

ISLAMIC ECONOMIC STUDIES

Vol. 17 No. 2

Muharram 1431H (January 2010)

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ISLAMIC DEVELOPMENT BANK
KING FAHD NATIONAL CATALOGING-IN-PUBLICATION DATA

ISLAMIC ECONOMIC STUDIES – JEDDAH
viii, 140 pages, 18x26 cm – (Islamic Economics) – Vol. 17, No. 2

ISSN 1319-1616
LDN 14-0721

Islamic Economic Studies (IES) is published biannually, in Muharram and Rajab, according to the Islamic calendar. The views expressed in the articles, reviews, etc., published in the *IES* are those of the authors and do not necessarily represent the position of the Islamic Development Bank (IDB) nor the Islamic Research and Training Institute (IRTI).

Islamic Economic Studies is a refereed journal that maintains high academic standards. It is included in the Abstracting Services CD-ROM indexing of the *Journal of Economic Literature* published by the American Economic Association.

References and citations are allowed but must be properly acknowledged. Anyone seeking to reprint material from the *IES* must obtain prior written consent of IRTI.

The subscription rate for first class mail is US \$15.00 for one year (2 issues). The cost of a single issue is US \$8.00. Subscriptions may be mailed to the address of the publisher given below.

Published by:

**ISLAMIC RESEARCH AND TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK
P. O. BOX 9201
JEDDAH 21413
KINGDOM OF SAUDI ARABIA
TEL: 966-2-6361400
FAX: 966-2-6378927/6366871
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Web Site: www.irti.org**

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ARTICLES

FAITH-BASED ETHICAL INVESTING: THE CASE OF DOW JONES ISLAMIC INDEXES

M. KABIR HASSAN*
and
ERIC GIRARD*

ABSTRACT

This paper examines the performance of seven indexes chosen from the Dow Jones Islamic Market Index (DJIM) vis-à-vis their non-Islamic counterparts using a variety of measures such as Sharpe, Treynor, Jensen and Fama's selectivity, net selectivity and diversification. Second, we examine the persistence of performance using Carhart's (1997) four factor pricing models. Third, we use co-integration to examine how the Islamic indexes compare to their non-Islamic counterparts. The sample period is from January 1996 to December 2005 (120 data points). It is further broken down into two sub-periods — i.e, January 1996 to December 2000 (60 data points) and January 2001 to December 2006 (60 data points). We find no difference between Islamic and non-Islamic indexes. The Dow Jones Islamic indexes outperform their conventional counterparts from 1996 to 2000 and underperform them from 2001 to 2005. Overall, similar reward to risk and diversification benefits exist for both the Islamic and conventional indexes.

JEL Classification Code: G11, G15, G24

Key Words: Ethical Investing, DJIM, Performance Measures

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A previous version has been presented at Financial Management Association Meetings (FMA), Federation of Business Disciplines and Islamic Research and Training Institute (IRTI). We thank the comments and suggestions of two anonymous referees, which improved the quality of this paper.

1. INTRODUCTION

Muslims represent approximately one-fifth of the world's population and are estimated to have more than \$800 billion to invest. This amount is growing by 15 percent annually. Only a small portion of the available funds are invested in Islamic products which is indicative that this market is, for the most part, unexploited (Hassan, 2002).¹

According to a McKinsey Management Consulting Firm report, "Islamic finance is the new force in the financial market place." In fact, the recent surge of liquidity in the Middle Eastern capital markets is attracting both domestic and international money managers who are tapping this market by offering Sharī'ah-compliant funds. For instance, many western financial institutions (such as Citibank, Barclays, Morgan Stanley, Merrill Lynch and HSBC) sell Islamic financial products. In addition, the New York and London Stock Exchanges launched Islamic indexes to track the performances of firms which conform to Islamic investing rules.² Such a trend is leading towards the integration of Islamic finance with conventional finance.

The Dow Jones Islamic Market Index (DJIM), a subset of the Dow Jones Global Indexes (DJGI), was launched in December, 1995. The DJIM excludes from the index universe any industry group that represents a line of business that is incompatible with Islamic principles. Such activities include tobacco, alcoholic beverages, pork, gambling, arms, pornography, the hotel and leisure industry, and conventional financial services (banking, insurance, etc.). Companies classified in other industry groups may also be excluded if they are deemed to have a material ownership in or revenues derived from prohibited business activities. Once companies with unacceptable primary business activities have been eliminated from the universe, the remaining stocks are tested according to three financial

¹ The Islamic mutual funds market is one of the fastest rising segments within the Islamic financial system. Yet, when compared to the mutual fund industry at large, Islamic mutual funds are still in their infancy stage of growth and development, most having been around for less than a decade.

² DJIM indices are not tradable per se but there are several no-load Islamic index funds, which have been substantially growing in size since the inception of the DJIM series in 1996. Large fund management companies are creating these Islamic funds with low costs to attract the Middle Eastern flush liquidity. Analysis of DJIM indices instead of investment funds has the distinct advantage of measuring the investment screening effect on their performance. Such approach avoids the difficult problem of correctly considering transactions costs of investment funds. Unlike investment funds, indices are not mirrored by the ability of the portfolio managers to produce outstanding performance by interfering with the screening criteria of ethical investing.

filters: (i) excluding companies if total debt divided by total assets is equal to or greater than 33%; (ii) excluding companies if accounts receivable divided by total assets is equal to or greater than 45%; and (iii) excluding companies if non-operating interest income is equal to or greater than 5%. Companies that pass these criteria are included in the DJIM investable universe. This allows the DJIM to invest in profitable companies that make positive contributions to society (Hassan, 2002; Hossein, 2005).

To the exception of few studies (Hassan, 2001; Hassan, 2002; Hakim and Rashidian, 2004; Hussein, 2005; Elfakhani, Hassan and Sidani, 2005; Hassan and Tag El-Din, 2005), research on Islamic investing is still in its infancy. Our paper adds new knowledge to the area of faith-based Islamic investing since it is the first study to address the performance of DJIM indexes. In particular, we conduct an in-depth examination of the performance and diversification benefits of Dow Jones Islamic indexes vis-à-vis their non-Islamic counterparts. Specifically, we examine risk-return and performance matrix of DJIM vis-à-vis its conventional counterparts. Secondly, we employ a variety of CAPM models such as two-factor, three factor condition and unconditional CAPM to ascertain the best asset pricing methods for Islamic investment funds. Finally, we use co-integration test to measure international diversification benefits from including Islamic funds into portfolio composition of investors. Our findings show that, from January 1996 to December 2005, there is no significant difference in performance between Islamic and non-Islamic indexes. Overall, similar reward to risk and diversification benefits exist for both set of indexes. There also exists scope for Islamic funds for international portfolio diversification.

This paper is organized as follows. We first describe the fundamentals of Islamic investing in Section 2. Then, we provide a comprehensive overview of empirical literature on faith-based Islamic investing in Section 3. Data and methodology are explained in Section 4. We analyze the empirical results in Section 5. Section 6 concludes the paper.

2. THE FUNDAMENTALS OF ISLAMIC INVESTING

Islamic alternatives to traditional investment tools have been driven by the fact that such tools do not conform to the Islamic standards (Usmani, 2002). There has been a growing desire to have funds in which profits are not based on *ribā*, or interest, which is rejected in Islam. The Muslim faith deems that profit should come as a result of efforts; this is not the case in interest dominated investments. In addition, there is a desire for investment portfolios which are morally purified. Thus investments in companies that do not comply with Muslims' moral orientations are not permitted and are eliminated from the portfolio. To ensure compliance with the foregoing condition, Islamic mutual funds are governed by

Sharī'ah advisory boards whose role is mainly to give assurance that money is managed within the framework of Islamic laws (Hassan, 2001; Hassan, 2002).

An Islamic mutual fund is similar to a 'conventional' mutual fund in many ways. However, unlike its 'conventional' counterpart, an Islamic mutual fund must conform to Sharī'ah investment precepts. The Sharī'ah encourages the use of profit-sharing and partnership schemes, and forbids *ribā* (interest), *maysir* (gambling and pure games of chance), and *gharar* (selling something that is not owned or that cannot be described in accurate detail in terms of type, size, and amount) (El-Gamal, 2000). The Sharī'ah guidelines and principles govern several aspects of an Islamic mutual fund, including its asset allocation (portfolio screening), investment and trading practices, and income distribution (purification).

When selecting investments for their portfolio (asset allocation), conventional mutual funds can freely choose between debt-bearing investments and profit-bearing investments, and invest across the spectrum of all available industries. An Islamic mutual fund, however, must set up screens in order to select those companies that meet its qualitative and quantitative criteria set out by Sharī'ah guidelines. Qualitative screens are used to filter out companies or securities based on *ribā*, *maysir* or *gharar*, referenced earlier, or other business practices considered unethical by Sharī'ah including, for example, selling alcohol, or engaging in biotechnology using aborted embryos and human cloning. Thus, excluded from Islamic-approved securities are fixed income instruments such as corporate bonds, treasury bonds and bills, certificates of deposit (CDs), preferred stocks, warrants, and some derivatives (e.g., options), etc. Moreover, Islamic mutual funds cannot trade on margin; in other words, they cannot use interest-paying debt to finance their investments. They are also not permitted to engage in sale and repurchase agreements (i.e., repos or buy-backs). These transactions are considered akin to indirect interest charges. There are various financial filtering rules (quantitative) used for DJIM and FTSE respectively and Chart 1 gives these financial filtering ratios in details (Derigs and Marzban, 2008).

The basis upon which an Islamic mutual fund operates must also be Sharī'ah compliant - i.e., its invested funds must be liberated from interest-based debt or speculation. Traditional funds that rely heavily on interest-based debt to finance their activities are not compliant with Islamic law. In addition, Islamic fund managers are not allowed to speculate. An Islamic economic unit is expected to assume risk after making a proper assessment of such risk with the help of information. Only in the absence of information or under conditions of uncertainty is speculation akin to a game of chance and considered reprehensible.

On another front, most scholars allow partially 'contaminated' earning income to be cleansed or purified. This means that investment can be made in stocks of companies with a tolerable (i.e., kept at a minimum proportion) amount of interest

income or with tolerable revenues from unacceptable business activities if all ‘impure’ earnings are ‘cleansed’ by giving them away to designated charities. If, for example, the company has 8 percent interest-related income, then 8 percent of every dividend payment must be given away to ‘purify’ the fund earnings. Cleansing capital gains, however, remains debatable. Some scholars argue that this is not necessary since the change in the stock price does not really reflect interest, while others suggest that it is safer and more equitable to purify earnings made from selling shares as well (Usmani, 2002). This purification process is done either by the fund manager before any distribution of income, or by reporting the necessary financial ratios for investors to purify their earnings on their own. Some researchers affirm that the fund ought to encompass a clear procedure and techniques of sorting out interest-based income and other sources of contaminated profits from the portfolio (Valpey, 2001).

Whether *Zakāt* should be paid out of funds income at the fund level or at individual level is still debatable. *Zakāt* is a form of charity paid on personal wealth (exceeding a minimum amount called *nisāb*) held idle for one lunar year. The rate of *zakāt* differs with the type of the asset, 2.5 percent being the rate on most forms of monetary wealth and earned income (Al-Qaradawi, 1999). *Zakāt* calculation on investment profits, however, is still controversial (DeLorenzo, 2000). In addition, such calculation is complicated given the intricacies of the timing of the portfolio incomes and capital gains (Hassan, 2003). Recipients of *zakāt* are clearly identified in Islamic jurisprudence and include charities and other bodies identified by the funds’ supervisory boards.

In addition to the above principles, Valpey (2001) identifies other pillars that help in promoting socially responsible business practices. Shareholder advocacy refers to the mechanism of involving shareholders in positively influencing corporate behavior. Shareholders in the Islamic environment are not merely concerned with higher returns on their investment, but they also have a proactive role given their position as corporate owners. Constant monitoring and timely reporting are also needed to ensure that the companies included in the portfolio continuously meet the guidelines for Islamic investing. Often company shares are dropped from a certain fund after information about a violation is reported.

3. EMPIRICAL LITERATURE ON FAITH-BASED ISLAMIC INVESTING

Several studies have assessed the performance of ethical funds and it is unclear whether investors have to bear no financial sacrifice in pursuing this strategy. For instance, Orlitzky, Schmidt and Rynes (2003) conduct a meta-analysis of 52 prior quantitative studies and conclude that there is a positive association between corporate social performance and financial performance across industries and across study contexts. On the other hand, Girard and Rahman (2007) refer to the results of several studies showing that socially responsible mutual funds tend to

underperform broad benchmarks. In addition, the authors suggest that, if some socially responsible funds beat broad benchmarks, it is likely due to style investments rather than social responsible screening.

The literature on Islamic investing, a subset of ethical investing, is still at its infancy. The following articles best describe the stage of current of research on faith-based Islamic investing.

Hassan (2002) empirically examines the issues of market efficiency and the time-varying risk return relationship for the DJIM over the 1996-2000 period. His paper employs serial correlation, variance ratio and Dickey Fuller tests to examine the market efficiency of the DJIM. The results show that DJIM returns are normally distributed and the returns show that DJIM returns are efficient. The paper also examines calendar anomalies of the DJIM. The results show that there is no turn-of-calendar-year, turn-of-financial-year, month effect of DJIM returns. Utilizing a GARCH framework, the paper examines volatility of the DJIM returns and finds a significant positive relationship between conditional volatility and DJIM equity index returns.

Hakim and Rashidian (2002) employ a co-integration and causality analysis to examine the relationship between the DJIM, Wilshire 5000 Index, and the risk-free rate proxied by the three month treasury bill over the time period 1999-2002. They find no correlation between the DJIM and the Wilshire 5000 Index, or the three month Treasury bill. The results also show that the changes in the DJIM are not caused by either the Wilshire 5000 Index or the three month treasury bill. They conclude that the filtering criteria adopted to eliminate non-compliant firms leads to an Islamic index with unique risk-return characteristics unaffected by the broad equity market. Hakim and Rashidian (2004) use a capital asset pricing model (CAPM) to examine to what extent a Sharī'ah compliant index is correlated with the Dow Jones World Index (DJW) and Dow Jones Sustainability World Index (DJS) or green index. Their results show that the DJIM has done relatively well compared to the DJW, but has underperformed in relation to the DJS.

Hussein (2005) provides a comprehensive study of the accurate performance of each Islamic index by capturing the effects of industry, size, and economic conditions on DJIM returns. Covering the period 1996-2003, he examines the hypothesis that returns earned by investors who purchase each share in Islamic indexes for an equal amount of money are significantly different from their index counterparts, throughout the entire bull and bear periods. He finds that Islamic indexes provide investors with positive abnormal returns throughout the entire bull period, but they underperform their non-Islamic index counterparts during the bear market period. He argues that positive abnormal returns by Islamic indexes are not due to technology sector investing by these indexes. Rather, these abnormal returns

are driven by investing in small size, basic material, consumer cyclical, industrial and telecommunication firms.

Hussein (2004) examines the performance of FTSE index funds vis-à-vis conventional funds (FTSE all world index) over a period of January 1996-July 2003 by using a number of performance measures such as Sharpe, Treynor, Jensen measures and CAPM, but does not use more sophisticated methods such multi-factor measures such as Fama-French 3 factor and Carhart 4 factor models. He finds that FTSE indices perform as well as conventional indices during overall period, but overperforms well during bull period and underperforms during bearish period.

Elfakhani, Hassan and Sidani (2005) examine Islamic mutual funds and the fundamentals of investing in such venues. They explore the dynamics of Islamic mutual funds, their governance and control, and marketing and distribution. They present the results of a study verifying whether the application of the Islamic investment guidelines in asset allocation and portfolio selection has had a downside effect on investors' wealth in terms of risk-adjusted returns relative to the market benchmark. Considering the overall sample of 46 Islamic mutual funds, the total number of outperforming funds ranges between 29 funds (63 percent of the sample) and 11 funds (24 percent), depending on the used performance measure and market benchmark. In terms of fund category, four of the eight fund categories outperform their benchmarks regardless of what performance measure is used. Moreover, the ANOVA statistical test shows that no statistically significant disparity exists for the performance of the funds compared to all used indexes. Therefore, a conclusion of their study is that the behavior of Islamic mutual funds does not differ from that of other conventional funds, with some Shari'ah compliant mutual funds outperforming their benchmarks and others underperforming them.

Elfakhani, Hassan and Sidani (2005) use the Treynor-Mazury (TM) model to measure the security-selection ability and market-timing ability of Islamic mutual fund managers. Their results show that the American Equity Fund, the European Equity Fund, the combined Emerging Fund, and the Technology Fund all have positive security selection, but only the Emerging Equity Fund has positive selectivity that is statistically significant. The remaining three funds (i.e., Global, Asian and Malaysian funds) have negative selectivity performance during the same period. This is not so surprising as the results may be dominated by the Asian crisis, while Western funds are less affected during the same sampling period. In particular, the Asian Equity Fund performs very badly as the intercept is statistically and significantly negative at the one percent level. However, other results show that the Asian Equity Fund has a significant positive market timing performance; all remaining funds have negative market timing performance particularly the European and the combined Emerging Funds that are statistically

significant at the five percent level. This observation is confirmed by the negative correlations reported in the table except for the Asian fund.

Hassan and Tag el-din (2005) adapt duration dependence tests to analyze Islamic mutual funds of the DJIM. The fundamental idea of the tests comes from survival analysis frequently used by engineers and biostatisticians. According to the theoretical rational speculative bubbles model, if bubbles do not exist, runs of positive excess returns should not display the duration dependence. To render this implication testable, returns are transformed into series on positive and negative observed excess returns. Then, the authors examine the probability that a run — a sequence of observations of the same sign — of positive excess return ends has positive dependence or negative hazard function with the length of the run. This approach is reliable and robust since duration dependence is not affected by fundamental price movements and is more unique to bubbles unlike the traditional measures of detecting bubbles such as autocorrelation, skewness, or kurtosis (for more details, see McQueen and Thorley (1994)). They use both weekly and monthly data of the DJIM and AMANX and AMAGX to test for the speculative bubbles in these markets. Their results show that none of the weekly and monthly returns of AMANX, AMAGX, and the DJIM show statistically significant evidence of speculative bubbles during our sample periods. Kia (2001) finds similar results for Canadian general stock markets.

Hassan, Antoniou and Paudyal (2005) examines the potential impact of Islamic Shari'ah screening on the Islamic investment portfolio performance vis-à-vis conventional portfolio. Since they examine index funds, their results are not confounded by transactions costs or management fees. They use a variety of similar methods as used in this present study and use DJIM databases from 1996-2003 period. They find similar results as in our study as that Islamic funds do not necessarily perform worse than conventional index funds.

