophers Lewis opines (p. 368): “The signature of Arabic philosophy (*falsafa*) was synthesis and commentary whose prototype came with the Persian-inflected writings of Ya‘qub ibn Ishaq al-Kindi during the middle of the ninth century.” Now, quite apart from characterising Islamic philosophy as concerned primarily with “synthesis and commentary” (which might be an accurate description of Hellenic philosophy in late antiquity), to portray al-Kindī’s writings as “Persian-inflected” is mistaken, since he was a pure Arab descended from the tribe of Kindah based in lower Iraq, frequently referred to afterwards as the ‘philosopher of the Arabs’. The greatness of al-Kindī and his profound contribution to the advancement of human thought through the circle of scholar-translators he promoted and patronised under Abbasid rule, is only today becoming apparent through studies by G. Endress, R. Rashid, and others.

Lewis pays attention to Ibn Rushd (the Averroës of the medieval Latin West), whose massive impact upon the Latins continues to reverberate today, and who is credited with having helped craft the Almohad Creed (‘*aqīdah*’) issued by caliph Abū Ya‘qūb Yūsuf in 1183 – rightly described by Lewis as (p. 373): “a triumph of rationalism mobilized in support of qur’ānic authority”. But Lewis curiously portrays him as (p. 372) “the greatest exponent of a modified Mu‘tazilism” whose Aristotelian philosophic doctrines (e.g., the heavens were created in time) “betrayed dangerous Mu‘tazilite ideas”. This again appears to be a case of being misled by secondary sources, or of his too casual and hurried reading. In truth, one cannot fault Lewis here for conflating the peripatetic strain of Islamic philosophic rationality with the theological school of Mu‘tazilite speculative reason, since this unwarranted confusion still remains a commonplace within the secondary literature and still today is deemed by many as conventional wisdom. This old misunderstanding was fostered by Occidental scholars who studied Islam in the late nineteenth and early twentieth centuries.³ Ironically, this error was much earlier intentionally perpetrated as a slander by *ḥadīth*-based Traditionalist Muslim authorities often suspicious of too wide a scope awarded rationality within religious thought. The Mu‘tazilites were the first major orthodox theological school in Islam for several centuries under the Abbasids, and actively opposed Hellenic philosophic doctrines – they certainly never held that the heavens were temporally created! To blame them for the sins of the Greeks (reason vs. revelation) is a fallacy, and it would be best to discard this old canard.

The thrust of this well written book brimming with battles, caliphs and kings, and insights into the cultural and intellectual formation of early medieval Europe, is that Europe's rise would not have been possible without the civilisational fertilisation which Islamic presence in Andalusia bestowed. In an interesting convergence with the thesis presented 30 years ago by the reputable Tunisian thinker Hichem Djaït,⁴ Lewis confirms that the history of modern Europe (and by extension, the globalised Euro-American system now in place) was brought about in large part as a *reaction* to Islam. This realisation may serve as a starting point for re-thinking the civilisational needs of Muslim societies now dominated by a powerful mercantile and military 'West'.

Notes

1. N. Daniel, *The Arabs and Mediaeval Europe* (London and New York: Longman, and Beirut: Librairie du Liban, 1979, 2nd ed.); the third of Daniel's great trilogy on the historical unfolding of mutual perceptions between Islam and Europe, that began with his classic *Islam and the West: The Making of an Image* (Edinburgh: Edinburgh University Press, 1960). Daniel exploited the original Latin and Arabic sources and made major contributions to our understanding of the reciprocal engagement between pre-modern Europe and Islam. Interestingly, Lewis ignores Daniel's work.
2. To be precise: 360 stone posts or 'idols' ringing the cubic centre, since the *Ka'bah* in most ancient times functioned as a solar calendrical device akin to Stonehenge and similar structures extant across Europe and North America. Few Muslims realise this today, of course.
3. Lewis makes clear his dependence on Orientalist discourse when he twice approvingly cites (pp. 374 and 421 n.17) the tribute paid to Ibn Rushd's great influence in thirteenth-century Christian Europe on the authority of that great doyen of neo-Thomist Catholic intellectuals, Etienne Gilson: "Rationalism was born in Spain in the mind of an Arabian philosopher as a conscious reaction against the theologism of the Arabian divines." Lewis here cites E. Gilson's *Reason and Revelation in the Middle Ages* (1938). See also Majid Fakhry, *Averroes: His Life, Works and Influence* (Oxford: Oneworld, 2001), xv–xvi.
4. Hichem Djaït [Ja'it], *Europe and Islam: Cultures and Modernity*, trans. P. Heinegg (Berkeley CA: University of California Press, 1985) – a work that still merits reading today.

Umer Chapra – *Muslim Civilization: The Causes of Decline and the Need for Reform*

(Leicester, United Kingdom: The Islamic Foundation, 2008), paperback, xxii + 225 pp. ISBN: 978-0-86037-4619, £13

Ibrahim Umar *University of Leicester, United Kingdom*

Chapra's book comes at a time when it is most needed. This is an era of upheavals and attempts at 'revivalism' in the Muslim communities and countries across the world. Chapra examines the factors responsible for the decline in Muslim civilisation and tries to offer suggestions on alternative routes for the Muslim world to regain its rightful position among the world's civilisations.

The book begins with raising some fundamental questions as to the reasons behind the current material and moral bankruptcy throughout much of the Muslim world. The author points at the contemporary disparity between the natural resources in the Muslim world and its poor indices of development. He argues that Islam was once a leading civilisation and a beacon for humanity. According to the author, its eclipse led to the crucial question of what has gone awry. Is the religion of Islam with its ideals, approaches and teachings ‘burned out’ or is the fault solely to be sought among its followers? Chapra tries to find answers by searching among the qur’ānic sources for factors responsible for the ‘downfall’ of any people such as the inability to initiate positive changes within themselves, loss of family values and bad governance. Chapra applies Ibn Khaldūn’s (d. 1406) theory of development and decline – to be found in his famous *Muqaddimah* or ‘introduction to history’ – as his theoretical framework and justifies his preference of this theory over other alternative models such as those offered by Edward Gibbon (d. 1794), Oswald Spengler (d. 1936) and Paul Kennedy (b. 1945).

In his first chapter, Chapra tries to explain Ibn Khaldūn’s model by considering the following themes: (a) the role of human beings; (b) the role of development and justice; (c) the role of institutions and the government; (d) the role of wealth; (e) the role of trigger mechanisms. He concludes the chapter by offering a critique of Ibn Khaldūn’s model pointing at its strength and shortcomings.

The second chapter examines the factors that contributed to the rise of Muslim civilisation in history and stresses the transformation of the backward early Muslim community – characterised by “bitter internecine feuds, paucity of resources, a harsh climate, difficult terrain, and excruciating poverty [...]” (p. 34) – by the Prophet of Islam from absolute obscurity to a global beacon.

Chapra devotes his third chapter to an examination of the factors responsible for the *general decline* of Muslim civilisation. He makes an attempt at debunking Kuran’s assertion that factors such as the absence of primogeniture, the lack of the concept of limited liability and legal personality in Islam, and the decline of the Islamic institution of *waqf* or charitable trusts, are responsible for the decline of Islamic civilisation. He also reiterates the issue of whether ‘moral degeneration’ is to be considered the main cause of Muslim decline. Chapra concludes that ‘moral degeneration’ alone does not adequately explain the causes of Muslim backwardness today. Other contributing factors, such as political oppression, tyranny and the subversion of the true and original meaning of *khilāfah* and responsible government in Islam need to be taken into consideration as well.

The fourth chapter is devoted to the *economic decline of the Muslims*. Chapra attributes to this decline fiscal imbalances, the allocation of massive land grants to the ruling family, unjust taxation, currency devaluation, external borrowing, corruption, the trading of political favours and the inability to develop physical infrastructures.