Khathatay and Nisar (2007) reviews and compares the Shari'ah screening rules used by three organizations such as Dow Jones Islamic Indices of USA, Securities and Exchange Commission (SEC) of Malaysia, and Meezan Bank of Pakistan by employing March 2005 Bombay Stock Exchange 500 stocks. They conclude that DJIM is the most conservative and Malaysian SEC is the most liberal. Based on the empirical results, they propose an independent set of norms that better reflect the objectives of formulating Shari'ah compliance. They propose a Shari'ah rating agency that will help promote this industry and argue that total asset is a better divisor than market capitalization in financial ratio filters.

Abdullah, Hassan, and Mohamad (2007) examines the relative performance of 14 Islamic funds and 51 conventional mutual funds in the Malaysian capital market over January 1992-December 2001 using a number of methods such as Sharpe index, adjusted Sharpe index, Jensen Alpha, Modigliani measure, and Timing and

selectivity ability. In their study, Islamic funds performed better than the conventional funds during a bearish market, while conventional funds performed better than Islamic ones during a bullish market. Including Islamic mutual funds in a portfolio helps hedge the downside risk in adverse economic conditions. Islamic and conventional funds have a diversification level that is less than 50 percent the diversification level of the market index proxied by Kuala Lumpur Composite Index (KLCI). They conclude that there is a poor selection and timing performance in both Islamic and conventional mutual funds.

Abderrezak (2008) employs 3 different benchmarks (conventional, Islamic and ethical benchmarks) and uses 46 Islamic equity mutual funds as used in Elfakhani, Hassan and Sidani (2005) study over January 1997-August 2002 to examine the relative performance of Islamic equity mutual funds. He uses similar methodology as Elfakhani, Hassan and Sidani (2005) and finds Islamic funds perform poorly against their respective indices. The co-movement of IEFs returns with the market, measured by the betas, is low. Further, he finds poor evidence for selectivity. IEFs are significantly affected by small cap firms and growth preference stocks. However, he does not find any significant performance differences between Islamic and ethical funds using Fama's performance measures. Finally, he found that IEFs do suffer from lower diversification.

Kräussl Hayat (2008) finds, on average, there is not any significant performance difference when IEFs are benchmarked against Islamic and conventional benchmarks during normal market condition. A closer look at the bear market of 2002 using conditional CAPM, they document that IEFs does significantly outperform the Islamic and conventional market indices. They also find that IEFs possess superior systematic risk-to-return ratios, thus, they argue that these IEFs "seem most attractive as part of a larger fully diversified portfolio like a fund of funds." However, consistent with previous studies, they do not find any evidence for market timing ability. In their study, they use 59 Islamic equity funds over 2001-2006 period and their sample is further divided into global, Malaysian, and other local regions. They use a variety of unconditional and conditional measures such as Jensen's measure, Sharpe ratio, Treynor ratio, Modigliani and Modigliani measure, TT measure, and the information ratio. Further, they use Treynor and Mazuy (1966) measure for market timing and conditional CAPM for negative movements.

Mansor and Bhatti (2009) use yearly data of Malaysian mutual funds industry from 1999 to March 2009, and daily return data of Malaysian mutual funds from July 1, 2008 to May 10, 2009 to analyze the performance and growth rates of Islamic mutual funds and conventional mutual funds in Malaysia. They use non-risk adjusted average returns, standard deviation, and correlation analysis. They do not provide any statistical tests except for Jarque-Bera test. There is strong correlation between Islamic mutual funds and conventional mutual funds. They are

moving together as proportion of the total industry. The ratio of Islamic to conventional funds is increasing indicating the importance of Islamic funds. The Growth rates of Islamic mutual funds are higher than that of conventional funds in terms of NAVs. They attribute factors such as expectations' stability, higher growth rates, and resilience during crisis, to the increasing global demand on Islamic mutual funds. They argue that Islamic funds are lesser than conventional funds in terms of size.

Hoepner, Rammal, and Rezec (2009) uses a unique dataset of 262 Islamic equity funds from 20 countries and 4 regions from September 1990 to April 2009 and uses one factor model, Fama and French (1993) 3 factor model, Carhart (1997) model, 3 level Carhart model, and conditional 3 level Carhart model to examine Islamic mutual funds performance. Islamic funds from eight nations (mostly from the western regions) significantly underperform their international equity market benchmarks, and funds from only three nations overperform their respective market benchmarks. Second, only small stocks have an effect on Islamic funds. Third, Islamic funds from the Gulf Cooperation Council (GCC) or Malaysia do not significantly underperform their respective benchmarks or were affected by small stocks. Finally, they conclude that Islamic equity funds "exhibit a hedging function, as their investment universe is limited to low debt/equity ratio stocks." Hoepner, Rammal and Rezec (2009) states that Girard and Hassan (2008) study that examines FTSE as a pioneer in this stream of literature ("Their paper is recommended as gateway into this literature"; footnote 4)

4. DATA

The DJIM follows Islamic investment guidelines by tracking Shari'ah compliant stocks from around the world. Stocks incompatible with Shari'ah law are associated with alcohol, pork-related products, conventional financial services (banking, insurance, etc.), entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.), tobacco manufacturers, or defense and weapons companies. The remaining stocks are tested according to three "filters" designed to remove those with unacceptable financial ratios — i.e., total debt divided by trailing 12-month average market capitalization must be less than 33%, the sum of company's cash and interest-bearing securities divided by the trailing 12-month average market capitalization must be less than 33%, and accounts receivable divided by the trailing 12-month average market capitalization must be less than 45%.

The indexes weighting scheme follows a free-floating market capitalization and is reviewed quarterly. The Islamic market family comprises nearly 50 indexes on blocks, markets and sectors. Not all series have been introduced at the same time. While the oldest series date as of January 1996 in Reuters, most series were

introduced between 1998 and 2003. Our study focuses on the older set of broad indexes which are the Dow Jones Islamic Market World Developed Index, the Dow Jones Islamic Market World Emerging Markets Index, the Dow Jones Islamic Market U.S. Index, the Dow Jones Islamic Market Europe Index, the Dow Jones Islamic Market Asia/Pacific Index, the Dow Jones Islamic Market Canada Index, and the Dow Jones Islamic Market U.K. Index.³

Using Reuters, we select Dow Jones Islamic indexes and corresponding MSCI indexes that do not explicitly claim to use Islamic screening.⁴ Our study uses closing prices and monthly returns on seven Islamic indexes (Dow Islamic Canada, Dow Islamic United Kingdom, Dow Islamic United States, Dow Islamic Asia Pacific Developed, Dow Islamic Europe Developed, Dow Islamic Emerging Markets and Dow Islamic World Developed Markets), seven “corresponding” non-Islamic indexes (MSCI Canada, MSCI United Kingdom, MSCI United States, MSCI Asia, MSCI Europe Developed, MSCI Emerging Markets and MSCI developed markets), and the MSCI AC World Index. The sample period starts in January 1996 and ends in December 2005 (120 data points; full period). It is further broken down into two sub-periods — i.e. January 1996 to December 2000 (60 data points; bull period) and January 2001 to December 2005 (60 data points; bear period). We have divided the sample period into two periods to examine the performance differences during bull and bear periods. Similar division has been done by Hussein (2004) and Hussein (2005).

The MSCI AC World Index is used as a buy-and-hold factor representing the broad stock market index. Since SMB, HML and MOM factors of Fama and French (1993) and Carhart (1997) are not directly available for the world market, we follow the methodology of Bauer, Koedijk, and Otten (2005) to construct a world version for each of the three factors—i.e., using all stocks of the Worldscope/Datastream⁵ universe, the SMB factor is computed by taking each month the difference between the return of a lower quintile and higher quintile size-sorted value weighted portfolios, the HML factor is computed each month by

³ The Dow Jones Islamic Market Japan Index is not included as the series starts as of 1998 in Reuters.

⁴ Dow is not the only provider of “Islamic” indexes. FTSE also has several indexes that screen for the “Islamic constraint”, however the series are not available in Reuters prior to 1999. As for the “non-Islamic” corresponding benchmarks, we also considered series other than MSCI which are more closely related to the Dow Islamic indexes — i.e., the Dow Global and Dow Stoxx series. Unfortunately, the emerging market series were only introduced in 2002. Furthermore the Stoxx series are only available in Reuters as of 2003 and do not specifically include emerging market series. Consequently, we chose the MSCI series which provide us with more history.

⁵ We limit our sample to (1) firms with a market capitalization greater than \$25 million, and (2) firms for which market capitalization and book value data are available.

taking the difference between the return of the top 30 percent and bottom 30 percent book-to-market-value-sorted value weighted portfolios, the MOM factor is computed by taking each month the difference of the return of the top 30 percent and bottom 30 percent 12-month-return value weighted portfolio.

Other data are retrieved from the International Country Risk Guide (ICRG) and Datastream. We use local and global variables similar to those used in Sanders and Walter (2001). For instance, local risk factors (lagged 1 month) are the GDP growth, short term interest rates, the inflation rate, the change in industrial production and the change in political, economic and financial risk ratings.⁶ Global factors (lagged 1 month) are the world GDP growth, world inflation, change in world industrial production, the US maturity spread, the change in the price of oil, and the US default spread.⁷

5. METHODOLOGY

5.1 Performance Measures

In addition to the Sharpe and Treynor ratio, we assess the alpha of an index as compared to the world benchmark from the following equation (Jensen, 1968):

$$R_{it}-R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt}-R_{ft}) + \varepsilon_{it} \quad (1)$$

where $R_{i,t}$ is the return of index i over period t ; $R_{f,t}$ is the risk-free security for period t proxied by the 1-month US treasury rate; $R_{m,t}$ is the return on the MSCI AC World Index for period t ; β_i is the beta of index i ; α_i is the alpha of the index; and $\varepsilon_{i,t}$ is the random error for index i over period t with an expected value of zero.

If “alpha” is positive (negative), then the index is comprised of outperforming (underperforming) stocks. Fama (1972) shows that the selectivity component of a

⁶ For Canada, UK, and US, we use series of GDP growth, short term interest rates, local inflation factors, local industrial production and the change in political, economic and financial risk ratings available in the ICRG database and the international financial statistics database of the IMF. For Asia Pacific, Emerging and Europe, we use the change in political, economic and financial risk ratings, inflation factors, and short term interest rates (for Europe only). For the World Developed series, obviously no local factors are used.

⁷ WDCONPRCF, WDGDP...D, USGBOND, USINTER3, FRCBAAA, and FRCBBAA are Datastream’s mnemonics for the world CPI, World GDP, long term US Interest rates, short term US interest rates, Moody’s AAA, and Moody’s BBA series, respectively. The price of oil series and the world industrial production series are obtained from the international financial statistics database of the IMF.

portfolio's performance usually comes at the expense of some diversification. He provides a methodology to measure diversification (the added return necessary to justify any loss of diversification in a portfolio) and net selectivity (the additional return from outperforming stocks net of the additional cost for incomplete diversification). Fama relates selectivity, net selectivity and diversification as follows:

$$\alpha = (R_{i,t} - R_{f,t}) - \beta_i(R_{m,t} - R_{f,t}) = \left(\frac{\sigma_{i,t}}{\sigma_{m,t}} - \beta_i\right) \times (R_{m,t} - R_{f,t}) + (R_{i,t} - R_{f,t}) - \frac{\sigma_{i,t}}{\sigma_{m,t}}(R_{m,t} - R_{f,t}) \quad (2)$$

$$= \text{Selectivity} = \text{Diversification} + \text{Net Selectivity}$$

where $\sigma_{i,t}$ is the standard deviation of index i over period t . Other notations are the same as for equation 1.

5.2 Controlling Performance for Style and Time Variability

Carhart (1997) proposes an attribution model that extends CAPM by including Fama and French (1993 and 1996) size and value factors, and a momentum factor that captures Jegadeesh and Titman (1993) momentum anomaly. The resulting model is a 4-factor market equilibrium model, where the coefficients associated with each factor provides indication of the style focus of a portfolio. This model is believed to improve average CAPM pricing errors and is formally described as follows:

$$R_{it} - R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt} - R_{ft}) + \beta_{i,2,0}HML_t + \beta_{i,3,0}SMB_t + \beta_{i,4,0}MOM_t + \varepsilon_{it} \quad (3)$$

where SMB_t is the difference in return between a small cap portfolio and a large cap portfolio at time t , HML_t is the difference in return between a portfolio of high book-to-market stocks and one of low book-to-market stocks at time t , and MOM_t is the difference in return between a portfolio of past 1month winners and a portfolio of past 12 month losers at time t .

Since risks vary over time (Chen and Knez, 1996; and Ferson and Schadt, 1996), the estimation of alphas in equations 1 and 3 are likely unreliable. Thus, we consider a conditional performance measurement by including a vector of lagged global and local instruments (Z_{t-1}) to allow for Carhart Model's betas to vary over time in a linear fashion, i.e.,

$$\beta_{i,k,t} = \sum_{k=1}^n \beta_{i,k,0} + \sum_{k=1}^n B'_{i,k} Z_{t-1} \quad (4)$$

where B'_i is a vector of response coefficients of the conditional betas with respect to the instruments in Z_{t-1} . Then, the conditional Carhart equation to be estimated then becomes

$$R_{it} - R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt} - R_{ft}) + \beta_{i,2,0}HML_t + \beta_{i,3,0}SMB_t + \beta_{i,4,0}MOM_t + Z_{t-1}[B'_{i,1}(R_{mt} - R_{ft}) + B'_{i,2}HML_t + B'_{i,3}SMB_t + B'_{i,4}MOM_t] + \varepsilon_{it} \quad (5)$$

As for the instruments in Z_{t-1} , we use local and global variables similar to those used by Sanders and Walter (2001). Local risk factors (lagged 1 month) are the GDP growth, short term interest rates, and the change in political, economic and financial risk ratings. Global factors (lagged 1 month) are MSCI AC World Index dividend yield, world GDP growth, world inflation, US maturity spread, change in the price of oil, and the US default spread.

5.3 Measuring the Benefit of a Portfolio Constructed with Islamic Indexes

We investigate cointegration using stock index price levels for all of the indexes during each period. We conduct Johansen cointegration tests to determine long term relationships between the markets.⁸ Considering a VAR of order p :

$$y_t = A_1 y_{t-1} + \dots + A_p y_{t-p} + \theta + \varepsilon_t \quad (6)$$

where y_t is a k vector of non-stationary, $I(1)$ variables; θ is a deterministic term; and A_i are $(n \times n)$ matrices. Equation (1) can be rewritten as:

$$\Delta y_t = \Pi_p y_{t-p} + \sum_{i=1}^{p-1} \Gamma_i \Delta y_{t-i} + \varepsilon_t \quad (7)$$

where Π_p is the impact matrix and associated changes in price, Δy_t , to prices, y_{t-p} p periods earlier. Johansen's method is used to estimate the matrix Π_p with a reduced rank r and then it tests if the restriction implied by the reduced rank of Π_p can be rejected. Lags, trend specifications and cases are established using the Akaike Info Criterion (AIC).⁹ Likelihood ratio¹⁰ is used as a trace statistic to determine whether cointegration (reduction to r of Π_p) between the two non-stationary variables is significant and how many cointegration equations are

⁸ In the cointegration theory (Engle & Granger, 1987), if non-stationary variables do not drift apart from each other, there is a long-term linkage between those variables; it is often seen as a test of cross-border equity market efficiency.

⁹ We evaluate model selection criteria in terms of consistency. As we cannot know the true data generating process, the most asymptotically efficient model selection criterion is the Akaike Info Criterion.

¹⁰ The determination of the rank of Π_p is solved by determining the number of eigenvalues ($\hat{\lambda}_i$) of Π_p that are statistically different from zero. The trace test statistic is calculated as follows: $-\ln \prod_{i=r+1}^n (1 - \hat{\lambda}_i)$ where T is the number of observations, and r is the number of cointegrating vectors.

significant. Significance is set by the critical values reported in Osterwald-Lenum (1992).

6. RESULTS

6.1 Descriptive Statistics, Sharpe, Treynor, Selectivity and Net Selectivity

Table 1 shows each index's descriptive statistics and performance measures for the overall period in Panel A (1996-2005), the first sub-period in Panel B (1996-2000), and the second sub-period in Panel C (2001-2005).

Table 1: Descriptive statistics and performance of indexes

Results from Table 1 are based on monthly return series for MSCI Canada (CAN), Dow Islamic Canada (CANI), MSCI UK (UK), Dow Islamic UK (UKI), MSCI US (US), Dow Islamic US (USI), MSCI Asia Pacific Developed (AP), Dow Islamic Asia Pacific Developed (API), MSCI Europe Developed (EU), Dow Islamic Europe Developed (EUI), MSCI Emerging (EM), Dow Islamic Emerging (EMI), MSCI World Developed (WDD), Dow Islamic World Developed (WDDI), and MSCI AC World (World). Mean and standard deviations are annualized. "Cum. Return" is the cumulative monthly return over the period. "corr (peer)" is the correlation between an Islamic index and its corresponding MSCI index. "Corr (World)" is the correlation between an index and the MSCI AC World index. Beta is computed relative to the MSCI AC World. "Sharpe" is the Sharpe ratio ($(R_i - R_f) / \sigma_i$). "Treynor" is the Treynor ratio ($(R_i - R_f) / \beta_i$). "Alpha" is the measure of selectivity ($(R_i - R_f) - \beta_i [R_m - R_f]$). "Diver." is cost of diversification ($\sigma_i / \sigma_m [R_m - R_f] - \beta_i [R_m - R_f]$). Net Sel." is Fama's measure of net selectivity ($(R_i - R_f) - \sigma_i / \sigma_m [R_m - R_f]$).