Similarly, in his fifth chapter Chapra tries to make out the reasons for decline in Muslim education, science and technology – a decline that reversed the huge strides made by the Muslims earlier in those crucial areas. Chapra believes that decline in state-funding and the inability to involve the private sector were responsible for the decline in these three crucial fields. He also introduces the reader to how the conflict between the rationalist and the conservative Muslim philosophers contributed to the decline in Islamic civilisation in general. In analysing the debate, he refers as examples to Al-Ghazālī (d. 1111) and Ibn Rushd (d. 1198), representing the ‘conservative’ and ‘rationalist’ schools of thought, respectively. He concludes this chapter by demonstrating how the increasing slide towards conservatism in the Muslim world led to the *ultimate decline of Islam as a world civilisation*. Chapra also makes an attempt at peering into the future of rationalism in the Muslim world. Likewise, he presents a comparative evaluation of Muslim and Western enlightenment movements.

The sixth chapter discusses the factors responsible for the *social decline* in the Muslim world. Notable among these factors were the yawning gap between the government and the people, the stagnation of *fiqh*, the role of Sufism which abstains from world pursuits as well as the deterioration in the position of women.

The seventh chapter draws some *lessons from Islamic history*. Chapra addresses the reasons for the negligence of their responsibilities from the part of Muslim rulers, the loss of the freedom of expression, the futile attempt by political authorities to inculcate positive values among the people, the loss of legitimacy by Muslim tyrants and the quest for external (non-Muslim) support. Chapra concludes by stating that Islam *per se* is not to be considered the cause of the decline of Muslim civilisation as a whole but itself, “a victim of lack of political accountability, corruption and repression” (p. 155).

In his eighth chapter, Chapra argues that the Muslim world failed to learn lessons from its past. Like the proverbial fool, the Muslim world kept stumbling over the same stone. The absence of democracy, lack of freedom of the press and a poor human development index continue to plague the Muslim world.

In the last chapter of this insightful book, Chapra makes a case for the *urgent need for reform in the Muslim world*. He advocates moral reforms, the establishment of justice, development and poverty alleviation, investment in education and microfinance, as well as institutional and political changes. Chapra suggests that globalisation, enlightenment and democratisation in the contemporary world would also lead to a more favourable climate for change among the Muslim *ummah*. Although he admits that the path to reform in the Muslim world is paved with thorns, he seems to believe that *peaceful struggle* is the only way of bringing reforms to the Muslim world.

However, it is rather disappointing to notice throughout the work that the author has failed to demonstrate how external forces, particularly Western ones, have

contributed to the decline of the Muslim world – by way of invasion, colonisation, and division. Rather naïvely, Chapra seems to believe that the Western world could ‘help’ the Muslim world to restore its lost glory. He offers his gratitude to the West for what he describes as its ‘humanitarian’ help to the Muslim world. He seeks to apologetically admonish the West for the damage that its adventures are causing in Iraq and Afghanistan and its support for Israeli aggression in Lebanon and Palestine. His attempt in this section simply reveals his poor comprehension of international relations and politics of international development.

On the other hand, Chapra has done a good job in kindling a lively debate on the important issue of *diagnosing the ailments of the Muslim world and prescribing alternative solutions*. However, the reader would have expected him to cite and criticise other works that have also focused on the causes of decline in Muslim civilisation and the need for reform. As a matter of fact, Chapra does mention a few works cursorily. However, those works offer no comprehensive diagnosis on the problems confronting Muslims today. Likewise, the author could have substantiated why the reader should believe in his suggestions as to how the Muslim world could regain its glory. Reference to other comparative sources could have helped the reader to know what others prescribe as solution, what are the similarities and differences in their argument, and why the author’s recommendations should be taken seriously. In similar vein, Chapra should have tried to offer an evaluation of the contemporary attempts by reformist groups in the Muslim world and should have presented some of the lessons from their various approaches. Chapra should have offered an in-depth critique of the different approaches. The limited space he devotes to Islamic movements is largely descriptive and presents rather unsubstantiated recommendations. Likewise, the reader misses an in-depth examination on whether the historical decay in Muslim civilisation was purely an inside factor or the result of other external forces such as Western intervention. The author is also silent on the effects that other important issues, such as the ‘war on terror’, can have on Islamic revivalism. In spite of those and other similar shortcomings, however, Chapra’s book should be considered an important contribution in the current ‘revival of Islamic civilisation debate’.

Muhammad Arif Zakaullah – *The Cross and the Crescent: The Rise of American Evangelicalism and the Future of Muslims*

(Kuala Lumpur: The Other Press, 2004), paperback, xii + 269 pp.
ISBN 983-9541-42-0

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Socrates, the great Athenian philosopher, once said that self-regard, self-knowledge and self-control would lead men to sovereign power. The idea was that through

understanding human nature one could determine how to live with others in successful communities, celebrating the unique qualities found in each human being, and recognising that sometimes individual interest must bow to the greater good. Thomas Hobbes, the English philosopher, wrote that persons should not do to others what they would not want others to do to them. The eighteenth-century German philosopher Immanuel Kant developed the concept of the categorical imperative, which states that individuals when considering a particular act that could impact others should also consider what the consequences would be if all others engaged in the same act. Rollo May, the psychologist, tells us that the truly mature human being is one who honours his or her talents and abilities, and puts these attributes in service to others, while at the same time honouring the talents and abilities found in others. One could argue that upon these basic concepts rest all flourishing and thriving human relationships.

Scott Gordon, a political philosopher and historian, has written that these basic principles and values are meaningless unless actualised through a strong nation-state with functioning and robust institutions and processes. Such a nation-state would provide safety and security for its members, do for the citizens what they could not do for themselves, operate within the framework of a constitution and the rule of law, create the means for citizens to make collective decisions on matters of general interest, establish a system of courts where the government and individual persons can plead cases before independent judges who have the authority to make binding decisions, and assure that the governors exercise authority under law and not act arbitrarily. Thus, it is within a stable and peaceful nation-state, following these basic institutions and processes, that it does become possible for human relationships to flower and for human potential to be realised.

David Landis, an historian of economic systems, and Thomas Friedman, a journalist, have both suggested that material progress is essential for any successful nation-state. Their research demonstrates that material progress is a product of a strong private sector, low rates of inflation, balanced budgets and price stability, low tariffs, allowing foreign investment, getting rid of monopolies, deregulating capital markets, making currency convertible, hiring and promoting on the basis of merit and competence, and increasing domestic competition. Governments should also eliminate corruption, create a strong educational system, promote gender equality, and assure the rights of property. An impoverished nation-state will not allow its citizens to achieve their potential and it will not foster the kind of institutions and processes that are critical to a healthy, stable and successful community.

In the book under review here, Zakaullah, an American-trained Muslim economist and a professor of economics at the International Islamic University of Malaysia, investigates American Christian fundamentalism and its impact upon the American political system, and how that impact might affect relations between the Western

world and the Muslim world. The book itself is a treasure trove of statistics and analyses of American elections and religious predispositions. The research is exhaustive in many areas of interest, and the insights into the American political mind are probing and suggestive. It is the salubrious professional attitude that Zakaullah brings to his research and writing, however, that sets the book apart from the many other efforts to compare and contrast the Western and Muslim worlds. He is wise in rejecting the Orientalist approach to his subject because of its inherent bias against anything non-western, its lack of scientific rigour and because he believes that the conflicts between these two worlds can only be resolved through scientific (empirical) studies of the issues involved. Dialogue based on empirical data, informed by universal ethical principles, and supported by religious and political leaders of good will can resolve issues that divide human beings.

Zakaullah begins his book by analysing the American 2000 presidential elections. The central question for him is why, given the excellent economy under President Bill Clinton, did his Vice President, Al Gore, lose the election to the Texas governor, George W. Bush? He looks at previous presidential elections and determines that when the economy is good the incumbent party usually retains the White House. His answer is that the phenomenon of 'meta-economics' intervened, an interesting concept that suggests there are larger forces at work during a presidential election than just economics or more mundane things. These larger forces had to do with rudimentary changes in the American political landscape that began to take shape in the 1960s beginning with the emergence of Christian fundamentalism and evangelicalism in the American south, which transformed southern political majorities from supporting the Democratic Party to the Republican Party. With the failure of the second term of President Richard Nixon, and the emergence of personal character and trustworthiness as meta-economic issues, the southern voter tended to look for presidential candidates who were not tainted by scandal or immoral behaviour, and it seems that the sexual licentiousness of President Bill Clinton, along with other improprieties, rubbed off on his vice president, with the southern voter rejecting Al Gore as a candidate too closely associated with the stain of a seemingly unprincipled incumbent.