Panel A: January 1996 to December 2005

N=120	Descriptive Statistics						Performance				
	Mean	Std. dev.	Cum. return	Corr (peer)	Corr (world)	Beta (world)	Sharpe Ratio	Trenor (world)	Alpha (world)	Diver. (world)	Net sel. (world)
CAN	11.31%	20.39%	105.89%		0.83	1.13	0.38	0.07	6.09%	0.32%	5.77%
CANI	13.57%	21.48%	129.11%	0.75	0.59	0.85	0.47	0.12	8.76%	0.83%	7.93%
UK	5.52%	14.21%	49.54%		0.86	0.81	0.14	0.02	0.77%	0.19%	0.58%
UKI	7.63%	14.17%	71.49%	0.72	0.69	0.65	0.29	0.06	3.11%	0.42%	2.69%
US	7.19%	15.65%	68.08%		0.94	0.97	0.23	0.04	2.20%	0.09%	2.11%
USI	8.16%	16.71%	76.39%	0.77	0.75	0.83	0.27	0.06	3.38%	0.40%	2.98%
AP	-1.40%	19.31%	-9.33%		0.77	0.99	-0.26	-0.05	-6.42%	0.42%	-6.83%
API	0.93%	16.43%	8.25%	0.78	0.62	0.69	-0.16	-0.04	-3.65%	0.58%	-4.23%
EU	7.04%	17.08%	65.30%		0.91	1.02	0.20	0.03	1.98%	0.16%	1.82%
EUI	8.38%	14.05%	79.19%	0.79	0.80	0.75	0.34	0.06	3.72%	0.26%	3.45%
EM	2.55%	24.45%	26.24%		0.80	1.31	-0.04	-0.01	-2.93%	0.45%	-3.38%
EMI	3.16%	24.35%	30.41%	0.83	0.57	0.93	-0.02	0.00	-1.77%	0.99%	-2.76%
WDD	5.20%	14.92%	49.33%		0.99	0.98	0.11	0.02	0.20%	0.01%	0.19%
WDDI	7.47%	15.43%	70.16%	0.79	0.79	0.81	0.25	0.05	2.72%	0.31%	2.41%
WORLD	5.03%	15.12%	47.86%		1	1	0.10	0.01	0.00%	0.00%	0.00%
RF	3.57%	0.52%	34.50%								
Averages											
Dow Islamic	7.04%	17.52%	66.43%	0.78	0.69	0.79	0.21	0.04	2.32%	0.54%	1.78%
MSCI	5.34%	18.00%	50.72%		0.87	1.03	0.11	0.02	0.27%	0.23%	0.04%

Panel B: January 1996 to December 2000

N=60	Descriptive Statistics						Performance				
	Mean	Std. Dev.	Cum. Return	Corr (peer)	Corr (World)	Beta (world)	Sharpe ratio	Trenor (world)	Alpha (world)	Diver. (World)	Net Sel. (World)
CAN	16.00%	21.72%	77.32%		0.80	1.17	0.50	0.09	4.16%	1.68%	2.48%
CANI	17.40%	23.41%	84.09%	0.75	0.50	0.79	0.53	0.16	7.77%	4.54%	3.23%
UK	9.75%	13.53%	47.11%		0.83	0.76	0.35	0.06	0.29%	0.86%	-0.57%
UKI	12.70%	13.56%	61.38%	0.58	0.53	0.48	0.56	0.16	4.87%	2.50%	2.37%
US	17.78%	15.36%	85.92%		0.92	0.95	0.83	0.13	7.22%	0.47%	6.75%
USI	22.22%	14.78%	107.41%	0.64	0.63	0.63	1.16	0.27	13.52%	2.11%	11.41%
AP	-4.20%	22.26%	-20.32%		0.80	1.20	-0.42	-0.08	-16.21%	1.71%	-17.93%
API	4.39%	17.00%	21.20%	0.80	0.65	0.75	-0.04	-0.01	-5.01%	2.28%	-7.28%
EU	12.65%	15.79%	61.13%		0.87	0.94	0.48	0.08	2.15%	0.70%	1.45%
EUI	15.59%	12.07%	75.36%	0.70	0.73	0.60	0.87	0.18	7.06%	1.22%	5.84%
EMER	-5.85%	26.95%	-28.28%		0.79	1.42	-0.40	-0.08	-19.14%	2.27%	-21.41%
EMERI	3.05%	27.93%	14.73%	0.85	0.57	1.07	-0.07	-0.02	-8.21%	4.68%	-12.89%
WDD	11.76%	14.61%	56.86%		0.99	0.98	0.46	0.07	1.03%	0.01%	1.02%
WDDI	19.20%	13.83%	92.80%	0.67	0.68	0.64	1.02	0.22	10.44%	1.68%	8.76%
WORLD	10.85%	14.89%	52.43%		1	1	0.39	0.06	0.00%	0.00%	0.00%
Rf	5.04%	0.17%	24.35%								
Averages											
Dow Islamic	13.51%	17.51%	65.28%	0.71	0.61	0.71	0.58	0.14	4.35%	2.72%	1.63%
MSCI	8.27%	18.60%	39.96%		0.86	1.06	0.26	0.04	-2.93%	1.10%	-4.03%

Panel C: January 2001 to December 2005

N=60	Descriptive Statistics						Performance				
	Mean	Std. Dev.	Cum. return	Corr (peer)	Corr (world)	Beta (world)	Sharpe Ratio	Trenor (world)	Alpha (world)	Diver. (world)	Net sel. (world)
CAN	6.62%	19.06%	28.57%		0.87	1.10	0.24	0.04	7.69%	-0.42%	8.11%
CANI	9.74%	19.50%	45.02%	0.76	0.70	0.92	0.39	0.08	10.29%	-1.02%	11.31%
UK	1.29%	14.87%	2.43%		0.89	0.87	-0.05	-0.01	1.70%	-0.29%	1.99%
UKI	2.56%	14.74%	10.11%	0.84	0.83	0.81	0.03	0.01	2.79%	-0.44%	3.23%
US	-3.39%	15.46%	-17.84%		0.96	0.97	-0.36	-0.06	-2.70%	-0.12%	-2.58%
USI	-5.91%	17.64%	-31.01%	0.87	0.86	0.99	-0.45	-0.08	-5.16%	-0.47%	-4.69%
AP	1.41%	15.99%	10.99%		0.78	0.83	-0.04	-0.01	1.70%	-0.62%	2.32%
API	-2.54%	15.92%	-12.95%	0.78	0.59	0.63	-0.29	-0.07	-2.83%	-1.18%	-1.64%
EU	1.44%	18.28%	4.17%		0.93	1.11	-0.04	-0.01	2.54%	-0.24%	2.78%
EUI	1.17%	15.61%	3.82%	0.85	0.86	0.88	-0.06	-0.01	1.60%	-0.40%	2.01%
EMER	10.95%	21.63%	54.52%		0.88	1.25	0.41	0.07	12.45%	-0.47%	12.92%
EMERI	3.27%	20.42%	15.68%	0.81	0.60	0.81	0.06	0.01	3.50%	-1.51%	5.01%
WDD	-1.36%	15.12%	-7.53%		0.99	0.99	-0.23	-0.03	-0.61%	0.01%	-0.61%
WDDI	-4.26%	16.31%	-22.64%	0.88	0.88	0.94	-0.39	-0.07	-3.65%	-0.36%	-3.29%
WORLD	-0.78%	15.30%	-4.57%		1	1	-0.19	-0.03	0.00%	0.00%	0.00%
Rf	2.10%	0.39%	10.15%								
Averages											
Dow Islamic	0.58%	17.16%	1.15%	0.83	0.76	0.85	-0.10	-0.02	0.94%	-0.77%	1.71%
MSCI	2.42%	17.20%	10.76%		0.90	1.02	-0.01	-0.00	3.25%	-0.31%	3.56%

During the overall period, Islamic indexes return on average 7.04 percent per annum as compared to 5.34 percent for MSCI indexes. Also, Islamic series are less risky than MSCI indexes with 17.52 percent standard deviation per annum as compared to 18% per annum. Furthermore, Islamic indexes are somewhat correlated with their peers (0.78), but less correlated with the MSCI AC World Index (average correlation of 0.69 with MSCI AC World) than with the MSCI indexes (average correlation of 0.87 with MSCI AC World). This translates into a lower beta with the world (0.79) as compared to MSCI indexes (1.03).

Overall Sharpe and Treynor ratios indicate that Islamic indexes outperform their non-Islamic peers. More specifically, the Islamic indexes offer an average of 205 basis points of excess performance as compared to MSCI indexes. Interestingly, Islamic indexes are less diversified than their peers — i.e., the cost of diversification is 31 basis points above the average MSCI index. On a diversification-adjusted basis, all Islamic indexes outperform MSCI indexes by 174 basis points over the last 118 months.

During the first period, Islamic indexes return on average 13.51 percent per annum as compared to 8.27 percent per annum for MSCI indexes. Equivalently, the average cumulated return for the Islamic indexes is 25.32 percent above the MSCI indexes average. Furthermore, the Islamic indexes are not as risky as corresponding MSCI indexes (average standard deviation of 17.51 percent per annum versus 18.60 percent per annum). Islamic indexes are strongly correlated with their peers (average of 0.71) but less correlated with the MSCI AC World Index than other indexes (average of 0.61 versus 0.86). Hence, they have lower betas (average of 0.71) than MSCI indexes (average of 1.06).

Sharpe and Treynor ratios indicate that Islamic indexes outperform their non-Islamic peers. More specifically, the Islamic indexes offer an average of 728 basis points of excess performance as compared to MSCI indexes. Islamic indexes are less diversified than their peers — i.e., the cost of diversification is 162 basis points above the average MSCI index. On a diversification-adjusted basis, all Islamic indexes outperform MSCI indexes by 566 basis points over the first 59 months of our sample.

During the second period, Islamic indexes return on average 0.58 percent per annum as compared to 2.42 percent per annum for MSCI indexes. The average cumulated return for the MSCI indexes is 9.61 percent above the average of the Islamic indexes over the most recent 59 months and the Islamic indexes are as risky as corresponding MSCI indexes (MSCI and Dow Islamic series average 17.2% standard deviation per annum). Islamic indexes are more correlated with their peers (average of 0.83) and somewhat correlated with the MSCI AC World (average of 0.76 versus 0.90). This translates into lower beta (average of 0.85) as compared to MSCI indexes (average of 1.01).

Sharpe and Treynor ratios indicate that Islamic indexes underperform their non-Islamic peers. More specifically, the MSCI indexes offer an average of 231 basis points of excess performance as compared to the Dow Islamic indexes. Islamic indexes are still less diversified than their peers — i.e., the cost of diversification is 48 basis points above the average MSCI index. On a diversification-adjusted basis, Islamic indexes underperform MSCI indexes by an average 185 basis points over the last 59 months of the sample.

Such results from Sharpe and Treynor measures are expected as both qualitative and quantitative screening of DJIM indices formation shrink the investment universe for deriving the full benefits of portfolio diversification. These results are consistent with other studies of Islamic investment performance behavior. However, results based on such measures only will be misleading as these measure do not fully capture the restrictions impose on portfolio formation by Islamic law. So, we turn to more sophisticated performance and asset pricing methods to study their performance and asset pricing behavior.

b. Results from multifactor tests

Results from multifactor tests are shown in Table 2. Results are broken down into three panels: Panel A (1996-2005) is the overall period, Panel B (1996-2000) is the first sub-period, and Panel C (2001-2005) is the second sub-period. While column 2 repeats the unconditional alphas from Table 1, the style-adjusted unconditional alphas are in column 4 and the style-adjusted conditional alphas are in column 10.

Table 2: Performance of Islamic indexes after controlling for style effects (Carhart factors)

$$\text{Unconditional CAPM: } R_{it}-R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt}-R_{ft}) + \varepsilon_{it}$$

$$\text{Unconditional Carhart model: } R_{it}-R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt}-R_{ft}) + \beta_{i,2,0}HML_t + \beta_{i,3,0}SMB_t + \beta_{i,4,0}MOM_t + \varepsilon_{it}$$

$$\text{Conditional Carhart model: } R_{it}-R_{ft} = \alpha_i + \beta_{i,1,0}(R_{mt}-R_{ft}) + \beta_{i,2,0}HML_t + \beta_{i,3,0}SMB_t + \beta_{i,4,0}MOM_t + Z_{t-1}[B'_{i,1}(R_{mt}-R_{ft}) + B'_{i,2}HML_t + B'_{i,3}SMB_t + B'_{i,4}MOM_t] + \varepsilon_{it}$$

To correct for the presence of autocorrelation and heteroskedasticity, standard errors and t-statistics are calculated using the Newey-West heteroskedasticity and autocorrelation consistent (HAC) covariance matrix. In the case of the conditional Carhart model, we save space by reporting the significance of (i) a Wald test (WT_1) for the null hypothesis of $\Sigma Z_{t-1}B'_{i,1}=0$, (ii) a Wald test (WT_2) for the null hypothesis of $\Sigma Z_{t-1}B'_{i,2}=0$, (iii) a Wald test (WT_3) for the null hypothesis of $\Sigma Z_{t-1}B'_{i,3}=0$, and (iv) a Wald test (WT_4) for the null hypothesis of $\Sigma Z_{t-1}B'_{i,4}=0$. WT_1 , WT_2 , WT_3 , and WT_4 follows a χ^2 distribution with 12 degrees of freedom (CAN, CANI, UK, UKI, US, USI), 10 degrees of freedom (AP, API, EU, EUI, EMER, EMERI), and 6 degrees of freedom (WDD, WDDI). “Adj. R^2 ” is the adjusted R-squared. Variance inflation factors are less than 1.2, suggesting the absence of multicollinearity. a, b, and c indicate statistical significance at the 1, 5 and 10 percent levels.

Table 2, Panel A (overall period) shows an increase in average adjusted R-squared for the modeling of Islamic indexes risk premiums using conditional multi-factor model (0.66), as compared to the 1-factor CAPM model (0.48) and the 4-factor model (0.55). The same observation can be made for the MSCI series (adjusted R-squared are 0.83, 0.78, and 0.77 for the conditional 4 factor model, the unconditional 4 factor model and the CAPM, respectively). Thus, the conditional Carhart model is better at explaining index returns, and reveals the series' exposures to global and local factors, indicating strong time-variation in betas. More specifically, the hypothesis of constant betas can be rejected at the 1% level in all series –i.e., at least one of the four conditional betas have significant Wald test statistics. Looking at the difference in unconditional and conditional alphas, Islamic indices have weakly outperformed MSCI indices during the period of study. Indeed, after controlling for market risk, size, book-to-market, momentum, local and global factors, the difference in return between Islamic and conventional indices is positive but rarely significant (MSCI US, MSCI Asia pacific, and Dow Islamic Asia pacific are the only series with alphas statistically different from zero).

Interestingly, the negative correlation with the HML factor reveals that Islamic indices contain more growth stocks, while non-Islamic indices have a positive correlation with the HML factor and are therefore more invested in value stocks.¹¹ The exclusion of value sectors like chemical, energy and basic industries could be the reason for this higher proportion of growth stocks exposure in Islamic indices—i.e., ethical portfolios are often under-weighted in companies with higher environmental risk.

Both type of indices have, on average, a positive correlation with the returns of a portfolio of small caps. In addition, Islamic series show a greater sensitivity to the SMB factor than MSCI series, indicating that the Dow Islamic indices are comprised of smaller firms than the MSCI series.

Table 2, Panel B also shows an increase in average adjusted R-squared for the modeling of Islamic and conventional indices risk premiums using a conditional multi-factor model, as compared to the unconditional models. Thus, the conditional model is better at explaining indexes returns with global and local factor exposure (again, the null hypothesis of constant betas can be rejected at least at the 1% level for all series), indicating strong time-variation in betas. As in table 2A, Islamic indices have a growth stock and momentum focus, while conventional indices are positively correlated with a value portfolio. Finally, the difference in return between Islamic and conventional funds increases with the inclusiveness of

¹¹ Bauer, Koedijk, and Otten (2005) reported similar results for international socially responsible mutual funds.

the model, and 6 out of the 14 alphas are statistically significant—i.e., this is the case for the Dow UK Islamic, MSCI US, Dow US Islamic, MSCI Asia Pacific, and Dow World Developed Islamic series. The overall convincing superior performance of the Islamic series as compared to the conventional series is likely period-specific since growth stocks outperformed value stocks from 1996 to 2000.¹²

As shown in Table 2, Panel C, the conditional multi-factor model has a higher average R-squared, as compared to the unconditional models. As in Table 2A and 2B, the conditional Carhart model is better at explaining Islamic and conventional index returns (again, the hypothesis of constant betas can always be rejected). Additionally, the difference in conditional alphas between MSCI and Islamic indexes increases from those observed with the unconditional CAPM. Indeed, after controlling for market risk, size, book-to-market, momentum and local and global factors, Islamic series underperform conventional indices; although, since only one alpha (Dow Islamic Asia Pacific) is significantly different from zero, it is difficult to conclude on the definite superiority in performance of one set of indices as compared to the other.

One reason behind the observed underperformance of the Islamic series is likely period specific and can be attributed to their growth focus relative to conventional indices. That is, if growth stocks fared well as compared to value stocks during the 1996-2000 period, portfolios with a growth focus considerably suffered during the 2001-2005 period.¹³

Our results are generally consistent with previous studies. Like Hassan, Antoniou and Paudyal (2005), an Islamic investor does not necessarily suffer from low return by following his religious restrictions in stock investing. However, we divide the sample into bull and bear period to see if the performance matrices of Islamic and conventional indices differ from each other. We also use a longer data period to capture such differences.

C. Diversification Analysis

Table 3: Cointegration tests

ADF and KPSS tests for stationarity have been performed on each price series. Stationarity in levels is rejected according to both tests. We conduct Johansen cointegration tests to determine if a long-term relationship exists between the

¹² For instance, the MSCI AC World Growth index outperformed the MSCI AC World Value by an average of 290 basis points per annum from January 1996 to December 2000.

¹³ For instance, the MSCI AC World Growth index underperformed the MSCI AC World Value by an average of 440 basis points per annum from January 2001 to December 2005.

markets. We evaluate whether ε_t in the cointegrating regression $x_t = \sum_{i=1}^k \lambda_i y_{i,t} + \sum_{i=1}^{k-1} \theta_i \Delta x_{t-i} + \varepsilon_t$ is found to be $I(0)$ given any particular cointegrating rank. Lags and trend assumptions are established using the Akaike Info Criterion (AIC). Likelihood ratio is used as a trace statistic to determine the number of cointegration equations between the two non-stationary variables; significance is set by the critical values reported in Osterwald-Lenum (1992). a, and b indicate statistical significance at the 1, and 5 percent levels.

Dow Islamic Price Series: Canada, USA, Asia-Pacific, Europe, Emerging					MSCI Price Series: Canada, USA, Asia-Pacific, Europe, Emerging				
1996:01 to 2005:12 (N=120) Trend assumption: No deterministic trend					1996:01 to 2005:12 (N=120) Trend assumption: Quadratic deterministic trend				
No. of CE(s)	Eigenvalue	Trace statistic	5 Percent Critical value	1 Percent critical value	No. of CE(s)	Eigenvalue	Trace statistic	5 Percent Critical value	1 Percent Critical value
None ^a	0.29	84.86	76.07	84.45	None ^a	0.27	88.89	77.74	85.78
At most 1	0.19	45.44	53.12	60.16	At most 1	0.18	52.38	54.64	61.24
At most 2	0.10	21.36	34.91	41.07	At most 2	0.14	29.16	34.55	40.49
At most 3	0.06	9.57	19.96	24.60	At most 3	0.08	11.77	18.17	23.46
At most 4	0.03	3.03	9.24	12.97	At most 4	0.01	2.02	3.74	6.4
1996:01 to 2000:12 (N=60) Trend assumption: Quadratic deterministic trend					1996:01 to 2000:12 (N=60) Trend assumption: Quadratic deterministic trend				
No. of CE(s)	Eigenvalue	Trace statistic	5 Percent critical value	1 Percent critical value	No. of CE(s)	Eigenvalue	Trace statistic	5 Percent critical value	1 Percent critical value
None ^a	0.80	146.95	77.74	85.78	None ^a	0.56	99.19	77.74	85.78
At most 1 ^b	0.36	60.29	54.64	61.24	At most 1 ^b	0.42	54.76	54.64	61.24
At most 2 ^b	0.32	36.28	34.55	40.49	At most 2 ^b	0.36	35.44	34.55	40.49
At most 3	0.25	15.77	18.17	23.46	At most 3	0.15	8.99	18.17	23.46
At most 4	0.01	0.32	3.74	6.40	At most 4	0.01	0.40	3.74	6.4
2001:01 to 2005:12 (N=60) Trend assumption: Quadratic deterministic trend					2001:01 to 2005:12 (N=60) Trend assumption: Linear deterministic trend				
No. of CE(s)	Eigenvalue	Trace statistic	5 Percent critical value	1 Percent critical value	No. of CE(s)	Eigenvalue	Trace statistic	5 Percent critical value	1 Percent critical value
None ^a	0.47	107.71	77.74	85.78	None ^a	0.50	100.32	87.31	96.58
At most 1 ^a	0.39	69.77	54.64	61.24	At most 1	0.34	59.04	62.99	70.05
At most 2 ^b	0.33	40.08	34.55	40.49	At most 2	0.23	34.52	42.44	48.45
At most 3	0.21	15.96	18.17	23.46	At most 3	0.18	18.81	25.32	30.45
At most 4	0.03	2.14	3.74	6.40	At most 4	0.11	6.94	12.25	16.26

The multivariate cointegration analysis suggests that both the Islamic and conventional groups are poorly integrated for the overall period. However, there seems to be some strong common stochastic trends in both groups during the first period (at most two significant cointegrating equations). For the second period, the Islamic group remains somewhat cointegrated while the non-Islamic group shows little evidence of common stochastic trends. These findings are illustrated in Figure 1 where an efficient set is created for each group for the overall period (Panel A), the first sub-period (Panel B) and the second sub-period (Panel C). Panels A and C clearly show a net advantage of allocating among Islamic indexes as compared to conventional indexes. However, the situation is reversed in the later period — the

Islamic indexes provide a less efficient mix than the MSCI indexes. Again, as for the analysis of the performance of each index, we cannot see much difference between Islamic and non-Islamic series either as stand-alone assets or as an asset class. Our results seem to point to a recent underperformance of the Islamic group as compared to the more conventional MSCI indexes.¹⁴

Chart 1: Quantitative Sharī‘ah Filtering Rules

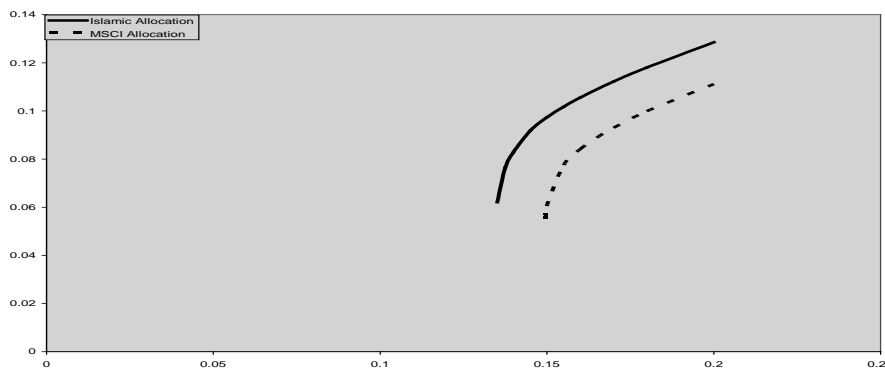
Asset-based Filtering Rule	Market Capital-based Filtering Rule
Non-permissible Income / Total Income < 5%	Non-permissible Income / Total Income < 5%
Interest-bearing Cash and Investments / Assets < 33%	Interest-bearing Cash and Investments / 12 month average market capitalization < 33%
Receivables / Assets < 33%	Receivables / 12 month average market capitalization < 33%
Interest-bearing Debt / Assets < 33%	Interest-bearing Debt / 12 month average market capitalization < 33%

Note: Total Assets are used as divisors for filtering screens of MSCI and FTSE. Different varieties of average market capitalization are used as divisors for Russell Indexes, Dow Jones Indexes, S&P Indexes as well as AAOIFI.

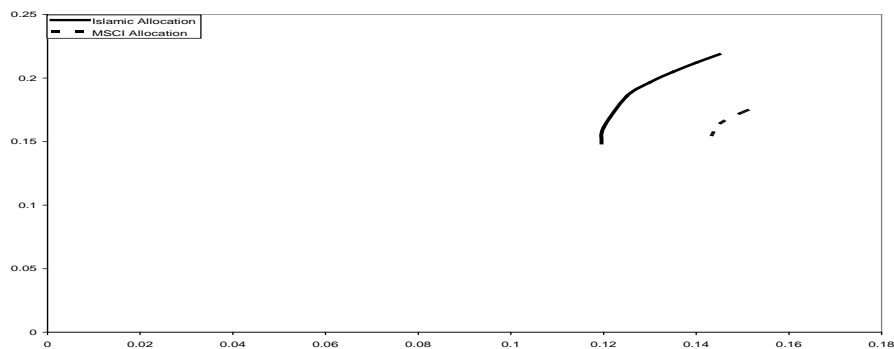
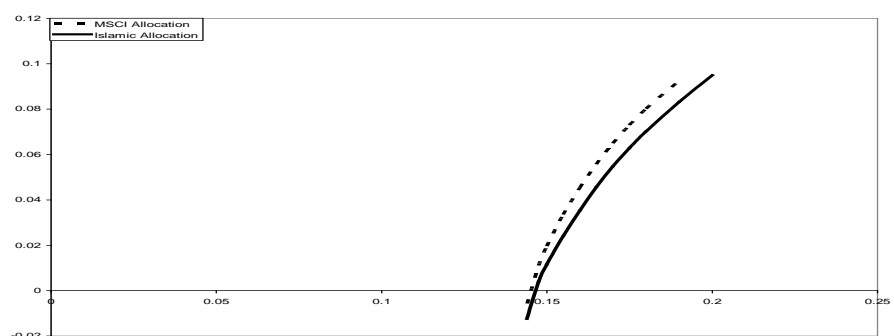
Source: Adapted from Dergis and Merzban, 2008

Figure 1: Efficient Frontiers

Panel A: 1996-2005



¹⁴ We conducted unit root tests to examine the stationarity properties of these series and find that they are co-integrated at the same level. We find that most of these series have unit roots after first differencing.

Panel B: 1996-2000**Panel C: 2001-2005****7. SUMMARY AND CONCLUSIONS**

Our paper focuses on a special kind of ethical investing based on Islamic principles. Investors want to know whether Islamic ethical investing screening criteria provide different performance than conventional ethical index funds. Focusing on DJIM indexes, this study has the advantage of examining effects of screening process on the risk-return performance directly without the need for extracting funds transaction costs, management skills or market timing of funds management. Because DJIM employs similar screening mechanism comparable to those based on Islamic mutual funds, this study is also relevant for the assessment of performance measures of ethical Islamic mutual funds or similar faith-based investment funds.

We find no convincing performance differences between Islamic and non-Islamic indexes from January 1996 to December 2005. Indeed, the Dow Islamic indexes outperform their conventional counterparts from 1996 to 2000 and underperform them from 2001 to 2005. Overall, similar reward to risk and diversification benefits exist for both indexes.

Controlling performance for style and time variability, we find that Islamic indices are growth focused and MSCI indices are value focused. In addition, Islamic indices comprise smaller firms than MSCI indices. In sum, Islamic indexes are growth and small-cap oriented and conventional indices are relatively more value and mid-cap focused. We suggest that one reason behind the high proportion of growth stocks may come from the exclusion of value sectors with higher environmental risk like chemical, energy and basic industries.

After controlling for market risk, size, book-to-market, momentum, local and global factors, we conclude that the difference in return between Islamic and conventional indices is rarely significant — i.e., only few the alphas are significantly different from zero. Although, Islamic indices convincingly outperform conventional indices during the first period (1996-2000), they underperformed the same conventional indices during the last period (2001-2005). Our findings suggest that the period-specific performance of Islamic indices is likely attributed to style differences between the two types of series.

The multivariate cointegration analysis suggests that both the Islamic and conventional groups are poorly integrated for the overall period. However, there seems to be some strong common stochastic trends in both groups during the first period (at most two significant cointegrating equations). For the second period, the Islamic group remains somewhat cointegrated while the non-Islamic group shows little evidence of common stochastic trends.

Our findings suggest that the behavior of DJIM indexes does not differ from that of their conventional counterparts, with some indexes outperforming their conventional counterparts and others under-performing them. Overall, similar reward to risk and diversification benefits exist for both type of indexes.

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ISLAMIC FINANCE IN EUROPE: THE REGULATORY CHALLENGE

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and
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ABSTRACT

Over the last few years, Islamic finance has developed and spread quite significantly all over the globe. This development brought with it many challenges and opportunities that industry players, supervisory authorities, and other parties are trying to examine and identify. The regulatory challenge is considered to be among the crucial challenges that need to be properly addressed as a prerequisite for an environment conducive to the development of this emerging industry.

This paper examines the European approaches to overcoming regulatory issues related to the establishment of Islamic finance institutions and the provision of Islamic products and services in these advanced and very sophisticated financial centers. The paper reveals that, despite the fact that cross-country examinations indicate the existence of a variety of models and approaches adopted worldwide to accommodate IF in conventional systems, European countries seem to follow the minimal change approach that relies primarily on tax regimes to achieve level playing field for IF through the policy of “no obstacles, but no special favours” initiated by the UK authorities in their handling of the matter. The paper also reveals that civil law countries in mainland Europe, like Italy, are adopting the policy of “wait and see” by letting market forces decide the future direction of the presence Islamic finance in their domiciles.

1. INTRODUCTION

Islamic finance came into being no more than five decades ago. Its institutional development went through two phases: the first one in the sixties that witnessed the

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introduction of a local saving bank in the rural area of Mit-Ghamr in Egypt¹, and the second, in the mid-seventies which saw the introduction of commercial private banking and an intra-government initiative² at a regional level among OIC³ countries. From then on, Islamic finance has grown steadily, spreading from one institution in one country to more than 400 institutions in more than seventy countries with total assets reaching the threshold of 1 trillion US dollars (Al-Iqtisadia, 2011). The paper also reported that some experts anticipate that by the year 2020 Shari'ah compliant assets to be around 4 Trillion US Dollars. In addition, the operations and products of IF have diversified and grown as well.

As a result, Islamic finance (IF) is no longer confined to its traditional Muslim and Arab countries; rather, it has spread, in various degrees, all over the globe. Among the places that have recently witnessed the emergence of IF is Europe. This paper addresses issues relating to the regulatory and supervisory challenges in this locality by discussing the following questions:

- What are the main regulatory issues that the presence of IF in Europe brings with it?
- Is there a variety of approaches adopted across Europe, or are the players following the same path?
- Have Islamic finance operations been taxed on the basis of the legal form of the contract, or on the basis of the economic substance of the transaction?

The paper prosecutes the issues attendant to these queries in four sections. Section I provides an overview of the basic principles of IF and its latest development in Europe. Then Section II touches upon the nature, rationale and objectives of the regulatory process and its relevance to IF. Section III summarizes the different approaches adopted worldwide in accommodating IF into conventional systems, and discusses the route pursued by some European countries within the context of those models. Finally, Section IV draws some concluding remarks from the discussion and analysis carried out in the preceding sections.

¹ The experiment is well known by its founder; Ahmed Al-Naggar and it lasted for four years from 1963 till 1967.

² The Islamic Development Bank (IsDB) which has been transformed into a group with many subsidiaries and affiliates.

³ Organization of Islamic Conference.

2. ISLAMIC FINANCE: BASIC PRINCIPLES & EVOLUTION IN EUROPE

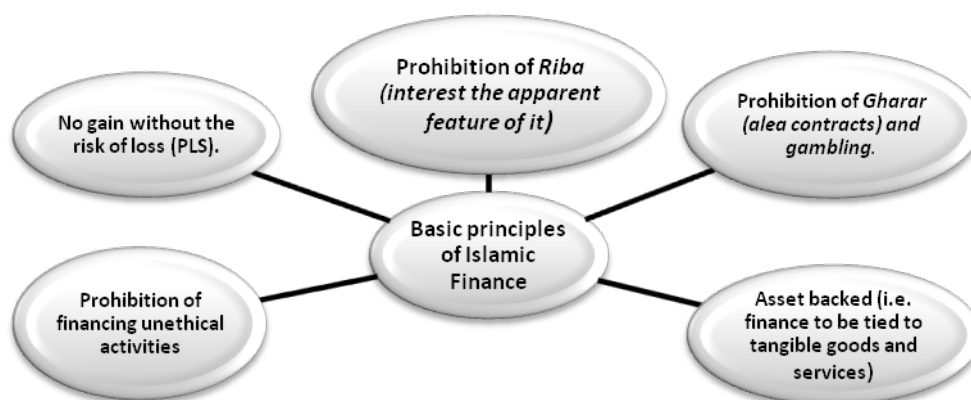
2.1. Basic Principles of Islamic Finance ⁴ and their Regulatory Implications

In order to pave the way for the introduction of IF in any conventional legislative body it is important to comprehend fully and properly the basic principles that regulate the operations of this newly emerging industry, the core foundations of which are based upon the ruling of Shari'ah (Islamic Law) that govern matters of rituals and transaction dealings of the individual and society. This law provides a general framework within which financial transactions can be conducted. Hence Islamic finance, in very simple and general terms, can be defined as "the provision of financial services and products in accordance to the principles of Shari'ah".

This definition implies that the main difference between the IF industry and its conventional counterpart lies in the "Islamicity" of its operations and products. If so what are then the basic principles that determine this "Islamicity"? And what are the legal, regulatory and supervisory implications?

It has been widely accepted that the framework of providing "Islamic" financial services is guided by the following basic principles as illustrated in the chart below:

Figure-1
Basic Principles of Islamic Finance



⁴ Some of these principles, such as the prohibition of *Ribā* and gambling, are not alien to the culture of the West, and even to some other cultures and religions (Dar *et. al.*, 1999:2-3); (Wilson, 2007b:1); (Chapra *et. al.*, 2000:1-2).

Among the elements displayed in the above chart, it can be noticed that the prohibition of *ribā*⁵ and the asset-backing norms represent the major principles that have a big impact on the nature of the operations to be carried out by Islamic Financial Institutions (IFIs), especially commercial banks. The prohibition of *ribā* is regarded by regulatory authorities as the overarching principle of the operations of IF industry (FSA, 2006). This is because interest-based dealings constitute the backbone of the operations of conventional finance. On the other hand, the asset-backing norm obliges IFIs to tie the assigned funds for investment purposes to an underlying or very determined and specified asset or service. In conventional finance that is not the case as the provision of funds does not require financial institutions to assume any responsibility of the ownership of the financed assets. In addition, funds pooled for investment purposes have to have guaranteed principals regardless of the outcome of the financed operation.

In order to assess the effect of such principles on the operations of a typical Islamic Financial Institution (IFI), a theoretical structure of assets and liabilities of that institution is examined briefly to identify some of the regulatory and supervisory issues that arise from such a structure:

Table-1: Theoretical Structure of Balance Sheet of a Typical IFI and the Policy and Tax Implications of Such Structure

Assets	Policy and/or tax Implications	Liabilities	Policy and/or tax implications
<u>Inventory:</u> Real estates /automobiles.	Distinct characteristic-ownership of assets.	<u>Investment Accounts:</u> Deposits assigned for investments are accepted on PLS basis. That is neither the principle nor the return is guaranteed. In this category there are two types of products; general or unlimited, to be used as the IFI sees fit, and special or limited, assigned for particular investments based on the customer preference and choice	In prevailing laws, deposits and their fixed returns are guaranteed to certain ceilings through compensation or insurance schemes. How will "Islamic" deposits be treated given the fact that return and principal payments depend upon the performance of the financed assets? - Capital adequacy ratios. - Risk management approach. - Corporate governance issues (e.g. moral hazard).

⁵ Interest-based operations represent the apparent and the most significant element of *Ribā* in nowadays financial practices.

<u>Asset backed placements</u> (e.g. <i>Murābahah</i> (cost plus), <i>Ijārah</i> (leasing), etc.): Finance has to be tied to real transactions, be it a plant, a good or a service. The IFI has to acquire such utilities and bear the associated risks by assuming the ownership of the underlying asset at some stage before transferring it to the client. And in providing finance, no predetermined fixed return (i.e. ex ante) can be claimed from the outset of the process. The IFI has to share in profits, if any, and bear part of the losses, if that is the case.	No placement of funds in interest based assets such as bonds and treasury bills. Exclusion of the most widely used instruments for liquidity management, and "safe" investment opportunities. Double stamp duty or registration tax on assets double sale. VAT on <i>Murābahah</i> mark-up. 100% capital treatment for some Islamic instruments used for mortgage financing. Ownership and illiquidity risks.	<u>Current/Demand deposits:</u> similar to conventional ones, but no interest or remuneration of any form to be given to customers.	Have to be fully guaranteed and subject to customer withdrawal at any time.
<u>Profit-sharing Transactions:</u> e.g. <i>Muḍārabah</i> (profit-loss bearing), <i>Mushārahah</i> (profit-loss sharing).	Rate of return Risk. Displacement Risk. Equity investment Risk.	Profit Equalization Reserves	Distinct characteristic as prudential tool.

Source: Authors & IFSB (2010: 17)

It is clear from the table above that there are sharp contrasts, at the theoretical level at least, between IFIs and their conventional counterparts. However, at the practical level, convergence between IF instruments and their conventional counterparts is dominating the scene through the certification mechanism carried out by scholars and boards (i.e. Shari'ah Supervisory Boards (SSB)), and in some cases, lawyers are also getting involved in the approval of the IFIs operations (El-Gamal, 2006: xi). In order to understand the nature of risks and regulatory concerns associated with IF instruments and operations, three main questions need to be addressed:

First, does the "Islamicity" of financial services and products expose institutions offering this type of arrangements to more, less, or the same sort of risks as conventional industry is exposed to?

Second, is it a must to have an SSB at each and every institution to ensure the "Islamicity" of operations?

Third, what are the regulatory implications of such a special nature and a set up?