After discussing the concept of meta-economics and the presidential elections of 2000, Zakaullah looks to see how Christianity impacts politics in America. He analyses the contributions of Martin Luther and John Calvin to the American character and how Protestantism led to the American ethic of hard work, individualism, self-discipline, and personal honesty and diligence. He recognises that the twentieth century brought a division within Protestantism with liberal theologians questioning the fundamentals of the 'old time religion' and Christian conservatives fighting back by confirming the fundamentals of their religion: the inerrancy of Scripture, the divinity of Christ, the virgin birth of Jesus, the purpose of the Cross and the bodily

resurrection of Jesus, and the Second Coming of Christ. With the battle lines set, the Midwest and the southern parts of America kept faith with the basics of Christianity while other parts of America divided religious allegiances.

During the second half of the twentieth century, with US Supreme Court decisions on civil rights, abortion, and school prayer challenging the moral and religious views of fundamentalist Christians; the emergence of fiery, fundamentalist preachers (Billy Graham, Pat Robertson, Oral Roberts, Jerry Falwell); the successful candidacy of 'born again' President Jimmy Carter; and the two term presidencies of Christian conservatives Ronald Reagan and George W. Bush, it seemed that Christian fundamentalism had won the political day. No presidential candidate could lose the southern states and a number of states in the Midwest and then garner the electoral votes necessary to win the American presidency. To win those sections of America, along with the Rocky Mountain states, assures a successful presidential candidacy. And it appears that successful presidential candidates must be, at least most of the time, republicans or middle of the political road democrats who carry the banners of fundamentalist Christianity.

If America is becoming more conservative, and that conservatism is embossed with Christian fundamentalism, what impact will that phenomenon have on the Muslim world? Zakaullah presents an in-depth look at Millennialism as the core belief of contemporary Christian fundamentalists. This belief system is grounded on the Book of Revelation found in the New Testament of the Bible. Millennialists interpret this scripture as foretelling the following events during the last days of the world: prior to the end of the world there will be a series of cataclysmic events and these events have already started; prior to or at the end of 1,000 years, Christ will literally and bodily come back to earth to reign with glory, depending on your interpretation of the New Testament's Book of Revelation; and all sinners will be banished from a coming paradise with all believers in Christ reigning with him for eternity. Of course, there are many variations on this theme from a very conservative point-of-view to the interpretation that says the whole Book of Revelation is allegory and not to be taken literally. This belief system becomes an important point of departure, however, because if a substantial portion of the American electorate really believes this foretelling, and they have some control over presidential elections, then public policy could, however tangentially, be affected by this apocalyptic vision.

Of course, with the two major wars of the twentieth century, the doctrine of 'Mutually Assured Destruction' (nuclear war), weapons of mass destruction (chemical and biological weapons), the creation of the State of Israel, the war in Babylon (Iraq), the coming resource crisis, and the radicalisation of important parts of the Muslim world, some religious leaders, many politicians, and leading intellectuals see a 'clash of civilisations' looming in the future of the human race. Almost all of the important events in current world history are interpreted by

Christian fundamentalists as either precursors for or explanations of the events foretold in the Book of Revelation. The question Zakaullah asks is what will this ominous and momentous perspective have on the political and economic relationship between Christian America and the Muslim world?

The answer Zakaullah gives to the question involves the need for Muslim countries to create scientific research programmes and institutions in order to understand Christian America and her politics, economics, and cultural institutions and ideologies. Specifically, the Muslim world needs to create three world-class think tanks, “one focused on the United States, the other on the European Union, while the third think tank would focus on Judaism and Israel”. These institutions should be well funded and staffed with the best scholars of international note. Think tanks specialising in other countries and parts of the world are also envisioned. The research agenda for these think tanks would include the following issues: the nature of Western liberal democracies and their internal socio-economic and ethno-cultural sensitivities; the historical, economic, and social trends in other societies and the reasons for them; understanding Western media and how they work; study “contemporary ideological forces and movements in the West and try to analyse their implications” for the Muslim world; and study why there is such negative reaction and condemnation of the West by Muslim nations. The studies produced by these research institutions should be widely distributed by Muslim media and other sources of information. Beyond these new institutions, Muslim universities should establish programmes in Western and Eastern studies. It is through education and understanding that a ‘clash of civilisations’ can be avoided and mutual respect among peoples established.

If one studies the seven great world faith traditions one is impressed that all profess the same body of basic moral principles and ethical practices. If one also studies the great secular philosophers of the Greek, Roman, English, Scottish, and American enlightenment periods one is also informed that, with a few exceptions, these philosophers would agree to the same basic moral and ethical codes. If one looks at the Eastern ethical and moral traditions of Confucius and the Buddha one learns the same principles of basic moral behaviour and ethical conduct as taught by traditional religious and secular leaders. In other words, there seems to be a form of agreement among most human beings, no matter what their religious preferences or secular philosophical predispositions, that certain forms of human conduct are appropriate and other forms are not. Christian fundamentalism may have a view of the coming Apocalypse but the rules of human conduct towards others are stated clearly in the New Testament of the Bible. Other faith traditions have views pertaining to the end of human history but their codes of human conduct towards others are explicit and understandable. Beyond principles of human conduct we also know, based on the information stated above, how to produce material prosperity for

a nation-state and what kinds of civil and governmental institutions and processes are necessary for successful group life. So, what's the problem?

Most scholars analyse a problem brilliantly and then offer solutions that are manifold but not particularly efficacious to the problem addressed. Zakaullah does not fall into this trap. While not specifically answering the question concerning the relationship between American Christian fundamentalism and politics and its impact on the Muslim world, he does give us the institutional framework for answering the question. He recognises, along with John Stuart Mill, that an open-ended study of the problems that face a society, learning from many sources, using empirical research to understand problems and the possible solutions to them, opening young minds to the possibilities of the future, and interacting with 'the other', is the only way to achieve a peaceful and orderly world.

EVENTS AND REPORTS

Visit by the CEO and the COO of IAIS Malaysia to Istanbul (29 May–3 June 2009)

Zarina Nalla, IAIS Malaysia

2nd International Ibn Khaldūn Symposium: Ibn Khaldūn Today Precursor or Alternative? (Istanbul, May 2009)

In 2008, IAIS Malaysia received a concept paper for the “2nd International Ibn Khaldūn Symposium: Ibn Khaldūn Today Precursor or Alternative?” which the Center for Islamic Studies (ISAM) and the International Ibn Khaldūn Society planned to organise jointly in Istanbul in May 2009. IAIS Malaysia decided to become a co-sponsor together with four other institutions, namely the Istanbul Foundation for Education and Research (ISAR), the Duke Islamic Studies Center (DISC) at Duke University, the Department of Malay Studies in the National University of Singapore, and the Department of Sociology at Sakarya University, Turkey.

The four-day symposium, attended by Professor Mohammed Hashim Kamali (Chairman and CEO, IAIS Malaysia) and this writer (COO and Co-Founder, IAIS Malaysia), began on 29 May 2009 and was an interdisciplinary forum that focused on applying Ibn Khaldūn to historical and contemporary issues rather than on meta-theoretical statements on his work.

The following themes were addressed: How can Ibn Khaldūn’s theory be applied to the study of modern political, economic, cultural, and religious phenomena? What is the relevance of the Khaldūnian approach to modern debates concerning the relationship between Islam and the social sciences? How can we interpret ethnic conflicts, empires and civilisations, and inter-cultural relations, alternatively using Ibn Khaldūn’s theory?