As for the first question, two views are held (El-Hawary *et. al.*, 2004:28); the one that advocates minimal regulation if IFIs operate according to the core risk sharing principles, and the other view is that IFIs must be subjected to the same regulation as their conventional counterparts. There has been a great deal of debate on the related literature. However, the practice of the industry and the attitude of the regulatory authorities in most jurisdictions have adopted the latter approach: requesting IFIs to adopt the norms and standards applied to their conventional counterparts (Chapra *et. al.*, 2000:22-25). On the other hand, infrastructure bodies of the industry, like the IFSB⁶, are striving hard towards the adoption of some modification of the standards developed by international regulatory settlers, like the Basel Committee, to take into account the special features of IFIs.

As for the second question, the development of the industry over the years indicates that ensuring the “Islamicity” of operations is vital for credibility and public confidence. The practice also reveals that the main form for ensuring that is through the appointment of an internal body (SSB) or an individual (scholar) to endorse the “Islamicity” of these operations. It is for this reason that Wilson (1999:438) noticed, about the early development of IF in the UK, that some of the conventional institutions offering “Islamic” products could not attract customers to increase their operations in this area until the appointment of an SSB. Having said that, it must be acknowledged that in recent years, Shari‘ah consultancy firms or individuals are emerging as other forms of ensuring the Islamicity of the operations of IF industry. Furthermore, much debate is taking place about the heavy load that many scholars are taking on, which affects the efficiency of their work and may create conflict of interest between their role as independent advisors, and the fact that the managerial committees of IFIs are responsible for their appointments and the remuneration that they get. For instance, Funds@Work (2010:7) organization reveals that the two top scholars are acting in more than seventy boards.

As for the third question, several implications that arose as a result of the aforementioned discussion are identical to those of IFIs counterparts. This may be partly due to the dominance of the fixed income products on the assets side of these institutions through the sales and lease contracts. Some of these issues that have been identified by regulatory bodies are standardization of products and instruments, information disclosure, corporate governance, capital adequacy requirements, and so on. So, almost all prudential matters that stand behind the rationale for regulation of the activities of conventional financial industry are relevant to IF as it is practised nowadays.

⁶ The Islamic Financial Services Board; a Malaysian based body that was created by a group of Central banks in 2002 with the IMF and BIS support as an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry. **Source:** <http://www.ifsb.org>, accessed February 27th, 2011.

In this respect, as will be seen in a later section, the UK authorities did not see any need or justification for major changes to the existing legislation, as the policy of “*no obstacles, but no special favours*” is providing good results by sending positive signs to the industry players and the responsible, and as it was also seen as neither appropriate nor legally possible to vary the UK standards for a particular type of institution or industry (Ainley *et. al.*, 2007:11).

2. 2. Evolution of Islamic Finance in Europe

The presence of Islamic finance in Europe can be traced back to the beginning of the eighties of the twentieth century, through the provision of some commodity *Murābahah* in the London market (Wilson, 2007b:2), and through the establishment of some financial institutions such as Islamic insurance (*Takaful*) with one in Luxemburg (Krawczykowski *et. al.*, 2010), and Al-Baraka International, in London (Wilson, 1999:426).

Since that time IF products and institutions have been introduced in various ways in the UK market. However, the dramatic steps in terms of legislation, the establishment of fully-fledged institutions, and the issuance and listing of some Islamic instruments such as the *Ṣukūk*, have taken place only over the last few years. At the time of writing this paper, the following facts can be cited as indicators of the development of IF in Europe (IFSL Research, 2010:3):

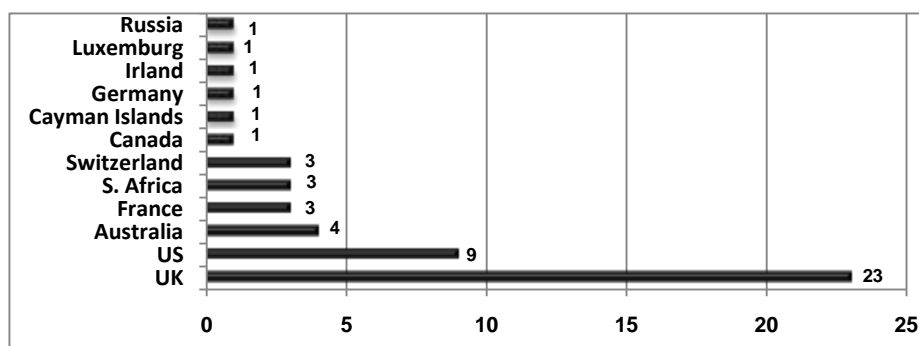
- Europe is a host of five fully-fledged Islamic banks; one is retail and the remaining are wholesale investment banks. All of these institutions are UK based, but they can increase their outreach to the mainland Europe through the European passport⁷.
- *Ṣukūk* instruments, or Islamic bonds, as some may prefer to call them, are rapidly expanding too. In the UK, since 2006 which saw the first London-listed *Ṣukūk*, transactions in these instruments have exceeded the value of £9bn through the 26 issues of *Ṣukūk* in the London Stock Exchange (Walmesley, 2011:2). And despite the slowdown of *Ṣukūk* issuance after the financial crisis, last year saw the issues of six *Ṣukūk* in London (Walmesley, 2011:2), while 16 *Ṣukūk* are currently listed on the Luxemburg Stock Exchange (representing approximately 6 billion in notes) in Luxemburg (Krawczykowski *et. al.*, 2010). In 2004, Saxony-Anhalt became the first state government in Germany and Europe to issue a sub-sovereign bond under Islamic principles (The Banker, 2004). And in 2008, this time in France, the Autorité des Marchés Financiers (AMF), the French market regulator, gave

⁷ In 2009, Gate House Investment Bank used such a tool to apply for the offering of its services in France.

admission to *Şukūk* to be listed in the regulated financial market (AMF, 2008).

- Investment funds are also present in some countries of the continent. Luxemburg hosts more than 40 Sharīḥ-compliant investment funds and sub-funds, which makes up around 7% share of the total funds across the world. As a result, Luxemburg is classified among the top five Islamic funds domiciles in the world (Luxemburg for Finance, 2010:7).
- Many European countries have some presence of IF in the form of fully fledged IFISs, or through Islamic Windows offered by conventional institutions, as the chart below demonstrates:

Figure -2: Number of IFIs & Islamic Windows in Non-Muslim and Non-Arab Countries



Source: IFSL Research (2010) and Islamic Finance (2010)

3. REGULATORY CHALLENGE: NATURE, OBJECTIVES, RATIONALE AND RELEVANCE TO IF

It is widely recognized and accepted that financial systems are the most highly regulated activities of the economy. This is mainly due to the fact that financial products and contracts provided by the financial institutions and markets are significantly different from products and services offered by firms of other sectors of the economy (Llewellyn, 1999:5). This specialness centers on the role of payment system handling and credit provisions and distribution carried out by these establishments. As a result, regulatory authorities in most countries, as noted by Llewellyn, (1999), pay particular attention to this issue, in order to maintain the integrity of the financial system, by affecting the behavior of the regulated institutions and markets in a way that aims to achieve certain objectives. These objectives are considered to be of vital importance to the smooth functioning and stability of the entire economy. Various pieces of legislation as well as the

literature explaining why financial regulation is beneficial, usually state the following objectives as mandates for regulatory authorities to achieve⁸:

- Market confidence – maintaining confidence in the financial system of the country.
- Financial stability - contributing to the protection and enhancement of stability of the financial system.
- Consumer protection - securing the appropriate degree of protection for consumers and users of the financial services and products.
- Reduction of financial crime - reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

In addition to the above general objectives related to financial activities as a whole, these authorities usually handle carefully the issue of incorporating newly emerging industry or products. Therefore, in dealing with the issue of accommodating IF, regulatory authorities try to achieve the following sub-objectives:

- Lifting uncertainty about the intent of the regulatory authorities to pave the way for level playing field for IF products & institutions. The clarity and intent are required as prerequisites to avoid over- or under –regulation that may respectively either stifle or leave too much room for risk taking (El-Hawary *et. al.*, 2004:28).
- Prudential regulation umbrella for Islamic modes of finance as part of the “*no obstacles, no special favours*” policy.
- Same level of regulatory protection for customers of Islamic products & services to boost confidence in, and stability of the system.

As for the rationale of the regulatory process and its relevance to Islamic Financial Institutions (IFIs), the following points can be made:

⁸ These objectives have been drawn from the statutory objectives given to the Financial Services Authority in the UK. Source: www.fsa.gov.uk. On the other hand, the Banking Act 2009, stressed upon the same objectives for the regulation of the banking institutions: Objective 1 is to protect and enhance the stability of the financial systems of the United Kingdom. Objective 2 is to protect and enhance public confidence in the stability of the banking systems of the United Kingdom. Objective 3 is to protect depositors. Objective 4 is to protect public funds (H M Treasury, 2009). Moreover, some other important Central Banks, like the European Central Bank, have concentrated on one aspect of these objectives, like price stability for example: “the overriding objective of [the ECB] monetary policy is price stability”. Even for the regulation of IBs almost the same objectives are stated and stressed upon (Chapra *et al.*, 2000:13 & 17).

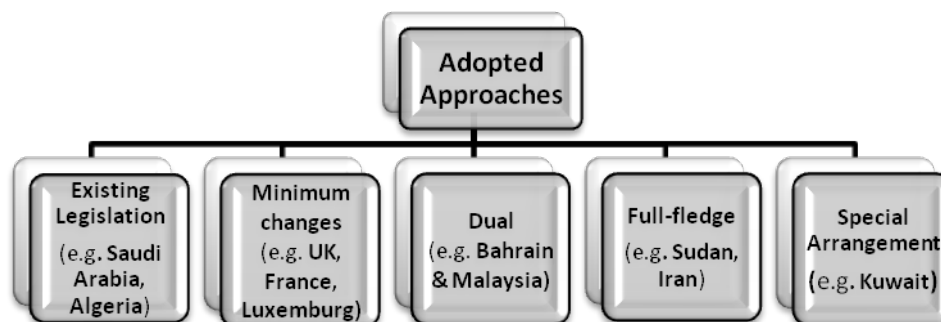
- Financial innovation often brings with it changes in the perception of risk (El-Hawary *et al.*, 2004:3). Merton (1995:462) makes the point that “less apparent understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system is unchanged or reduced”.
- Legal: do existing laws in secular jurisdiction allow financial transactions to be governed by Shari‘ah principles (Hesse *et al.*, 2008:179)? The practice reveals that there is no problem in that, as existing laws are flexible enough to accommodate new innovations and products as long as they are well understood, and they do not bring excessive risks that are beyond control. Although this is the case, one must admit that there is a cultural and historical sensitivity linked to the issue of IF operations in Europe; especially if emphasis is given to the inclusion of certain religious laws within the mainstream secular ones (Wilson, 2007a).
- Regulatory: Do Islamic financial institutions & products require similar levels of supervision as their conventional counterparts (Hesse *et al.*, 2008:179)? We discussed this point in details in the previous section and we concluded that most regulatory authorities, especially European, are of the opinion that IFIs must be subject to the same existing prudential regulations as their conventional counterparts whenever that is possible, without subjecting the institutions of this newly emerging industry to stringent constraints that will penalize their customers or affect the innovation process that is so vital, particularly when the industry is still in its infancy. So, the main point at stake is to strike a balance between over-and-under regulation that may send the wrong signals to interested players, parties and markets.

4. THE EUROPEAN APPROACH WITHIN THE CONTEXT OF THE VARIOUS APPROACHES ADOPTED⁹

Practices and examination of regulatory and supervisory authorities in various countries reveal that there are mainly four approaches, as summarized in the chart below, adopted in accommodating IF in conventional systems. The fifth one, of Kuwait, falls under the auspices of the third approach, i.e. the dual one; however, it has been stated separately to highlight its specialness in two aspects: the first is the fact that the established institution, although depository, has been given the name of a house rather than a bank; and the second aspect is the fact that the institution is regulated by the Ministry of Commerce rather than the Central Bank of Kuwait (El-Hawary *et al.*, 2004:27).

⁹ For an in-depth analysis of the variety of models adopted and their progressive nature, see Belabes, (2011).

Figure-3: Approaches Adopted Worldwide in Accommodating Islamic Finance



Apart from the case of Kuwait which has been explained earlier, the above chart is self explanatory in dividing conventional systems in accommodating IF into four categories in a gradual order: the first is the one that preserves the status quo; the second introduces minimum changes to the existing laws; with the third, special laws that go hand in hand with conventional laws are brought in for the regulation of IF activities; and as for the fourth category, which is very limited, it operates the conversion of the full system into an Islamic system. It is clear that so far, the European approach falls within the second category, with minimum changes to the existing laws. In the subsequent sections, we will look at the experiments of three actors in this context: The UK, France and Luxemburg, and then we will briefly account for the latest development in other countries, such as Italy and Germany.

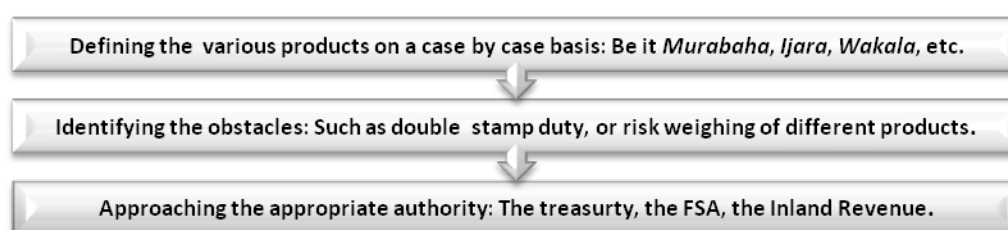
4. 1. The Experiment of the UK

The United Kingdom is by far the most active player in the area of accommodating IF on its territory. Many conventional institutions operating in the London market have been active in the provision of Shari‘ah compliant products since at least the beginning of the eighties in the last century. However, much of the significant development has taken place over the last few years¹⁰. Among these evolutions are the legislative measures taken by the government to provide level playing field for IF industry. In 1995, the then governor of the Bank of England, Sir Edward George, recognized the ‘growing importance of Islamic banking in the Muslim world and its emergence on the international stage’ as well as the need to put Islamic banking in the context of London’s tradition of ‘competitive innovation’ (Ainley *et. al.*, 2007:8).

¹⁰ For more details about the latest developments of IF in this country, see Belouafi, (2011).

Since that recognition, no significant step had been taken by the UK government until 2001 when a high level working group, chaired by Lord George, was established to identify the barriers that IF faces in the UK (Ainley *et. al.*, 2007:8). According to Lord George (1995:77), the analysis conducted by the working group had been carried out along the following steps:

Figure–4: Steps Followed by the Working Group that Was Chaired by Lord George



From the time of the formation of the aforementioned group onwards, the UK government has taken several initiatives before attaining the current status of the development and growth of IF on its territory. Among the measures taken was the formation of more specialized groups, such as the one that looks at tax issues, and the consultation method through various consultation papers¹¹ in order to get a wider prospect from the stakeholders of the industry; the Treasury, the FSA, the Inland Revenue, the Muslim community, Shari‘ah experts, IF industry and its infrastructure institutions, such as the IFSB and AAOIFI, the City, Lawyers and consultancy firms. In addition, the process was guided by clear principles¹² and objectives¹³. This lengthy work has resulted in the identification of several obstacles. Among them are:

- Definition of a deposit and how to reconcile its legal requirement under the English Law with that of IF principle of the prohibition of taking and giving interest without linking that to the performance of an underlying asset.

¹¹ A typical example is the consultation paper on “Legislative framework for the regulation of alternative finance investment bonds (*Shukūk*)” that was published on December 10th, 2008 and the received summary of responses was published on October 2009.

¹² These are: fairness, collaboration and commitment (HM Treasury, 2008:13-14).

¹³ These are: enhancing the UK’s competitiveness in financial services by establishing the UK as a gateway for international Islamic finance; and ensuring that everybody, irrespective of their religious beliefs, has access to competitively priced financial products (HM Treasury, 2008:13).

- The double stamp duty land tax (SDLT) on the purchase of the property of the Bank from the seller, and the re-sale of that property to the customer (the purchaser) through the various modes of IF available for home purchase, such as *Murābahah*, *Ijārah* or Diminishing *Mushārakah*¹⁴.
- The role of the Sharī'ah advisory board; and if it is going to interfere and overlap with that of the managerial committee, the shareholders and the general assembly of the institution.
- Transparency, clarity, information disclosure and the promotion of products and services.
- Standardization of products and accounting information.

In overcoming the above hurdles and other issues, the practical steps taken by the created groups and the various official entities involved in the process of providing level playing field for IF and derived from the whole exercise can be arranged as follows¹⁵:

Figure-5: Practical Steps derived from the UK Experiment in Regulating IF activities



It can be noticed from the above encounter that the process has been lengthy and thorough in order to avoid the reach of unintended results or outcome. As a result, the UK authorities started the process of introducing legislation in the Finance Act of 2003 where the removal of the double SDLT on “*Islamic mortgage*” through the *Murābahah* and *Ijārah* modes of finance first took place. And in subsequent years, some more legislation was introduced as summarized on the table below:

¹⁴ In this process the bank pays the price in full on spot and adds to it a margin (mark up) and the customer pays the due amount in deferred instalments during the agreed upon period. So it is clear that there is a double sale that requires the double charge of SDLT if tax changes have not taken place.

¹⁵ For a typical example of these steps through the legislation of *Şukūk*, see Belouafi, (2011).

Table-2: Examples of Some of the Introduced Changes from 2003 to 2010

Date	Introduced Changes
2003	Removal of the double charge of Stamp duty Land Tax (SDLT) for <i>Murābahah</i> & <i>Ijārah</i> contracts that allows individuals to purchase homes. Other measures were introduced as well, to offer Islamic products for Child Trust Fund, asset finance and ISAs.
2005	Extension of the removal to <i>diminishing Mushārah</i> (another mode of alternative finance).
2006	Extension of removal to beneficiaries (i.e. companies) and the introduction of <i>Wakālah</i> (profit share agency).
2007	Discussion of applying the same tax rules of conventional debt instruments like bonds to <i>Ṣukūk</i> (Islamic Bonds).
2008	Dealing with more issues relating to the issuance of <i>Ṣukūk</i> .
2009	Legislation measures for SDLT, Capital Gains Tax (CGT), and capital allowance rules for land transactions involved in the structuring of <i>Ṣukūk</i> instruments
2010	The Financial Services and Markets Act 2000 Order 2010 exempts alternative finance investment bonds (AFIBs), a class of debt-like security which includes <i>Ṣukūk</i> , from collective investment scheme (CIS) regulations

Source: www.hm-treasury.gov.uk, www.fsa.gov.uk, and www.londonstockexchange.com

On the other hand, in granting the license to the Islamic Bank of Britain (IBB) in 2004, the UK authorities, in collaboration with the IBB responsible came to the following solution with regard to the issue of ‘deposit’; ‘legally, depositors are entitled to full repayment to fulfill the FSA requirements; however, customers have the right to turn down deposit protection and choose instead to be repaid under the Sharī‘ah-compliant risk sharing and profit bearing formula’ (Ainley *et. al.*, 2007:14). And with regard to the issue of Sharī‘ah compliance, the policy adopted was that there will be no central Sharī‘ah board at the FSA or at the Bank of England, as applied in other jurisdictions, like Malaysia. This is because the FSA is a secular regulatory entity, and interfering in this area may string up financial innovation in this newly emerging and promising industry (Ainley *et. al.*, 2007:14). So, in the end, it was left to individual institutions to choose the appropriate method of ensuring the “Islamicity” of their operations. However, the FSA stresses upon the fact that the information given on this respect must not be misleading.