The event was also attended by Dr Bruce Lawrence (Director, Duke Islamic Studies Center), Dr Abdesselam Cheddadi (Mohamed V University of Rabat, Morocco). Two papers were presented from Malaysia: One by Professor Kamali, entitled “*Umran Hadhari, Islam Hadhari and Tajdid Hadhari*”, and the other, “Ibn Khaldūn and Urban Planning”, by Associate Professor Dr Zaid Ahmed of University Putra Malaysia.

Meetings Conducted after the Symposium

Several visits had been organised for IAIS Malaysia by the Turkish Cultural Centre. In this regard, IAIS Malaysia is grateful to Dr Fateh Uğur Ergun (Turkish Cultural Centre, Malaysia), who was instrumental in setting up the meetings.

The Centre for Islamic Studies (ISAM)

ISAM is a teaching and research institution on the way to becoming a university. We met Dr Akif Aydin, director-general of ISAM, Dr Cengiz Kallek (Deputy Director), Dr Nuri Tinaz (Research Fellow, Sociology and Sociology of Religion) and Dr Mehmet Sait Ozervarli. We discussed the content of the Memorandum of Understanding (MOU) between our two institutions which is awaiting final decisions. Possible areas of cooperation were explored, such as contributions by IAIS Malaysia to the Islamic Encyclopedia project and exchange of scholarly articles.

The Istanbul Foundation for Science and Culture

Here, we met Professor Dr Faris Kaya, the foundation's secretary and had been introduced to one of the few living students of Said Nursi, Muhammed Firinci, who is in his nineties. This most memorable meeting took place in an centuries-old *madrasah*. Plans were discussed to co-organise a joint conference in 2010.

The Kaynak Publishing Group

Kaynak Publishing Group is one of the leading publishers of books on Islamic religion, history, art, spirituality, and traditions. Based in Turkey and with offices in New Jersey, Cairo and Moscow, Kaynak generates income that helps fund the efforts of the Fethullah Gülen Movement. We met with Kaynak's chairman Naci Tosun, Fikret Yaşar (publishing coordinator), Hakan Yeşilova (senior editor of *The Fountain*, the English-language organ of the Gülen Movement), and his colleague Hüseyin Bingül. We had a tour of their impressive office building and were walked through the various work processes of their publishing business and operations. It was an eye-opening experience, as we witnessed the importance of work-flow between various units in such a large organisation. Kaynak publishes many magazines in several languages, as well as textbooks. They explained in detail their vision, as well as their current and future projects. We signed an MOU with them and explored plans for further collaboration.

The Journalists and Writers Foundation

The Journalists and Writers Foundation was established in 1994 and plays a key role within the Gülen Movement. The activities include the organising of conferences as well as publishing. They are active in the media industry, especially as they are closely connected to *Today Zaman*, one of two major English-language daily newspapers circulating in Turkey. We met with Erkam Tufan Aytav, its vice president. We agreed to an exchange of articles and the Foundation plans to translate into Turkish the writings of Professor Kamali for posting on their website and print publication in the media. We signed an MOU with the Journalists and Writers Foundation, and there are currently on-going discussions between our two organisations to co-organise a conference in 2010.

The ISM (Centre for Sciences and Arts) and the Istanbul Foundation for Education and Research (ISAR)

ISM is an impressive centre of Islamic learning in which Dr Recep Senturk, a professor at Istanbul's Fatih University, plays a major role. We met many young folks there who were apparently university students. Professor Kamali presented a lecture on "*Ijtihād* and *Maqāṣid* in Islamic Law". The question and answer session was very lively. The writer of these lines spoke about IAIS Malaysia and also her experiences as a former university student in Malaysia. Many female students came forward to speak to me and I went away realising that more women must be given opportunities to contribute to our future in visible and significant ways in order to become role models for younger members of our community.

The OIC Research Centre for Islamic History, Art and Culture (IRCICA)

IRCICA is a subsidiary of the Organisation of the Islamic Conference (OIC) and is active in research, publishing, documentation and information. Its mandate covers multifarious themes in the history of Muslim nations, the history of arts and sciences in Islam, and other areas in Islamic culture and civilisation. We met with Dr Halit Eren (Director-General) and Dr Fatih Bayram (Researcher). We were also given a tour of their newly improved library which is set in a historical building. Any future cooperation with them would need to be coordinated through Malaysia's Foreign Ministry as the relationship with IRCICA falls into the domain of government-to-government relations.

Visits by the CEO and the COO of IAIS Malaysia to Universities and Research Institutions in New Zealand and Australia (July 2009)

Zarina Nalla, IAIS Malaysia

New Zealand

*Colloquium "The Role of the Study of Islam in the Western University",
Otago University, Dunedin, New Zealand (6–8 July 2009)*

IAIS Malaysia was invited to attend the colloquium "The Role of the Study of Islam in the Western University", organised by Otago University, Dunedin, New Zealand, during which two main questions were addressed:

- What relation is there between the study of religion of Islam and the study of those cultures that have shaped and been shaped by that religion?
- What is the appropriate public role of a scholar of Islam?

The answers and the discussion that ensued were meant to assist the University of Otago and Victoria University of New Zealand in jointly establishing a Centre for the Study of Islam and Muslim Cultures (CSIMC), intended to take a lead role on Islam

and issues of concern to Muslims in New Zealand. Other aims include becoming the national centre for the best quality academic research and instruction in Islamic Studies. The event featured four keynote speakers and 15 other presenters. Professor Kamali was among the major speakers that included Dr Alia Imtoul, Dr Anthony Johns, and Dr Andrew Rippin. Danny Mellsop from the New Zealand Ministry of Foreign Affairs and Trade was also present. Professor Mohammed Hashim Kamali (Chairman and CEO, IAIS Malaysia), spoke on “Teaching Islam in Western Universities”, while this writer (COO and Co-Founder, IAIS Malaysia) spoke on “The Teaching of Islam in the East and the West – a student’s perspective”. Both of us positioned IAIS as a key resource to aid in the setting up of the Islamic Centre.

CSMIC Wellington Symposium, Victoria University, Wellington, New Zealand (9 July 2009)

Participation at this high-level event was limited to invitees only. The intention was to explore the various contemporary models of ‘Islamic Studies’ in the context of the modern university, their merits, the academic environment for the field and future events. There were four panels; Professor Kamali participated in Panels 1 and 2, while this writer was a speaker in Panel 3:

Panel 1: Current Models of ‘Islamic Studies’ in the University – or how did we get to here?

Panel 2: ‘Islamic Studies’ beyond colonialism and orientalism

Panel 3: Islam and the Study of Islam – relationships, personnel and issues

Panel 4: The future contours of the university and issues

Australia

In mid July 2009, IAIS Malaysia was invited to Australia to make presentations in several cities. Professor Kamali and this writer used this opportunity to introduce our newly launched Institute, to share and exchange information and to seek collaboration with like-minded organisations.

Visit to Griffith Islamic Research Unit (GIRU), Griffith University, Brisbane

We visited GIRU where we had an audience of 30 keen listeners, comprising PhD students, academics and administrators. Our main hosts were: Dr Mohammad Abdallah, head of GIRU, and a respected committee leader; Dr Halim Rane, deputy director of the Griffith Islamic Research Unit and a lecturer in the National Centre of Excellence in Islamic Studies at Griffith; and Dr Mahmoud Nathie, a lecturer who specialises in Islamic banking and finance. During that occasion, Professor Kamali gave a lecture entitled “The Higher Objectives of the *Shari‘ah* Law” and launched a book written by Dr Halim Rane entitled *Reconstructing Jihad Amid Competing International Norms* (Palgrave Macmillan, 2009). The audience also watched a video presentation that introduced IAIS Malaysia. This was followed by a

short speech which this writer delivered, describing with some detail our beginning, research agenda, activities and publications. We later discussed the possibility of collaborating with GIRU in the area of research and publication.

Visit to National Centre of Excellence for Islamic Studies (NCEIS),

University of Western Sydney and University of Melbourne

Upon the invitation of Dr Abdullah Saeed, the director of NCEIS, we visited the National Centre of Excellence for Islamic Studies (NCEIS). The centre, though based in the University of Melbourne, provides academic access to the Griffith University and the University of Western Sydney. The centre established in 2007 with government funding, aims to advance the knowledge and understanding of the rich traditions and modern complexities of Islam and to profile Australia's strengths in the field of Islamic studies. Professor Kamali was requested to speak on "Reforming Islamic Law" to a sizeable group of scholars and students. The presentation went well and generated a lot of interest from the floor. Audiences were also keen to learn more of IAIS Malaysia's willingness to collaborate with international parties. The event, chaired by Dr Abdullah Saeed, ended with the discussion on several proposals which were raised by his deputy, Associate Professor Dr Shahram Akbarzadeh. We also met three Malaysians who were visiting fellows, currently doing their PhDs.

Visit to University of Western Sydney (UWS)

Professor Kamali and this writer met with four scholars for a two-hour meeting and in-depth discussion. There was no formal presentation. Instead our hosts were essentially interested to know more about how and why IAIS Malaysia came about. I spoke mainly on our plans, exchanging our ideas for the future. The meeting also featured a video presentation about IAIS Malaysia, and we discussed possible avenues of collaboration. Moreover, we met with Dr Nancy Wright, Dr Bryan Turner, Dr Steven Drakeley, Dr Jan Ali, and Dr Nigel Bond. Later, we discovered that USW has launched a new research centre, the Centre for the Study of Contemporary Muslim Societies, which aims at exploring the place of Muslim communities in contemporary multicultural societies. The Centre, an independent research group, is a component of the National Centre of Excellence for Islamic Studies (NCEIS).

Three Conferences on Intercivilisational Dialogue (Shanghai, China, 28 June–3 July 2009)

Karim D. Crow, IAIS Malaysia

I was fortunate to attend three meetings in the Peoples' Republic of China involving a team of international Christian and Muslim scholars working on cross-cultural and civilisational issues, interfacing with Chinese scholars at leading academic and policy institutes in Shanghai.

This international team, organised by the Washington-based Council for Research in Values and Philosophy (RVP) in collaboration with the host Chinese institutions, consisted of twelve scholars plus one organiser:

Prof. George McLean (RVP, Catholic University of America, Washington DC); Prof. Gholamreza Aavani (director, Iranian Institute of Philosophy, Tehran, and president of the International Society for Islamic Philosophy, ISIP); Prof. Vincent Shen (Lee chair in Chinese Thought and Culture, University of Toronto, Canada); Prof. William Sweet (Dept. of Philosophy and Religious Studies, St Thomas University, New Brunswick, Canada); Prof. Tran Van Doan (Dept. of Philosophy, National Taiwan University); Prof. João J. Vila-Chã, Dept. of Philosophy, Pontifical Gregorian University, Rome); Prof. Edward Wamala, Dept. of Philosophy, Makerere University, Kampala, Uganda); Prof. Wilhelm Danca (Roman Catholic Theological Institute, Iași, Romania); Prof. Anatolij Karas (chair, Dept. of Philosophy, Lviv Franko National University, Ukraine); Assoc. Prof. Edward ‘Alam (Faculty of Humanities, Notre Dame University, Louaize, Lebanon); Prof. Janis Ozolins (chair, Human Research Ethics Committee, Australian Catholic University, Victoria, Australia); Dr Karim D. Crow (principal research fellow, IAIS Malaysia); Dr Hu Yeping (RVP, Washington DC).

“The Enlightenment and Its Contemporary Re-Evaluation” (28–29 June 2009)

This colloquium was convened at the National Research Base for World Marxism and Thought Trends, in the School of Philosophy at Fudan University (FU), with 13 scholars from FU’s School of Philosophy presenting papers. Founded in 1905 as a college, Fudan University is perhaps the most prestigious university in mainland China; the philosophy school has 50 teachers and about 500 students up to the doctorate level. The final afternoon was devoted to a roundtable discussion on the future cooperation among philosophers from social, cultural and civilisational aspects.

As China’s modernisation gathers speed, they are re-thinking the legacy of the Enlightenment Project for their continuing development. Issues of the environment, market societisation, the negative role of instrumental reason, the need to better exploit cultural resources, and the goal of harmonious international relations consistent with Eastern traditions, were all discussed. All papers were presented in English, with Chinese summaries provided orally. Exchanges were energetic, fruitful, sometimes controversial yet collegial.

“Consultation on Religions and Cultures” (30 June 2009)

This event took place at the Shanghai Institutes for International Studies (SIIS), Center for Ethnic, Religion and Culture Studies (CERCS). Three directors of

separate institutes were present, including the influential Madame Professor Yu Xintian (director of CERCS), the Director of the Institute for Strategic Studies, and Professor Ye Jiang, director of the Institute for Global Governance Studies. SIIS was established in 1960 by Chou En-Lai (1898–1976), the first premier of the Peoples' Republic of China, and today represents one of the three most important think tanks for China's foreign policy, with over 100 researchers and staff.

Madame Yu gave an overview of the foreign policy objectives of China: in her view, peaceful international relations, sustainable development, openness and reform, and cultural authenticity are paramount for national policy. Ye Jiang suggested the need to go beyond the nation-state identity and to learn and integrate from other cultures. He addressed the topic of tradition and modernity, stressing his view that today's China encourages the fostering of cultural traditions (which in the past had been neglected).

The role of religions and renewed religious identity, too, was discussed, and one director forcibly raised the issue of the Dalai Lama – *is he a political or a religious leader?* The new confident even strident sense of self-assurance exhibited by the political leadership class was clearly evidenced. All the Chinese thinkers agreed that Islam (like Christianity) was a 'foreign religion', while Buddhism could be viewed as 'Chinese' or as exhibiting 'Chinese characteristics'. The increasing spread of Protestant Christianity (unofficial 'house' churches) among Chinese elites was raised, and it was suggested that its attraction was partly due to identification with being Western and modern. Madame Yu argued that essentially Chinese are not truly religious and only adopted religions for social or material needs.

The visiting scholars sought to convey that religions must be studied and understood not merely for strategic or security reasons, but for assisting the cultural transformations underway in arriving at authentic forms of modernity, and for national advancement and international cooperation. Economic and political ties need to be reinforced and deepened with cultural understanding and appreciation of traditions.

“Diversity in Unity: Harmony in a Global Age” (2–3 July 2009)

This conference was convened at the Institute of Philosophy of the Shanghai Academy of Social Sciences (SASS), with eight scholars from SASS's Institute of Philosophy participating by presenting papers. SASS includes several high-quality post-graduate institutes.

These papers with ensuing wide-ranging discussions dealt with broad issues of civil society, underlying values, pluralism, particularist trends in societies or regions, and critical themes of epistemic importance at the heart of Eastern and Western traditions. The connecting concern was how to support international harmony in the face of the cultural diversification spread by globalising forces, and the conflicting

visions of self-interest and identity exhibited by nations and peoples. The tone of discourse was uniformly high and very well-informed, Chinese scholars being well acquainted with European thought and contemporary intellectual fashions.

Assessment

In the course of both the Fudan University and SASS's discussions, several basic realities became apparent to the foreign visiting scholars: Contemporary Chinese thinkers – being very well trained in historical materialism and still wedded to a formal ideology of Marxist social theory with its reductionist view of the human – do not accept the reality of universals for knowledge theory. Even more remarkable is their explicit *rejection* that ancient Chinese philosophic worldview (Daoism; less so Confucianism and Buddhism) embraces any sort of transcendent basis for human awareness and achievement. In a very real sense, mainland Chinese thinkers remain good children of the Enlightenment (Kant, Hegel, Marx...), and uphold a materialist anthropology and epistemology. This feature of contemporary thinking in China was painfully demonstrated when the Iranian professor Aavani presented a profound summary of the metaphysical basis of Daoism, comparing it to the Pre-Socratic thinkers Heraclitus and Parmenides, supported by references to Ibn al-‘Arabī, Suhrawardī, and Mullā Ṣadrā, and offered this metaphysical harmony as a realistic grounding for global unity. Several highly respected Chinese professors attacked him for *mis*-understanding the essence of Chinese thought, heatedly insisting that ‘transcendence’ has always been foreign to Chinese thinking and experience. This led them to an amused dismissal of Professor Aavani.