Despite the positive steps and initiatives taken by the British regulatory authorities, there are still deep issues that are of much concern to the customers of IF in the UK. Among these:

- Are Sharī‘ah compliant products and services really “Islamic,” given the fact that more emphasis has been given to compliance with conventional legislation rather than with Islamic finance principles¹⁶? In this respect one might mention the way the issue of deposits has been dealt with. Does customer choice have any legal enforcement if the customer chooses the “Islamic” way when a dispute arises between him/her and the bank?
- Does the current approach favour some types of IF products over others? Or is it a matter of convenience and/or an industry request¹⁷? In this regard, the legislation of *Şukūk* provides a typical example of such an issue. In the summary of responses of the consultation paper in relation to the legislation of *Şukūk*, the government stated that ‘the proposed regulatory framework is not intended to cover all types of *Şukūk* (some of which are more akin to equity or equity-indexed instruments [i.e. Asset-backed *Şukūk*]) (HM Treasury & FSA, 2009:5). So ‘the legislation intended to cover *Şukūk* that are structured to have similar economic characteristics to conventional debt instruments [i.e. Asset-based *Şukūk*]. And it seems that the issue is not limited *Şukūk*, it rather represents a general policy for the taxation of IF instruments in European countries. In reviewing the taxation of Islamic finance in major Western countries, UK in particular, Amin (2007) concluded that “*the new tax treatment only applies to a commercial return which equates, in substance, to the return on an investment of money at interest*”. Amin goes further to say that the tax treatment of IF “*is designed to mirror the tax treatment of conventional finance, it is limited to transactions which are providing finance economically equivalent to debt, and it does not apply to something which is economically in the nature of an equity participation*”.
- How can one make sure that the information given to a customer is not misleading? Is it enough to have just the signature or the stamp of the

¹⁶ In this respect, one can understand the argument of the FSA, as a secular regulator that has nothing to do with the certification of religious verdicts, but regulators, as noted Wilson (2003) should make sure that proper procedures are in place for ensuring Sharī‘ah compliance (Wilson, 2003:1). We think this matter could be dealt with within the general framework of corporate governance issues that the regulators require from the firms that are granted licenses to carry out financial services transactions in their jurisdictions.

¹⁷ In justifying the rationale of the policy adopted for the legislation of asset-based *Şukūk* rather than asset backed ones, the government indicated that the majority of issued *Şukūk* are of this nature and it was the industry that has asked them to focus on this type of *Şukūk* (HM Treasury and FSA, 2009:5).

“extensively” used scholars, to ensure the “Islamicity”,¹⁸? Or again, is it enough to provide general and brief information about the products, when in fact very lengthy and complicated contracts are provided at the moment of signing the deal?

The above issues are but some examples of the concerns raised by customers most of whom are still reluctant to use these products. We are aware that some of the issues raised, especially the latter ones, may apply to conventional products as well, but there is a big difference between the two cases. Conventional practices and contracts are well established and understood, and the laws that regulate the disputes are clear, and the legal expertise is widely available. On the other hand, it must also be stressed that what the UK government has done towards IF, many Muslim and Arab countries have failed to do; so, in that situation the reservation we have made must be read within this context and the context of the scientific enquiry that requires a balanced and rigorous examination that puts every opinion and analysis in its perspective.

4. 2. The Experiment of France

Despite the fact that France is home to the largest Muslim minority in the EU countries, and the fact that French banks have played an important role, since mid 1980's in offering Shari'ah compliant products in the Gulf region and elsewhere, France becomes only recently active in the area of IF. At the end of 2008, French authorities took a pro-active attitude in promoting Paris as a European hub for IF. France's goals in this respect are twofold (Arnaud, 2010:171); attracting global funds to French soil and making France more competitive in the area of IF. In order to achieve that, the authorities have looked into how legislative amendments can be made to attain these goals. The process went through various stages, and at the end, the authorities concluded that (Arnaud, 2010:173):

“IF should not need any exceptional consideration under the French law; the only point is that the structure of the products be examined on a case-by-case basis... institutions and customers using Islamic financing schemes are protected by the same level of strength and legal soundness using conventional schemes ... [as a result] specific issues that arise could be dealt with in the existing framework”.

The table below gives a summary of the most important eventualities that have taken place from 2009 up till now:

¹⁸ This issue “raises concerns over the ability of Shari'ah scholar boards to provide enough rigorous challenge and oversight of firms' products and services” (Arnaud, 2010:171).

Table-3: Measures Taken by the French authorities to accommodate IF Products and Operations

Date	Event
February 3, 2009	The Islamic Finance Committee of Paris Europlace states in its 2009 work program the need to adapt the French trust system to allow the issuance of <i>Şukūk</i> in French law
February 25, 2009	French tax planning framework for <i>Şukūk</i> and <i>Murābahah</i>
March 18, 2009	The Senator Philippe Marini proposes an amendment to the civil law and the trust system (régime de fiducie) to develop the French financial system and facilitate the issuance of <i>Şukūk</i> . The Senate adopted the law
September 9, 2009	Member of parliament Chantal Brunel proposes a disposition in favor of Islamic finance as part of a bill facilitating SME financing
September 17, 2009	The parliament adopted the bill after a heated debate
September 18, 2009	60 parliamentarians of the opposition filed a censure motion to the Constitutional Council
October 14, 2009	the Constitutional Council censure Article 16 concerning Islamic Finance
August 24, 2010	Publication of tax instructions on the <i>Şukūk</i> , <i>Murābahah</i> , <i>Ijārah</i> and <i>Istişnā'</i> by the General Directorate of Treasury and Economic Policy (DGTPE)

After the failure of the French government in passing laws for IF through the Parliament, it seems that the French approach has turned to the route of tax instructions for accommodating various IF products.

4. 3. The Experiment of Luxemburg

As mentioned in Section I, Luxemburg has engaged in IF since the beginning of the eighties of the last century; however, its legislative initiative took off only over the last three years. In April 2008, the Ministry of Finance formed a task force to identify obstacles to the development of IF and to pave the way for its growth (Luxemburg for Finance, 2010:1). In 2009, the government asked tax authorities to examine the characteristics of IF products and to come up with solutions that provide level playing field with conventional counterparts. In early 2010, the Ministry of Finance produced a comprehensive document detailing the regulatory and tax treatment of IF transactions and operations in Luxemburg (Luxemburg for Finance, 2010). In that document more emphasis was given to investment funds, private equity, capital venture, real estate investments, and wealth management. However, the documents also dealt with tax treatment relating to the well known modes of finance, such as *Murābahah* and *Şukūk*, as a continuation process of an early circular issued to the tax authority on this regard (Administration des contributions directes, 2010:3-5). The main guiding principle in these procedures was to treat revenues of IF products as if they 'were interest' (Administration des

contributions directes, 2010:3-5). Once again it can be noticed that this approach is akin to that of the UK (HM Treasury, 2008:16).

4. 4. The Experiments of Other Countries

In other European countries not much work has been done except the awareness programs in the form of seminars or colloquies organized by some regulatory authorities, like the *Banca d'Italia*¹⁹ Italy Central bank, in order to give authorities the opportunity to understand the reality of IF and its regulatory and supervisory implications for the hosting countries. Up to date, there are varying views with regard to the presence of IF in these domiciles. One of these views, like the one held by the Italian regulators (Donato *et. al.*, 2010:197), is letting the market forces decide when IF may enter their domicile; the other is rather skeptical and doubtful about the presence of IF in a European country. This latter view is held by BaFin²⁰, the German single financial regulator.

5. CONCLUSION

The above analysis, with regard to the issue of accommodating IF in European conventional systems, reveals that there is a spectrum of views ranging from the more advanced and welcoming to the skeptical and doubtful. The UK is an example of the former, and Germany is an example of the latter. In between the two opposing views, some other countries are adopting the 'wait and see' policy to let market forces impact the direction of the swing. Furthermore, the European experiment showed that the main work has concentrated on the tax treatment through the economic substance of IF transactions, rather than on their legal form structure, to provide 'level playing field' for IF industry. Hence, the process seems to prefer the avoidance, as much as possible, of indulging in the legal process which is not only cumbersome, but probably also very difficult and time consuming to pass through legislative bodies. The French have tried that route, but they were not able to overcome the very sophisticated and sensitive hurdles that path was fraught with. The analysis also reveals that the handling of matters arising from the regulation of IF in Europe has been highly affected by the approach taken by the UK authorities. Over all, there are good lessons and important practical steps to be learnt from the European approaches in regulating the activities of Islamic finance in conventional systems, especially in the more advanced financial centers. However, it must be stressed that the current positions and trends are not established enough to allow us to derive concrete and somehow well confirmed

¹⁹ On November 2009 the Bank of Italy organized an awareness seminar about Islamic Finance and its relevance to Europe in general, and Italy in particular. Official delegates from the Central Banks of Italy and Malaysia, as well as academics from the UK and Italy, attended the seminar.

²⁰ For details about the BaFin reservations about the presence of IF in Germany, see (Engles, 2010:179-180).

policies. It is left, therefore, to other jurisdictions to look into these experiments, taking into consideration the infancy development of many aspects of IF industry at the European level and elsewhere. In this sense, the standards developed by the IFSB and other infrastructural bodies might ease the process of new-comers in the race of opening the gates for IF to operate in conventional systems.

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CONTEMPORARY ISLAMIC FINANCING MODES BETWEEN CONTRACT TECHNICALITIES AND SHARĪ‘AH OBJECTIVES

ABDULAZEEM ABOZAIID *

ABSTRACT

Some contemporary Islamic banking and finance practices have raised legal controversies that arguably eliminate any substantial differences between them and their conventional counterparts. These practices seek their legitimacy from adherence to merely contractual requirements in terms of form and structure, far from considering and looking into the contractual substance and content. These controversial practices of Islamic banks are thought to pose a threat to this emerging industry, and they have somehow led to the distortion of the religion in the eyes of the discerning public and the non-Muslims. This paper examines, through a maqāṣidi approach, the most controversial financing modes adopted by different Islamic financial institutions, and discusses the various justifications provided to support their legitimacy. The paper also outlines the prospectus of what constitutes a genuine Shari‘ah compatible product.

1. INTRODUCTION

Islamic banks and financial institutions have developed several financing instruments for the purpose of fulfilling the increasingly demanding market needs. Such sophisticated market needs were not perceived by the earlier generations of Muslim jurists and therefore, those jurists did not feel the need to further develop the already established financing instruments.

However, for developing and structuring the modern modes of finance, contemporary Islamic financial institutions have basically relied on the conventional financial institutions, which fall back on decades of experience in providing financial services. In other words, modern financing modes in the Islamic financial institutions were modelled after their conventional counterparts as

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Islamic financial institutions wanted to emulate, with some modifications, the conventional institutions in providing the best financial services.

In this respect, Shari'ah, in principle, never objects to benefiting from others' experiences; rather, Islam is a religion that encourages and instructs its followers to exchange experiences with, and obtain knowledge from Muslims and non-Muslims alike. However, the problem arises when we know that interest or *ribā*, which is one of the gravest crimes a Muslim may ever commit, constitutes the core of almost every conventional financing instrument.

This is one important thing to bear in mind before embarking on our discussion in this paper. Another important thing is the well-known fact that any contract can be used to obtain good ends and bad ends. A contract thus is like a tool that one can use for different purposes, lawful or unlawful ones. A knife, for example, can be used in the kitchen and can be used to murder someone. A glass is another example as it can be used to drink water, or to drink wine with. Similarly, a contract like marriage contract can be resorted to by a couple not to realise its many original objectives but to only obtain the sexual pleasure for maybe one hour or two, then to immediately effect divorce. So used, it becomes a legal trick to avoid *zinā* (adultery). Thus, any contract, including a sale contract, can be used not to realise what it has been originally designed for, but to obtain some unlawful ends on grounds of its legitimate form and structure.

These two facts, namely the modern Islamic financing instruments being modelled after the conventional financing products though the later involves *ribā*, and the possible abuse of any contract, must not escape the attention of any researcher or scholar trying to examine and determine the legitimacy of the contemporary financing contracts as implemented in the Islamic financial institutions.

For the sake of brevity, our discussion in this paper will be limited to only examining the controversial financing instruments as practiced in some Islamic banks and financial institutions. As for financing instruments whose legitimacy is in principle free from doubt, they are excluded from this study, since there is no conflict between their technicalities and Shari'ah objectives.

However, it is worth noting before we start our discussion that Islamic banks and financial institutions vary in terms of their adoption of the controversial financial instruments. This can be attributed to factors like: how committed and learned the Shari'ah board members are; the policy of the institution and the extent of its adherence to Shari'ah; the level of awareness of the public where the Islamic bank operates and their ability to evaluate Shari'ah related matters.

2. SHARĪ'AH PRINCIPLES FOR DETERMINING THE VALIDITY AND PERMISSIBILITY OF CONTRACTS

The aim of the following discussion is to elucidate the juristic approaches towards determining whether a contract is valid and permissible from Shari'ah perspective.

2.1 Juristic Methodology in Validating Contracts

When jurists were in the process of deriving from Shari'ah texts the criterion that determines contracts validity, they could identify two categories of texts. The first category implies the need to adopt intention of contractors as one of the bases for validating their contracts, such as the well known *ḥadīth* “matters are determined by intention” (إنما الأعمال بالنيات)¹. This *ḥadīth* implies that intention, i.e. the purpose or substance of the contract, is very basic to accept a contract and rule it as valid; therefore, contract's form or structure alone is not sufficient for ruling it as valid.

The second category of Shari'ah texts suggests the opposite; judging all things including contracts must be based on their form and structure alone, apart from contractors' intention and objectives.² Among these texts is the *ḥadīth* in which the prophet P.B.U.H. says: “I am a human, so I give judgments based on what I hear; however, if I happen to make a wrong judgment, my judgment then would not legalise the prohibited...”³ Based on this text, judging things, including contracts, must be on the basis of apparent evidences. This suggests giving no attention or consideration to intentions and purposes.

Finding such apparently-conflicting evidences, jurists justifiably adopted two different approaches to validating contracts:

The first approach, which is adopted by the Hanafi and Shafi'i schools of fiqh (Islamic law), states that validity of contracts must be judged by means of their form and structure, giving no consideration to contractors' intentions and real purposes of a particular contract; even if the contract was accompanied by some clues that may suggest an evil intention of contractors. To this group of jurists, any contract whose structure and form comply with Shari'ah must be judged as valid, unless an unlawful objective is stated in the contract or declared by contractors.

¹ - This *ḥadīth* was narrated by Omar bin Al-khattab (ra). See *Sahih al-Bokhari*, 1/3, *ḥadīth* No (1); *Sahih Muslim*, 3/1515, *ḥadīth* No (1907).

² - For more details on this matter see *Contemporary Eina; is it a Sale or Usurious Transaction* by Abdulazeem Abozaid, p 47.

³ - This *Hadith* was narrated by Umm Salama (ra). See *Sahih al-Bokhari*, 2/867, *ḥadīth* No (2326); *Sahih Muslim*, 3/1337, *ḥadīth* No (1713).

However, this group of jurists does not neglect or overlook the first category of *ḥadīth* as we will explain soon.

Unlike the first approach, the second approach gives weight and consideration to the contractors' intention or purpose of a specific contract. If the intention has not been made clear in the contract, it can be ascertained from any clues or surrounding circumstances that may harbour the contract initiation. If the clues suggest an evil or unlawful intention, the contract will then be deemed as null and void. Among the clues accepted in this regard is the customary unlawful objective of people from a specific type of contract. To them, this kind of customary objective is powerful enough to invalidate the contract regardless of the real intention of the contractors in a particular contract. This approach was adopted by Maliki and Hanbali schools of *fiqh*⁴

After demonstrating an exposition of the two juristic approaches in respect of validating contracts, it can be said that practicality and appropriateness tend to be in favour of the one that validates contracts on the basis of their form and structures alone, as it is obviously impractical, if not impossible, to ascertain the contractors' intentions in a particular contract. It is true that clues and customary practices may help assess the contractors' intention; however, there is still an avenue for making a wrong assessment of the contractors' intention. Hence, people's contracts may be invalidated due to a wrong assessment, which is an evil in itself.

2.2 *Al-Hukum Al-Diani and Al-Hukum Al-Qada'i*

In order to reconcile the conflicting texts pertaining to this issue, proponents of the approach that validates contracts on the basis of only their form and structure have distinguished between *Hukum Diani* and *Hukum Qada'i* in contracts. The former represents the validity of the act between God and Man, which is realised upon Man having a lawful intention. The later represents the validity of the act between Man and Man; in other words, it is concerned with the worldly affairs. This validity is realised upon having a sound and defect-free structure. They opined: let us judge people's conducts on the basis of their structure (*Hukum Qada'i*) and leave the issue of intentions and objectives (*Hukum Diani*) to the All-Knowing, Allah S.W.T. so as to avoid the evil of possibly making wrong judgments. However, this does not mean that the evil intention of contractors will go unpunished, simply because unlike man-made laws, Shari'ah is a religion so that if one could escape a worldly punishment, and one did not repent or was not

⁴- Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 5/48; Al-Dasuqi, *Hashiyah* 3/76; Qurafi, *Al-Furuq*, 3/268; Mohammad Ali, *Tahzeeb al-Furuq*, 3/275; Ibn Juzai. *Al-Qawanin Al-Fiqhiyyah*, p140; Al-Shafi'i, *Al-Um*, 4/114; Ibn al-Qaiyyem, *I'lam al-Muaqi'een*, 3/109-121; Al-Ghazali, *Al-Mustasfah*, 2/36.

forgiven, definitely one will not escape the punishment in the second life.⁵ Therefore, a valid act from the perspective of *Hukum Qada'i* is in not necessarily valid from the perspective of a *Hukum Diani*.