Fifth International Conference on Children and Youth in MENA Cities: "Education, Reintegration and Rehabilitation of Youth for the Labour Market" (Aleppo, Syria, 6–8 July 2009)

Azizah Anuar, LAIS Malaysia

The Fifth International Conference on Children and Youth in MENA Cities, organised by the Arab Urban Development Institute (AUDI) and MENA Child Protection Initiative (MENA CPI), with the collaboration of Aleppo Municipality, Syria Trust for Development–SHABAB Project, UNICEF, and the World Bank, inaugurated by the Governor of Aleppo, Eng. Ali Ahmad Mansourah, gathered 26 speakers and 300 participants to share lessons learned and best practices related to vulnerable and marginalised children and youth in the MENA (Middle East and North Africa) region. The conference aimed to share experiences from other countries regarding policies and programmes for children and youths and seek solutions and offer recommendations to curb socio-economic illnesses

among children, especially street-children, and address youth employment and employability in the MENA region.

The first session was on “Youth as the Core and Crux of Development in the Arab World” and “Youth Employment Experiences in Five Arab Cities”, which addressed the critical issues of street-children in Egypt, the impact of economic sanctions on Palestinian youths, the increasing numbers of child-labourers in Jordan, the breach of human rights, and inadequate educational programmes affecting youth employability in Arab cities. The session “Problems and Challenges of Youths and Children in the MENA Region” dealt with issues of poverty, school dropouts, unemployment, parental education and low household income in MENA countries; the session “Programs for Reintegrating Children and Youth in Formal, Informal, and Non-formal Education” described a researcher’s experience in setting up community-based projects to curb street-children and unemployment in the Arab region. Other themes were: “Youth Employment Programme: Experiences and Lessons Learned from Regional and Arab Countries” and “Youth Rehabilitation: Training and Skills Development for Youths” – mainly based on research into social illnesses among youths in Jordan, Syria, Ghana, Nigeria, Uganda, Kenya, Tanzania, Egypt, Morocco, the United States and some European countries.

The writer of these lines was fortunate to be invited – for the session on “The Role of Governmental and Non-governmental Organisations in Alleviating the Youth Unemployment Problem” – as the only speaker/participant from Southeast Asia to share the Malaysian experience in eliminating the issue of street-children, curbing poverty among children, and creating job opportunities. Many participants commended the Malaysian Government’s inculcation of what they referred to as “the true spirit of Islamic teachings” in upgrading their citizens’ quality of life, dealing with child labour, creating better health, education and economic programmes, and fostering new job opportunities for their graduates and youngsters. A dialogue between youths and municipal mayors on youth employment programmes and policies brought this session to a close. The closing plenary session included the ‘final declaration’ and the conference recommendations, remarks of Dr Ma’an Alshibli (mayor and chairman of the Aleppo City Council), and the closing speech by AUDI chairman HE Sheikh Abdullah Al Ali al-Naeem, delivered on his behalf by Dr Ibrahim Al-Turki (executive director of the Child Protection Initiative in the MENA region).

It is recommended that IAIS give increasing attention to issues affecting youths and children in Muslim societies and direct research toward addressing major problems impacting on urban children in particular. Moreover, it is suggested that the Malaysian Government focuses on the arising of social illnesses among children and youths due to the current economic crisis and the impact of globalisation.

Public Seminar on Cash *Waqf*: "Empowerment of the Islamic Economy Through *Waqf*" (IAIS Malaysia, 11 March 2009)

Azizah Anuar, IAIS Malaysia

This seminar was organised by IAIS Malaysia in cooperation with the Department of Awqaf, Zakat and Hajj at the Prime Minister's Department (JAWHAR), the Malaysian Waqf Foundation (Yayasan Waqaf Malaysia) and Pertubuhan Muafakat Sejahtera Masyarakat Malaysia, a Malaysian Muslim NGO. The seminar explored the possibilities of how extensive *waqf* assets and cash *waqf* could be mobilised more efficiently for economic growth to benefit Malaysia and the Muslim *ummah* at large. The topic attracted 45 participants from financial and educational institutions, non-profit organisations, government agencies, corporate bodies, as well as IAIS research staff. Emeritus Professor Datuk Osman Bakar (Deputy CEO, IAIS) chaired this bilingual Malay and English discussion.

The seminar began with the welcoming address by Professor Mohammad Hashim Kamali (Founder and CEO, IAIS) with his brief introduction to *waqf* or 'Islamic charitable endowments'. Then Dr Magda Ismail Abdel Mohsin presented "Issues and Challenges in the Cash *Waqf* Development in Malaysia". She highlighted several issues and challenges facing the current development of cash *waqf* in Malaysia from a *shari'ah* perspective, recommending methods of preserving the *waqf* fund, decentralisation, amendment of the law of *waqf* administration by state rulers or religious bodies, and the importance of legal cash *waqf* documentation.

The "Empowerment of the Economy Through *Waqf* – Malaysian Experiences" by Dr Hj. Sohaimi Hj. Mohad Salleh (chief director of JAWHAR) was delivered on his behalf by Mr Syarqawi Muhammad (an assistant director of JAWHAR). He dealt mainly with the success of JAWHAR in administering and supervising *waqf* assets, *zakāt* and *hajj* in Malaysia. Mr Azri (CEO, Malaysian Waqf Foundation) in his "Implementation of Cash *Waqf* Malaysia", highlighting the Government's objectives in establishing the Malaysian Waqf Foundation and outlining its functions and challenges in implementation of the 'Malaysia Cash *Waqf* Scheme' by recommending its centralised collection.

In her presentation, entitled "The Implementation of Cash *Waqf* Education", the writer of these lines – an assistant research fellow at IAIS – proposed a new model for cash *waqf* in order to cater for free human capital activities and research funds. She also highlighted the success of cash *waqf* in Malaysia before the country's independence from Britain in 1957, describing the important role of the Government in encouraging more founders to set up their own cash *waqfs*, including Islamic cooperatives and Islamic non-profit organisations and individuals. She also recommended that individuals be allowed to administer and collect cash *waqf*.

under the supervision of religious bodies or state rulers as a means of assisting the Government to overcome the current economic crisis and socio-economic defects. She further advised the implementation of cash *waqf* education at IAIS itself.

This interesting and well-attended seminar closed with remarks by Professors Mohammad Hashim Kamali and Osman Bakar.

NOTES ON THE CONTRIBUTORS

Abdul Karim Abdullah (Leslie Terebessy) is Assistant Research Fellow at IAIS. An ethnic Hungarian, he was born in Bratislava in then Czechoslovakia (now the Republic of Slovakia) before immigrating to Canada in 1968 and holds dual Canadian and Slovak citizenship. Abdul Karim earned his MA in political philosophy from the University of Toronto in Ontario, Canada (1999), his BA (Hons) from the University of Guelph in Ontario (1976) in Political Science and Economics, and obtained a MEd (1986) from the University of Toronto's Ontario Institute for Studies in Education (OISE) with graduate work in moral and religious education. He was active for five years (2002–08) at University Sains Islam Malaysia (USIM) as lecturer, editor, writer and coordinator of the English programme. Current projects involve research into the causes of the current financial crisis and on critical thinking in Muslim societies. His forthcoming IAIS monograph *Enhancing Critical Thinking Skills Among Muslim Students* analyses the reasons for their often weak critical thinking skills. Among his publications is (ed.) *Islamic Studies at World Institutions of Higher Learning* (Kuala Lumpur: USIM, 2004).

Sanep Ahmad is Associate Professor at the School of Economics in the Faculty of Economics and Business at Universiti Kebangsaan Malaysia (UKM) at Bangi, Selangor. He obtained his BEcon (Hons) from the University of Malaya, his MA (Econ) from the University of Manchester, United Kingdom, and his PhD (Econ) from the International Islamic University in Islamabad, Pakistan. At UKM, he had been Coordinator of the Islamic Economics Programme and Head of the Department of Statistical Economics. Currently, he is the Head of the Econometrics and Islamic Economics Programmes. He specialises in Econometrics Modelling and Islamic Economics and is involved in various research projects on the Economy of *Zakāt* as well as Islamic Banking and Finance. He has published widely on those areas (mostly in Malay). He is also a member of Institut Kajian Rantau Asia Barat (IKRAB), the Islamic Economics Research Group (Econis) and the Dinar Research Group (DRG) at UKM. In addition, he has also been appointed as a consultant (most recently, on Malaysia as a '*ḥalāl* hub', in cooperation with Unipeq and MiGHT).

Syed Othman Alhabshi is Professor of Islamic Economics as Econometrics and Dean of the *Takāful* Faculty at the Kuala Lumpur-based International Centre for Education in Islamic Finance (INCEIF). He holds a BEc (Hons) in Statistics from

the University of Malaya, a MS (Statistics) from the University of Wisconsin, United States, and a PhD in Econometrics from the University of Birmingham, United Kingdom. Since 1969, he has served in various academic capacities in several public universities in Malaysia. He also served as the Founding President and CEO of Universiti Tun Abdul Razak (October 1997–March 2005), after serving at the Institute of Islamic Understanding Malaysia (IKIM) as Deputy Director-General (1992–97). He is currently a member of the Board of Directors of Etiqa Takaful Berhad; Pak-Kuwait Takaful Pte Ltd Pakistan; Maybank Islamic Berhad; Asia Unit Trust Berhad, Prima Prai Sdn Bhd.; Epen Bina Sdn Bhd.; Kolej Poly-Tech MARA Sdn Bhd. He also sits on the *Sharī'ah* Advisory Committee for Labuan Reinsurance (L) Ltd.; MNRB Retakaful Berhad; MIDF Group of Companies; Amanah Mutual Berhad (formerly known as Maybank Unit Trust Berhad) and Singapore Unit Trusts Ltd. He has written more than 200 papers on Islam, economics, banking and *takaful* and has published twelve books.

Azizah Anuar is an Assistant Research Fellow at IAIS Malaysia. She earned her MBA from the University of Newcastle, United Kingdom. Her research covers Islamic balanced economy, socio-economic and human development, and Islamic management. Current projects treat Cash *Waqf*, Poverty, Marketing, and Auditing. She is also working on Islamic banking, Islamic endowment funds (*waqf*), *Sharī'ah* Auditing, and Islamic microfinance and poverty relief. She is also a specialist in developing retail and commercial financial products in Islamic banking, and their marketing. Before focusing on writing and research, she worked for a *halāl* consultancy and marketing firm for four years. She has 20 years' experience in conventional and Islamic banking. Her expertise is in banking supervision, branch operations and management, business development and marketing, securities and legal documentation, treasury and budgeting, customer service, as well as retail and commercial banking credit marketing and evaluation. In 1999, Azizah proposed the first rebate system *ibra'* for the International Bank of Malaysia, and her new concept became widely accepted in Malaysia's Islamic banking industry.

Muhammad Umer Chapra is a Senior Research Advisor at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) at Jeddah, Saudi Arabia. Prior to this position, he worked at the Saudi Arabian Monetary Agency (SAMA), Riyadh, for nearly 35 years, retiring as Senior Economic Advisor. He has also taught as Assistant and Associate Professor of Economics at the University of Wisconsin (Platteville) and the University of Kentucky, Lexington; as Senior Economist and Associate Editor of the Pakistan Development Review at the Pakistan Institute of Development Economics; and as Reader (Associate Professor) at the Central Institute of Islamic Research (Pakistan). Among his 15 books are *Towards*

a Just Monetary System (1985), *Islam and the Economic Challenge* (1992), *The Future of Economics: An Islamic Perspective* (2000), and *Muslim Civilization: The Causes of Decline and the Need for Reform* (2008). Some of his works have been translated into a number of languages, including Arabic, Bengali, French, Indonesian, Japanese, Malay, Persian, Polish, Spanish, Turkish and Urdu. For his scholarly contribution he received numerous awards, among them the Islamic Development Bank award in recognition of his contribution to Islamic Economics and the King Faisal International Award in recognition of his contribution to Islamic studies (both in 1990).

Mohammad Hashim Kamali is Chairman and CEO of the International Institute of Advanced Islamic Studies (IAIS). He graduated from Kabul University, before going on to complete an LLM in Comparative Law and a PhD in Islamic and Middle Eastern Law at the University of London from 1969 to 1979. Kamali was a Professor of Islamic Law and Jurisprudence at the International Islamic University Malaysia (IIUM), and also Dean of the International Institute of Islamic Thought and Civilisation (ISTAC) from 1985 to 2007. He was previously Assistant Professor at the Institute of Islamic Studies, McGill University and has also held Visiting Professorships at the Capital University, Ohio, and at the Institute for Advanced Study (*Wissenschaftskolleg*) in Berlin. Kamali is on the board of several local and international bodies and was a signatory of the international ‘Common Word’ document between Christians and Muslims. He has addressed over 120 national and international conferences, published 16 books as well as over 110 academic articles.

Abbas Mirakhor, born in Tehran, Iran, is an International Monetary Fund (IMF) Executive Director representing the Iranian government at the IMF. He obtained his PhD from Kansas State University in economics in 1969. From 1969 to 1984, he taught in various universities in the United States and Iran. From 1984 until 1990, he served as an economist in the Research Department of the IMF, and from 1990 to the present he has been the Executive Director for Afghanistan, Algeria, Ghana, Iran, Morocco, Pakistan, and Tunisia. He was formerly also Professor of Economics at the Florida Institute of Technology. He has published in a variety of areas, including microeconomic theory, mathematical economics, and Islamic Economics, among them being (co-author) *Theoretical Studies in Islamic Banking and Finance*. Dr Mirakhor is also the co-editor of *Essays on Iqtisad: Islamic Approach to Economic Problems* (1989), and *Theoretical Studies in Islamic Banking and Finance* (1987). He has received several awards including the ‘Order of Companion of Volta’ for service to Ghana, conferred by the President of Ghana in 2005, the Islamic Development Bank Annual Prize for Research in Islamic economics (shared with Mohsin Khan)

in 2003, and the ‘Quaid-e Azam’ star for service to Pakistan, conferred by the President of Pakistan in 1997.

Mohamed Aslam Haneef is Professor of Economics at the International Islamic University Malaysia (IIUM). He received his PhD from the School of Development Studies, University of East Anglia, United Kingdom, and also holds a Masters of Economics from the University of Malaya and a Bachelor of Economics (Hons) from IIUM. His PhD dissertation, entitled “Intellectual Parameters of Contemporary Islamic Economic Thought and Policy”, won the Ismail Faruqi Award for Academic Excellence at IIUM (1996). He teaches economics and Islamic economics at both the undergraduate and graduate levels as well as in executive MBA and Post-Graduate Diploma programmes. He was Head of the Economics Department at IIUM (June 1996–September 1999) and a Fulbright Visiting Scholar at the Center for Muslim–Christian Understanding, Georgetown University, United States (September–October 1996) and held a Commonwealth Fellowship at the Oxford Centre for Islamic Studies (1999–2000). He has published several books and articles and conducted research in various areas of Economics, Development Studies and Islamic economics and is also involved in numerous public and private executive training programmes, specialising in Islamic economics and contemporary development issues. He has served as Chief Editor of the *IIUM Journal of Economics and Management Sciences* (July 2005–December 2008) and is currently the President of the Academic Staff Association of IIUM.