To summarise, Hanafis and Shafi'is, just like the other schools of *fiqh* (Islamic Jurisprudence), believed that validity of all matters, be them devotions or transactions, must be originally determined by intention as the *ḥadīth* clearly suggested. However, they found it impractical to determine the validity of transactions by means of intention; in addition, they came across other texts that suggested that validating worldly actions must be determined by their form only. Therefore, they said: we limit the functionality of intention to the *hukum diani* and judge things on the basis of their structure and form.⁶

2.3 Judging a contract as valid does not necessitate its permissibility

The earlier discussion on determining contracts validity on the basis of their form and structure alone, or on the basis of also contractors' intentions and purposes does not in any case cover the issue of determining contracts permissibility. Rather, according to all schools of *fiqh*, the well established *ḥadīth* of role of Intention constitutes the basis for determining contracts permissibility. Should it have been identifiable and its assessment not possibly resulting in error, intention would have been relied on in determining contracts validity too, as it is the case with devotional acts for intention is essential for even the very existence of the devotional acts. For example, in fasting if a person refrains from eating and drinking from dawn until sunset without observing the intention of the legal fasting, he will not be performing the legal fasting.

Therefore, it is a flaw to take a valid contact as necessarily permissible, or to attribute such a stand to those jurists who validate contracts on the basis of their structure like Hanafis and Shafi'is. Rather, the basis of contract permissibility is always and unanimously its purpose and objective.

⁵- Imam Shafi'i says: "We should judge things on the basis of their form, and Allah S.W.T. takes care of the unseen (purposes and intentions). One who judges peoples' conducts according to his own assessment of their intentions, he will have legalized for himself what Allah and Muhammad P.B.U.H. have prohibited, for it is only Allah S.W.T. who knows the peoples' real intentions (the unseen), and He will punish or reward them accordingly. Allah has commanded people to rely on form in judging each other's conducts. If there existed a person with authority to judge people's conducts on the basis of his own assessments of their intentions based on certain clues, then he would solely be the prophet P.B.U.H.". See Al-Shafi'i, *Al-Um*, 4/114.

⁶- Al-Ghazali, *Al-Mustasfah*, 2/36; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 5/48; Al-Dasuqi, *Hashiyah* 3/76; Qurafi, *Al-Furuq*, 3/268; Mohammad Ali, *Tahzeeb al-Furuq*, 3/275; Ibn Juzai. *Al-Qawanin Al-Fiqhiyyah*, p140; Al-Shafi'i, *Al-Um*, 4/114; Ibn al-Qaiyyem, *I'lam al-Muaqi'een*, 3/109-121.

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Al-Ghazali, another great Shafi'i scholar, also made it clear that ruling something as valid is a different issue altogether from ruling it as permissible. ⁸

To summarize, to all jurist, contracts' permissibility is established on contractors' intention and objective; if it is to obtain an unlawful end, the contract is then *ḥarām*. If, on the other hand, the intention is to obtain a lawful end, the contract is then lawful.

Examples:

Among the relevant applications of the distinction between a valid contract and a permissible contract is *bay' al-eina* (buy-back sale), which is a sale that may be resorted to for the purpose of circumventing the prohibition of *ribā* by selling a commodity on credit then instantly buying it back at a lesser price for cash. ⁹ This sale was naturally ruled as valid by Shafi'is, and also by Hanafis in certain cases. However, based on the former discussion, ruling this transaction of *bay' al-eina* as valid does not necessarily imply that it is permissible according to Shafi'is and Hanafis; rather, its permissibility is all based on the contractors' objective of this transaction; if it is to obtain cash with a hidden payment of interest by means of a sale contract, then it is *ḥarām* (prohibited). If, on the other hand, the objective is to genuinely acquire the commodity sold in both sale contracts so that the occurrence of the two consecutive sale contracts was not planned for from the beginning, then, it is lawful. In fact, this analysis is nothing but a practical implementation of the *ḥādīth* narrated by Omar bin al-Khattab "Matters are determined by intention".

Another application is a marriage contract; if the couple's intention is to have a permanent marriage relationship with all its implications, then this is a permissible marriage contract, while if their objective is merely to legalise having sex for sometime then to execute divorce afterwards, then it is an impermissible marriage

⁷ - Al-Shafi'i, *Al-Um*, 4/114.

⁸ - Al-Ghazali, *Al-Mustasfah*, 2/36.

⁹ - See details of *bay' al-Eina* on page (13) of this paper.

contract, and it may be tantamount to *zinā* (adultery) though it may take a perfect structure and thus, be ruled as a valid contract due to observing all marriage contract requirements.¹⁰

2.4 Good intention is not sufficient to legalise a contract

A financier via *eina* may not claim having a good intention to legalise his transaction, like intending helping those who need cash, not obtaining *ribā*. Similarly, a person selling grapes to a wine maker may not claim a neutral intention, i.e. normal trade, to legalise his transaction. According to jurists, if the contract results in evil, like committing *ribā*, then this contract is unlawful regardless of any intention that might be claimed to be observed therein.¹¹

Result

The foregoing discussion has somehow indicated that in order for the financial products to be deemed Shari'ah compliant, they must be both valid and permissible. In other words, their form and substance must comply with Shari'ah. This result raises the question whether the current Islamic banking and finance products are indeed following the same principle.

Below some examples of various forms of controversial Islamic banking products are examined to illustrate the problem of failure in distinguishing between a valid contract and a permissible one, as well as the problem of the misapplication of *maqāṣid al-sharī'ah* (al-sharī'ah objectives) in legitimising contracts that substantially go against the very spirit and essence of *maqāṣid al-sharī'ah*.

3. EXAMINING SOME CONTEMPORARY MODES OF FINANCE IN ISLAMIC FINANCIAL INSTITUTIONS

Some Islamic financial institutions have practiced some financing modes that meet all contractual requirements but breach shari'ah objectives. The following are the justifications provided in support of their adoption:

- Realisation of *maqāṣid al-sharī'ah*, which are basically structured on the basis of *maṣlaha* (public interest).

¹⁰- Al-Shafi'i, *Al-Um*, 3/78; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 4/279; Al-Kasani, *Badai' Al-Sanai'* 5/198-199; Ibn Al-Humam, *Fatih Al-Qadeer* 6/71.

¹¹- Al-Kasani, *Badai' Al-Sanai'* 5/198-199; Al-Shafi'i, *Al-Um*, 3/78; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 4/279; Ibn Al-Humam, *Fatih Al-Qadeer* 6/71.

- Being in a state of *ḍarura* (necessity), and *ḍarura* may render prohibited things permissible.
- The flexible stand attributed to some schools of *fiqh* towards transactions such as *bay' al-eina* and *tawarruq*, which constitutes the basis of some contemporary modes of finance¹²

Before we subject these justifications to scrutiny, we examine some financing modes as adopted by different Islamic financial institutions. However, the last justification above has already been discussed, and we reached the conclusion that although some jurists validated *bay' al-eina* and its likes, this validity never entails the permissibility of these transactions.

3.1 *Eina*-based Financing (Back-to-Back Sale)

Bay' al-eina as indicated earlier connotes a sale contract whereby a person sells an article on credit and then instantly buys it back at a lesser price for cash. Example: "A" asks a loan of \$10 from B. B, instead of asking for interest on this loan applies a contrivance. He sells an article to "A" for \$12 on credit and then buys it back from him for \$10 cash. So, "A" departs having \$10 in hand but indebted to B for \$12.

Such mechanism suggests that the article itself is not meant for purchase; rather, it is used only as a tool to provide cash. To illustrate, it makes no difference to the one seeking finance to conclude the sale contract on a car, a house or anything else. Moreover, practically, such a transaction rarely involves actual possession of the item sold or official documentation of the contract.

Some examples of *eina* products

A. BBA Home Financing

BBA stands for *Bay' Bithaman Ājil*; an Arabic term which means "deferred payment sale". Technically, BBA refers to a sale contract practiced mainly in Malaysia whereby a person "A" who does not have enough cash to pay the full price of his house of choice will pay only around 10% of the full price. In return, "A" gets from the seller of the property a 'Beneficial Ownership', which is somehow a commitment on the part of the owner to conclude the sale upon payment of the balance (90%). After paying the 10% and obtaining the Beneficial Ownership, "A" sells the house as represented by the Beneficial Ownership to the Islamic bank for a cash price equivalent to the outstanding amount (90%) of the house price. So if the total price was RM (Malaysian Ringit) 100, 000, then the selling price between "A" and the Islamic bank would be RM 90,000. Afterwards,

¹²-See these justifications in *Resolutions of the Securities Commission Syariah Advisory Council, Malaysia*, p. 21-22..

the Islamic bank immediately sells the house, which is represented by the Beneficial Ownership, back to "A" in instalments at a mark up, say for RM 130,000 over a period of 5 years.

The RM 90,000 paid by the Islamic bank as the purchase price will be extended to the property developer in conclusion of the sale contract. "A", however, remains indebted to the Islamic bank for the RM 130,000; the price in the last sale contract.

Resemblance of BBA home financing to Mortgage

This mode of finance, apart from the technicalities followed therein, is hardly differentiated from the conventional mortgage used in home financing. The only difference an observer may find is the way cash is advanced from the bank to the client; in the conventional mortgage it is through conventional loan, while in BBA it is through *bay' al-eina*. Further examination of BBA contract particulars and terms of agreement will even enhance convergence of BBA with Mortgage.¹³

B. Islamic Overdraft Facility

Another application of *bay' al-eina* is 'Islamic' Overdraft (OD) Facility¹⁴. It operates on the concept of *bay' al-eina* though it is marketed using different names – *al-nakad*, *al-tamwil*. The purpose of this overdraft facility is to enable customers to draw cash up to a certain limit over their accounts. Conventionally it functions on the concept of interest-bearing loans. Since charging interest on loans is prohibited in Islam, some Islamic banks have resorted to *bay' al-eina* as a presumably lawful alternative. To explain the mechanism, the Islamic bank would execute two simultaneous back-to-back sales with different prices; one on cash basis, the other on deferred payment terms. The objective of these two sale contracts is to create out of the difference between the two prices a debt liability on the part of the customer so as to deduct from which charges imposed upon utilizing the overdraft facility. Bank charges depend on the amount and frequency of draws.

So, the question that imposes itself after exposing these two application of *eina* is whether there exist a genuine difference between *eina*-based financing and conventional loans, that is capable of rendering the former a Shari'ah compliant basis for financing.

Shari'ah appraisal of *bay' al-eina*

As discussed earlier, while some schools of *fiqh* determine contracts validity on grounds of their form and structure, all schools of *fiqh* determine contracts

¹³ - See for mortgage mechanism: Abozaid Abdulazeem. *Fiqh Al-Ribā*, p.576.

¹⁴ - A product offered in some Islamic banks in Malaysia.

permissibility on grounds of their objectives and substance.¹⁵ Examining *bay' al-eina* as implemented in some Islamic banks leads to the fact that its purpose is obviously to provide clients with cash yet in a securely profitable manner to the bank. Therefore, as far as the substance of *eina* is concerned, this transaction is nothing but a camouflaged interest-based loan.

Has *eina* been a real sale contract, it would not be free from risks that are normally associated with sale contracts; besides, it would then entail a real interest of the client in the commodity of sale. However, in *eina*, the underlying asset subject to the dual sale is inconsequential and typically not related to purpose of financing, and it may originate from the customer or the bank.

Moreover, the sequence of contracts in *eina* is not accidental; rather, it is something predetermined in order to reach the end set in advance, i.e. to legalize charging clients upon providing them with cash.

Logically, it makes no sense for the sharī'ah to prohibit *ribā* then to accept from its followers to circumvent such prohibition by some technique like *eina*. Definitely sharī'ah would then have contradicted itself and acted against its very principles and objectives, let alone against logic and sound reason. Thus, sharī'ah would fail then to convince its followers, before outsiders, of its rationality and validity which have always been some of its cornerstones in proving and defending its authenticity.

3.2 *Tawarruq*-based financing

The meaning of *tawarruq* is to purchase a commodity from one party on credit then sell it immediately to another for cash. Thus, *tawarruq* shares the same objective of *eina* as both are meant for extending cash money. However, *tawarruq* remains technically distinguished from *eina* as in the later the commodity is resold to its original seller, while in *tawarruq* it is sold to a third party.

Tawarruq in Islamic banks

The mechanism of *tawarruq* which is practiced in some Islamic financial institutions is a slightly modified version of the original form of the *tawarruq* described above.¹⁶ In this institutional *tawarruq* the bank purchases some commodity from the market, like metal from London Metal Exchange (LME), and then sells it to the customer on *Murābahah* basis for deferred payment. Subsequently, the bank, as the customer's agent, sells the metal on LME for

¹⁵ -Al-Shafī'i. *Al-Um*, 3/78; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 4/279; Al-Kasani. *Badai' Al-Sanai'* 5/198-199; Ibn Al-Humam, *Fatih Al-Qadeer* 6/71; Al-Bahuti. *Kashaf Al-Qina'*, 3/186; Ibn Qudamah. *Al-Mughni*, 4/278-279.

¹⁶ -This transaction is mostly practiced in some Islamic banks of Arab Gulf countries.

immediate cash. In result, the bank gains *Murābahah* profit and agency fees, the customer obtains immediate cash and remains committed to repay the outstanding debt that he has incurred when acquiring the commodity from the bank on *Murābahah* basis.¹⁷

Shari'ah appraisal of *Tawarruq*

A very limited number of early jurists ruled that *tawarruq* was allowed; however, the *tawarruq* that was practiced and received somehow some jurists' acceptance is different from the modern contrived *tawarruq* from different aspects.¹⁸

First, the former *tawarruq* was in most cases free from deliberate contrivance and complicity. Its modus operandi was as follows: 'A' individual purchases a commodity from B on credit. After purchasing and taking possession of the commodity from B, A sells it in the market to a third party without B's assistance or mediation. Although the purchase of the commodity was for the mere objective of selling it in the market at lower price, this transaction had received some jurists' acceptance (Hanbali)¹⁹ due to the absence of contrivance and complicity between contractors. However, even if there was an element of contrivance between parties, then the transaction would be deemed **valid** by Hanafis and Shafi'i' with all differences, of course, between valid and permissible as explained earlier.²⁰

Second, the views in *fiqh* literature on *tawarruq*, even if contrived, are all related to individual practices and cases, and they were deemed irregular and dissenting from the mainstream juristic view on *tawarruq*.

Third, similar practices to *tawarruq* were sometimes criminalized in the Islamic state, and were subject to constant interference and patrol by Shari'ah authorities,

¹⁷ - See for example mechanism of *Tawarruq* in Abu Dhabi Islamic Bank.

¹⁸ - To all jurists, purchase of a commodity then selling it without an intention of sale at the time of purchase is not a form of *Tawarruq*. The mechanism is as follows: An individual owns a particular commodity which he has bought for its own sake against spot, deferred payment or other means. After sometime he wants to have cash so he sells it in the market for immediate cash. If he has acquired it on credit, he remains committed to repay the outstanding debt that has been incurred during acquiring the commodity. This kind of transaction raises no Shari'ah objection.

¹⁹ - Al-Bahuti. *Kashaf Al-Qina'*, 3/186; Ibn Qudamah. *Al-Mughni*, 4/278-279; Ibn al-Qaiyyem. *Tahzeeb Al-Sunan*, p. 9/253-254.

²⁰ - Ibn Abideen. *Hashiyat* 4/279; Al-Dasuqi, *Hashiyah* 3/78; Qurafi, *Al-Furuq*, 3/275; Mohammad Ali, *Tahzeeb al-Furuq*, 3/275; Al-Shafi'i, *Al-Um*, 3/78; Al-Kasani. *Badai' Al-Sanai'* 5/198-199; Ibn Al-Humam, *Fatih Al-Qadeer* 6/71.

while *tawarruq* is introduced nowadays as a well-established Islamic banking product and as an integral part of the Islamic financial system.²¹

In conclusion, including the *tawarruq* practiced nowadays by some Islamic financial institution under the *tawarruq* approved by some early jurists is incorrect especially that it involves known intensions and complicity.

As a matter of fact, in both *eina* and *tawarruq* the bank acts as a financier who makes a secured profit from the clients he finances, and not as a real trader who takes market risks, though taking market risk is, as commonly known, the line between sale and *ribā*, profit and interest. Moreover, in both transactions, *eina* and *tawarruq*, bank knows that the client has no interest in the commodity but to resell it immediately; either to the bank as in *eina*, or to third party but through Bank's mediation as in *tawarruq*. These facts about *eina* and *tawarruq* eliminate real differences between the two; and more generally, they eliminate differences between both of them on one side and an interest-bearing loan on the other, reducing differences to only technicalities followed in the execution of the two. Had *eina* or *tawarruq* not been *ḥarām*, it would then be easily and comfortably resorted to by people to circumvent the prohibition of *ribā*; anyone wishing to legitimately provide interest-loaded loans would simply effect *eina* or *tawarruq* with people seeking finance, so *ribā* would be 'lawfully' practiced. Therefore, claiming the permissibility of such transactions contradicts the *\sharī'ah* objective meant from the prohibition of *ribā*.

Furthermore, the absence of substantial differences between *eina/tawarruq* based financing in Islamic banks on one hand, and conventional loans on the other, annuls the justification for burdening clients seeking finance from Islamic banks with extra costs due to extra procedures. For clients of some Islamic banks accept willingly bearing extra cost for cash financing in return for obtaining *\sharī'ah* compliant products, but ultimately they end up paying the cost of the technicalities followed by some Islamic banks to claim legitimacy of their products.

3.3 *Al-Rahn* Islamic Pawn Broking²²

Al-Rahn (collateral) contract in the *\sharī'ah* is meant to be used as a debt security. However, in some Islamic banks it is used to generate profit thereof in a transaction called Islamic Pawn Broking. In this transaction, the Islamic bank provides its customer with so called benevolent loan on condition that the later provides *rahn*; e.g. a valuable jewel to be kept by the bank under its custody as collateral; however, the problem arises when the Islamic bank charges this customer for the so called safe-keeping of this jewel. Ironically, the fee charged

²¹- See for some examples Ibn Abedeen. *Hashiyat* 4/175

²²-Currently being offered by a number of Islamic financial institutions in Malaysia.

varies with the amount of the loan, and it is sometimes equivalent to the market interest rate.

Should the storage cost be reflective of actual storage costs incurred by the bank, it would be then determined by size, weight or some other physical dimension, instead of the amount of the loan. This is besides the many sharī'ah provisions that invalidate this transaction, such as the prohibition to combine between a loan contract and any commutative contract (contract that involve exchange of two counter values) in order to block the means to charging interest indirectly through the later, in addition to the sharī'ah provision that expenses of the keeping the collateral must be borne by the *muratahin* (mortgagee).

3.4 The Misguided Justifications

The proponents of the current controversial practices of Islamic banks and financial institutions argue that Islamic banks need to be treated with leniency especially at their infancy stage. This is needed in order to facilitate their growth and development, and to ensure their sustainability and viability amid the hegemony and prevalence of the conventional banks and the interest-based economic systems. Otherwise, Islamic banks would be doomed to fail, and their failure is a failure of the whole Islamic economic system, which would in turn affect the very project of establishing the modern Islamic state. This, to the proponents of such views, necessitates a more flexible and liberal approach when structuring Islamic banking products in order to meet the sharī'ah objectives.