Norma Md Saad is an Associate Professor at the Department of Economics (Kulliyyah of Economics and Management Sciences) at the International Islamic University Malaysia. Her areas of specialisation are International Trade (specifically Foreign Direct Investment, *Takāful* and Islamic Finance). Her teaching and research focus on the intra-trade patterns of major economic blocs and their impact on regional integration. She is also doing research on Islamic finance, investigating the efficiency of Islamic financial institutions in Malaysia. Dr Norma has published several books, book chapters as well as articles on Islamic finance, International Trade, Macroeconomics, and Business Mathematics.

Amer Al-Roubaie is a Professor of Economics and currently Dean of the College of Business and Finance at Ahlia University in the Kingdom of Bahrain. In 1967, he received his BA from the University of Baghdad and, in 1974, his MA from the University of New Brunswick, Canada. He holds a PhD in Economics from McGill University, Montreal, Canada (1986). His main area of research is sustainable development in general and economic development in the Middle East with emphasis on oil resources, the environment, and labour migration. Recently,

Professor Al-Roubaie has written a book entitled *Globalization and the Muslim World* (Kuala Lumpur: Malita Jaya Publishing, 2002), underlining some of the important challenges facing Muslims in the age of globalisation. In addition, he has published numerous other articles on the same subject. Prior to his present position, Professor Al-Roubaie taught economics in both Canada and the United States. Since the early 1990s he has also been an Associate Professor, and subsequently Full Professor of Economics, at the International Institute of Islamic Thought and Civilisation (ISTAC) at Kuala Lumpur. He is also a much sought-after speaker at international conferences, such as at the 2003 Kuala Lumpur meeting of the Organisation of the Islamic Conference (OIC).

Shaikh Hamzah Shaikh Abdul Razak is currently a Research Fellow at INCEIF. He obtained his DBA from Universiti Sains Malaysia (USM), Penang, and his MBA from Central Missouri State University, United States. He obtained a Bachelor of Science (Hons) in Finance from Northern Illinois University, also in the United States, in 1983. Prior to joining INCEIF, Dr Shaikh Hamzah was with Malayan Banking Berhad since 1974 and held several posts in various departments such as Branch Operations, Trade Finance, Credit and Credit Control. His last position with Malayan Banking was Komtar Branch Manager. Whilst pursuing his DBA, he was a part-time lecturer with USM, teaching corporate finance. Dr Shaikh Hamzah has also been actively involved in several consultancy works and conducted service training.

AIMS OF THE JOURNAL

Islam and Civilisational Renewal (ICR) was established in order to link up with the unique Islamic tradition of more than 1,400 years of dialogue, pluralism, and coexistence with other world civilisations.

ICR advances civilisational renewal, based on Malaysia's *Islam Hadhari* (Civilisational Islam) initiative and its ten component principles:

1. Faith in God and piety
2. A just and trustworthy government
3. A free and independent people
4. A rigorous pursuit and mastery of knowledge
5. Balanced and comprehensive economic development
6. A good quality of life
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- Articles should not have been published elsewhere or sent for publication. Articles that have been a part of a dissertation can be considered if there is a major modification and adjustment.
- Articles should be between 6,000 and 8,000 words. Authors should also include a 100 to 150 word abstract, outlining the aims, scope and conclusions but not containing sentences from the article; a list of six key words should be suggested. Book reviews should be between 1,000 and 2,000 words. Viewpoints should be between 1,000 and 1,500 words.
- All submissions must include a separate page with the author's name and current affiliation as they should appear in the journal and contact information (e-mail address, phone and fax numbers, and mailing address: all to remain confidential).
- Contributors will receive a free copy of the Journal issue in which their article appears.

Content

- The Journal is devoted to civilisational renewal, in particular of Muslim communities, while, at the same time, reaching out to non-Muslims.
- Submitted articles should be scholarly, but also accessible to a wider audience.
- Articles should be of relevance to contemporary practical issues faced by Muslim communities, such as Islam and its encounter with the West, but also science, technology and ethics. A particular focus of this Journal is on civilisational renewal based on the ten component principles of *Islam Hadhari*.

TRANSLITERATION TABLE

Consonants

Ar = Arabic, Pr = Persian, OT = Ottoman Turkish, Ur = Urdu

Ar		Pr	OT	Ur	Ar		Pr	OT	Ur	Ar		Pr	OT	Ur
ء	'	'	'	'	ز	z	z	z	z	گ	-	g	g	g
ب	b	b	b	b	ط	-	-	-	ر	ل	l	l	l	l
پ	-	p	p	p	ث	-	zh	j	zh	م	m	m	m	m
ت	t	t	t	t	س	s	s	s	s	ن	n	n	n	n
ٹ	-	-		ṭ	ش	sh	sh	s	sh	ه	h	h	h ¹	h ¹
ڈ	th	th	th	th	ص	ḍ	ḍ	ḍ	ḍ	و	w	v/u	v	v/u
ج	j	j	c	j	ض	ṣ	ṣ	ṣ	ṣ	ی	y	y	y	y
چ	-	ch	ç	ch	ط	ṭ	ṭ	ṭ	ṭ	ة	-a ²			-a ²
ح	ḥ	ḥ	ḥ	ḥ	ظ	ẓ	ẓ	ẓ	ẓ	ال	-al ³			
خ	kh	kh	h	kh	ع	ʿ	ʿ	ʿ	ʿ	¹ when not final ² -at in construct state ³ (article) al- or l-				
د	d	d	d	d	غ	gh	gh	ğ	gh					
ڈ	-	-	-	d	ف	f	f	f	f					
ذ	dh	dh	dh	dh	ق	q	q	k	q					
ر	r	r	r	r	ك	k	k/g	k/ñ/ğ	k					

Vowels

	Arabic and Persian	Urdu	Ottoman Turkish
Long	ا ā	ā	ā
	آ Ā	Ā	-
	و ū	ū	ū
	ي ī	ī	ī
Doubled	يَّ iỵy (final form ī)	iỵ (final form ī)	iỵ (final form ī)
	وَّ uẉw (final form ū)	uṿ	uṿv
	وَّ uṿv (for Persian)		
Diphthongs	و au or aw	au	ev
	ي ai or ay	ay	ey
Short	ا a	a	a and e
	u	u	u or ü
			o or ö
	i	i	i

Urdu Aspirated Sounds

For aspirated sounds not used in Arabic, Persian and Turkish add h after the letter and underline both the letters e.g. جھ جھ گھ گھ

For Ottoman Turkish, modern Turkish orthography may be used.

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Malaysia (institutional)	£25	\$40	€30	£15	\$25	€20	£25	\$40	€30

* Afghanistan, Albania, Algeria, American Samoa, Angola, Argentina, Armenia, Azerbaijan, Bangladesh, Belarus, Belize, Benin, Bhutan, Bolivia, Bosnia and Herzegovina, Botswana, Brazil, Bulgaria, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Chile, China, Colombia, Comoros, Congo (Dem. Rep.), Congo (Rep.), Costa Rica, Côte d'Ivoire, Croatia, Cuba, Djibouti, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Eritrea, Ethiopia, Fiji, Gabon, Gambia, Georgia, Ghana, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, India, Indonesia, Iran, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kiribati, Korea, Kyrgyz Republic, Lao PDR, Latvia, Lebanon, Lesotho, Liberia, Libya, Lithuania, Macedonia, Madagascar, Malawi, Malaysia, Maldives, Mali, Marshall Islands, Mauritania, Mauritius, Mayotte, Mexico, Micronesia, Moldova, Mongolia, Montenegro, Morocco, Mozambique, Myanmar, Namibia, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Palau, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Romania, Russian Federation, Rwanda, Samoa, São Tomé and Príncipe, Senegal, Serbia, Seychelles, Sierra Leone, Solomon Islands, Somalia, South Africa, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sudan, Suriname, Swaziland, Syrian Arab Republic, Tajikistan, Tanzania, Thailand, Timor-Leste, Togo, Tonga, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, Uruguay, Uzbekistan, Vanuatu, Venezuela, Vietnam, West Bank and Gaza, Yemen, Zambia, Zimbabwe.