Obviously, from this justification it can be implied that they have based their arguments on various sharī'ah concepts, the most important of which are sharī'ah objectives (*maqāṣid* al-sharī'ah), *maṣlaḥa* and *ḍarura*.

To further address this issue we need to examine these concepts in detail in order to have a better understanding on how the justifications of the contemporary controversial financial transactions can be refuted.

4. REALISATION OF MAQĀṢID AL-SHARĪ'AH & MAṢLAḤAH

Maqāṣid (the plural of *maqṣad*: objective) al-sharī'ah are the objectives, spirit and the rationale of the Sharī'ah. A comprehensive and careful examination of the Sharī'ah rulings entails an understanding that sharī'ah aims at protecting and preserving public interests (*maṣlaḥah*) in all aspects and segments of life.²³

So, sharī'ah laws in general are designed to protect these benefits, and to facilitate improvement and perfection of human lives' conditions on earth. This

²³ - Ibn al-Subki, *Al-Ibhaj*, 3/52; Al-Shatibi, *Al-Muwafaqat*, 2/2.

fact suggests that we are required to maintain *maqāṣid* al-sharīʿah when implementing sharīʿah rulings, and to observe these *maqāṣid* when deducing rulings for the new arising matters.

Therefore, in the context of Islamic banking, if observing *maqāṣid* al-sharīʿah naturally entails observing the rationale and the spirit of the texts, then to observe only the form and the structure requirements of a transaction while structuring a financial banking product functions against the very concept of *maqāṣid* al-sharīʿah. Hence, for a proper realization of *maqāṣid* al-sharīʿah, Islamic banking and finance must ensure that all transactions comply with sharīʿah; not only in terms of legal technicalities and forms but more importantly in terms of the economic substance of these transactions which is premised on the objectives outline by sharīʿah.

Surprisingly enough, *maqāṣid* al-sharīʿah have been used as a justification for adoption of some *ribā* -disguised banking products though observing *maqāṣid* al-sharīʿah must be the first factor to determine their prohibition.

4.1 Macro *Maqāṣid* versus Micro *Maqāṣid*

One may think that by legalizing some controversial transactions such as *bayʿ al-eina* the macro *maqāṣid* are observed. What we mean by macro *maqāṣid* here is the interests or benefits related to the overall well-being and welfare of the economic system, which have always been the objectives of Islamic economics; whereas micro *maqāṣid* only relates to certain micro issues pertaining to certain individual financial transactions. Obviously macro *maqāṣid* are more important to observe than any micro *maqāṣid*. These macro *maqāṣid* manifest themselves in structuring an Islamic economy and pushing it forward to compete with and supersede the conventional banks at least in the Muslim countries. On the other hand, maintaining the prohibition of certain transactions helps in observing the particular *maqāṣid* of certain detailed rulings but possibly at the expense of the macro *maqāṣid* of sharīʿah in a particular age, or more specifically, the *maqāṣid* of the Islamic law of transactions, since the later aims at building a strong and just economic system.

To address this misconception, we need to highlight a very important issue which is the conflict between a perceived *maṣlaḥah* and sharīʿah texts. In brief, if there appears to be a conflict between a perceived *maṣlaḥah* and a sharīʿah text, then sharīʿah texts must always prevail over the perceived *maṣlaḥah*. This is particularly true for three reasons: Firstly, the very presumption of the occurrence of a conflict between a definitive sharīʿah text and a real *maṣlaḥah* is false, simply because all Sharīʿah texts aim at realisation of *maṣlaḥah* as admitted by proponents of *maṣlaḥah* prevalence. Secondly, even if such a conflict hypothetically exists, then it is the sharīʿah texts that must be given priority over the perceived *maṣlaḥah*.

This is because *maṣlaḥah* itself derives its authority from the sharī'ah texts and not vice versa. Moreover, jurists who stated *maṣlaḥah* as one of the authoritative sources of sharī'ah had qualified this *maṣlaḥah* by being *mursala* (silent on); i.e. there is no textual authority on its validity or otherwise. Therefore, *maṣlaḥah* does not operate if found to be in conflict with definite sharī'ah texts. Thirdly, human perception of *maṣlaḥah* is not necessarily true; human intellect is doomed to err and change its perceptions.

In other words, the determination of *maṣlaḥah* in terms of what is beneficial and what is harmful cannot be left to human reasoning alone. Instead, as Muslims we should put high recognition to what has been prescribed by the Lawgiver in sharī'ah text. This is because the inherent limitations of human beings posit a strong reason which requires divine guidance especially to ascertain what is right and what is wrong. In this regard, *Ibn Taymiyah* says: "What constitutes a *maṣlaḥah* or a *mafsada* (the opposite of *maṣlaḥah*) is subject to the sharī'ah standards".²⁴ *Al-Dahlawi* also says: "Our lawgiver is more trustworthy than our reasons".²⁵

If there was any kind of *maṣlaḥah* in *ribā* or its sale-based tricks, then the Lawgiver would not have considered *ribā* as the worst of evil and one of the gravest sins that invoke curse and declaration of war by the Almighty. The Qur'an says: "But God has permitted the sale and forbidden the *ribā*" (2:275) and, "God destroys/eliminates the *ribā*;" (2:276) and, "O ye who believe, fear God and quit what remains of the *ribā* if ye are indeed believers; but if ye do it not, take notice of war from God and His Messenger" (2:278-279). As a matter of fact, no other sin is prohibited in the Qur'an with a notice of war from God and His Messenger. Obviously, *maqāṣid* al-sharī'ah have been abused to justify certain financial contracts which in fact contradict the sharī'ah texts and principles.

4.2 Overruling the Prohibited Practices on the Grounds of *Darura*

There is a tendency in some Islamic banks today to justify implementing *aina* and its likes, as well as some other controversial practices, on grounds of *darura*. So, what is *darura* and is it a valid justification?

Darura means necessity. Unanimously *darura* renders the prohibited things permissible as this constitutes a well-established *fiqh* maxim in sharī'ah "Necessities permits the forbidden" (*Al-Darurat Tubih Al-Mahzurat*). However, when jurists discussed and explained the applications of this *fiqh* maxim, they mentioned what is known in Arabic as *ḍawābit*, which means conditions and guidelines, for the functionality of this maxim. These guidelines (*ḍawābit*) are of course stated in or derived from the sharī'ah texts. The first guideline (*ḍabit*) is:

²⁴- Ibn Taymiyah, *Al-Fatawah*, 8/129.

²⁵-Al-Dahlawi, *Hujattullah al-Balighah*, 1/13.

what constitutes a *ḍarura*. The juristic concept of *ḍarura* can be summarised by saying that *ḍarura* is something which is indispensable for the preservation and protection of the five essential values: faith, life, intellect, posterity and wealth.²⁶ This means that the concept of *ḍarura* would give the Muslim a legal excuse to commit the forbidden; if indispensable for his survival, spiritually and physically.²⁷

Applying the principle of *ḍarura* to the case in question would not in any way imply rendering the unanimously forbidden transactions to be permissible so as to apply them in Islamic banks. If it is presumed that such products are indispensable for the Islamic bank's survival and long-term sustainability due to certain considerations, then the argument is that the very concept of the bank itself is not indispensable for the Muslim's survival from the Sharī'ah perspective. If such *ḍarura* hypothetically exists, then it would rather legitimise dealing with conventional banks directly.

Obviously, when sharī'ah prohibits something it provides alternatives; when it prohibits *zinā* it permits marriage, when it prohibits wine and pork for consumption it permits all other sorts of food and drinks. Likewise, when sharī'ah prohibits certain contracts such as contracts based on *ribā*, it alternatively permits many other contracts like sale, lease, *salām*, *istiṣnā'*, *muḍārabah* and *mushārahah*. To economists, such contracts are the better alternatives to *ribā*, and ultimately can yield a prosperous and a healthy economy.²⁸ Conversely, an economy based on *ribā* leads to disparity and inequality of wealth distribution between rich and poor. If this is the case, then where is the *ḍarura* that may allow Muslim to abandon these beneficial contracts in favour of harmful and destructive ones? In fact, legalising a forbidden thing on the grounds of *ḍarura* is supposed to solve a problem not to create a bigger one. Surprisingly, Islamic banks have been in the business for more than three decades, and they still offer the same excuses of *ḍarura* and the impracticality or impossibility of adopting genuinely lawful business contracts, due to the existence of certain obstacles and deterrents. Do these obstacles and hindrances still exist after more than three decades of Islamic banking development? Are there any indications to suggest a possible change?

Moreover, it is a well-established ruling that when a person is given the excuse to commit the forbidden on the grounds of *ḍarura*, he can never deny the original ruling of its prohibition; i.e., he cannot claim the original permissibility of his commission of the forbidden. For example, if a person is excused to seek a *ribā*-

²⁶ - Al-Shatibi, *Al-Muwafaqat*, 2/10.

²⁷ - Majallat Al-Ahkam Al-'adliyyah, section 22; Ibn Nujaim, Zainulddin, *Al-Ashbah Wal Naza'ir*, 1/105-107; Al-Seyoti, Jalaulddin, (911 H). *Al-Ashbah Wal Naza'ir*, p.84-92; Al-Kurdi, Ahmad. *Al-Madkhal Al-Fiqhi*, p.48.

²⁸ - Abozaid Abdulazeem, *Al-Murabaha and its Modern Applications in the Islamic Banks*, p.71.

based loan due to the occurrence of an extreme urgency and the absence of any possible alternative source of finance, then under no circumstances can he deny the prohibition of *ribā* or regard it as permissible. Otherwise, such an act is tantamount to betrayal of God's ruling and *kufur* since *ribā* impermissibility is definitive. Therefore, even if the justification of *ḍarura* to implement a contract like *bay' al-eina* is valid, Islamic banks must then acknowledge the original ruling of the contract and not simply alter it then attribute it to shari'ah.

Very clearly, the proponents of *bay' al-eina* and its likes, in their endeavour to justify them, have fallen in contradiction when they claimed their original permissibility as discussed before, and at the same time used the principle of *ḍarura* to justify them, though using *ḍarura* conceptually entails their original prohibition.

5. IMPLICATIONS OF IMPLEMENTING *RIBĀ*-DISGUISED SALES ON ISLAMIC BANKING INDUSTRY AND SHARĪ'AH

In order for Islamic banking industry to survive and maintain its popularity, urgent and diligent efforts must be made towards restructuring many of its products. It is quite noticeable to observers that as time goes on Islamic banking is slowly making more concessions at the expense of shari'ah principles, thus bringing this industry closer to its conventional counterpart. It is feared that such concessions may eventually lead to people losing confidence in Islamic banking, though this confidence is its greatest asset giving it a competitive advantage against conventional banks. Once this confidence is lost, it is very hard to be restored. Islamic bankers as well as shari'ah boards should be far-sighted enough not to allow controversial practices to bring about the demise of this industry. If the current practices continue as such, sooner or later Muslim public will start losing confidence in the Islamic banks and their shari'ah boards. They will start to question the legitimacy of every single product Islamic banks are offering despite any endorsement by shari'ah boards that these products may have received.

Therefore, Islamic banking needs to differ significantly from conventional banking, not only in the ways of doing business, but above all in the values which guide Islamic banking operation and outlook. More importantly, implementing controversial transactions has defamed shari'ah by transforming some of its rulings into a meaningless set of rules that is incapable of convincing Muslims and non-Muslims of its rationality and wisdom. Rather, it leaves the public baffled; being unable to comprehend why *ribā* or interest is prohibited regardless of how small the interest is, while a financing based on *bay' al-eina/tawarruq* which share the same economic and social implications is permissible. Why is it forbidden for the Muslims to seek a personal financing on basis of interest-bearing loan from a conventional bank while it is permissible for him to seek a personal financing from

an Islamic bank though in the later case, he might end up repaying even more than what he repays to the conventional bank.

There are many state-owned conventional banks that offer businessmen, farmers and manufacturers cash at very low interest rate to support development of economy. Does it make any sense to claim that such finance is *ḥarām* while resorting to a product like *eina* or *tawarruq* as offered by some Islamic banks is *ḥalāl* though their clients may end up paying double or triple what they pay to governmental banks.

Furthermore, non-Muslims who have no knowledge of shari'ah might be mistakenly thinking that some controversial Islamic banking products described in this paper represent the true face of the shari'ah. Moreover, they would believe that it is sufficient in Islam to change the name of the forbidden contracts and tailor their mechanism to make it permissible. Surely, such practices, if continued, may indirectly distort the teachings of Islam.

6. CONCLUSION

After deliberation on the foregoing arguments, we may conclude the following:

- So far, most of efforts to Islamise the banking and financing products have been focusing on their forms and technicalities, while the shari'ah objectives of these transactions are to great extent neglected. This is because the economic substance of many products of Islamic banks is hardly differentiated from that of conventional banks and financial institutions.
- Both form as well as the substance of contracts are important and so must be in compliance with shari'ah. However, substance rather than form is what should be more importantly looked into when structuring a financial product. Thus, the restricted view of understanding shari'ah compliance by merely focusing on the legality of contractual forms and technicalities needs to be changed. Otherwise, Islamic banks will just appear as an exercise of semantics; their functions and operations will become no different from conventional banks, except in their use of euphemisms to disguise interest and circumvent the many shari'ah prohibitions.
- Islamic banks and financial institutions are facing some ideological and conceptual challenges. These challenges emerge from the improper understanding of *maqāṣid* al- shari'ah and the *maṣlahah* and *ḍarura* concepts. Failure to understand these concepts and their application to modern transactions has led to their abuse, such as using *maqāṣid* to justify certain contracts which are in fact contradictory to the shari'ah texts and principles.

- Circumventing the prohibition of *ribā* by means of *bay' al-eina* or *tawarruq* and their likes is against the very *sharī'ah* objectives of *ribā* prohibition. Therefore, those who claim the permissibility of such transactions under the pretext of realising *maqāṣid* al-*sharī'ah* are effectively acting against the true spirit of *maqāṣid* al-*sharī'ah* .
- Attributing the permissibility of *bay' al-eina* and its likes to the early great jurists like Shafi'is is wrong as these jurists ruled the validity and not the permissibility of these transactions, for a valid contract is not necessarily permissible.
- As a criterion for distinguishing between a lawful transaction and an unlawful one is to examine the economic substance of a given transaction; if found to be identical to that of the prohibited transaction, such as a sales contract in which the bank or the financier acts as a creditor not as a real trader of real property, then this must render the transaction impermissible regardless of any legal form it may take, or any name it may be given.
- Use of dubious financial products may have fatal implications on the Islamic banking industry as a whole, since such practices may eventually lead to convergence between Islamic banking and conventional banking; confining differences only to semantics and technicalities.
- Claiming *sharī'ah* permissibility of the *ribā*-disguised products leads to the distortion of the *sharī'ah* and harms the image of Islam.
- In the final analysis, Islamic banks should forgo all the *ribā*-disguised products and all controversial contracts that may impede the growth and progress of Islamic banking and finance industry. Indeed Islamic banking system has the potential to become one of the promising sectors to realize the noble objectives of *sharī'ah*; however, this requires the internalisation of *sharī'ah* principles on Islamic financial transactions, in its form, spirit and substance. By so doing, it epitomizes the objectives of *sharī'ah* in promoting economic and social justice.

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**ACTIVITIES AND
REPORTS**

REPORT

“The 3rd International Conference on Islamic Banking and Finance: Risk Management, Regulation and Supervision” Jakarta, Indonesia, 22-24 February 2010.

The conference “3rd International Conference on Islamic Banking and Finance: Risk Management, Regulation and Supervision” was jointly organized by IRTI and Center of Islamic Economics and Business (PEBS) University of Indonesia and co-hosted by Bank Indonesia. It started with a welcoming ceremony and dinner on 22nd of February. The ceremony was addressed by H. E. Sri Mulyani Indrawarti, then Minister of Finance, Republic of Indonesia (currently Executive Director at World Bank). In her speech the Finance Minister emphasized the need to bring about an efficient and stable Islamic financial system. She also emphasized the need for human capital development in Islamic finance in general and in the area of risk management in particular. The Deputy Governor of Bank Indonesia, The Dean of Faculty of Economics, University of Indonesia, and Manager Training on behalf of the Director General IRTI also spoke on the occasion.

The main program of the conference took place on February 23 and 24, 2010 that comprised of two plenary sessions, and eight parallel sessions in which a total of 31 papers were discussed by authors from 10 countries (Indonesia, Bahrain, Iran, India, Jordan, Malaysia, Qatar, Saudi Arabia, UK and USA). A book of conference papers (more than 766 pages in total) was printed and also included in the conference kit that was distributed to the participants. The summary program of conference is given below. The conference was well participated by over 150 participants. At the end of the conference a conference communiqué was also issued that thanked the organizers and host country Indonesia and recommended future steps for policy makers and further research areas for the academia and finance community. Some key recommendations of the communiqué were the following:

- That this conference series should be continued and with the participation from supervisory bodies, finance practitioners, Shari‘ah boards, academics and research communities.
- In view of the global financial crises, Islamic financial institutions should move to implement the original concept of Islamic finance avoiding products not compatible with *maqāsid* of Shari‘ah and having no wider

consensus and which encourage consumerism, speculation and which are based on gimmicks to provide personal loans etc.

- Islamic countries are called upon to provide legal and institutional framework to promote the development and use of those products that need such support. Techniques should be devised to measure the efficiency along with social responsibility and *maqāṣid* of Shari'ah. Islamic governments are also invited to provide environment to expand risk sharing and to enable Islamic finance to operate competitively and effectively.

By grace of Allah the conference was a big success. The dedication of the people working for the organization of the conference in all concerned institutions, the willingness of the authors to contribute their papers and taking the time to come for the conference, all contributed to its fruitfulness.

The program of the conference is given below:

EVENING OF FEBRUARY 22, 2011 (WELCOME DINNER)	
Welcoming Speech by Rector of UI	Prof. Gumilar R. Sumantri
Welcoming Speech by IRTI	Representative of IRTI on behalf of Prof. Bambang P. S. Brodjonegoro
Grand Opening and Speech by the Minister of Finance, Republic of Indonesia	H. E. Sri Mulyani Indrawarti
FEBRUARY 23, 2011 (BUSINESS DAY-1)	
Welcoming Speech	Dean of FEUI
Officiating Remarks	Osman Babiker on behalf of Director General of IRTI
Official Opening Ceremony	Deputy Governor of Bank Indonesia
Keynote Speech: Risk Management, Regulation and Supervision in Indonesia	Dr. Muljaman Haddad
PLENARY SESSION	
Risk Management Assessment Systems: An Application to Islamic Banks	Prof. Habib Ahmed
Impact of Global Financial Crisis on Islamic Banking	Salman Syed Ali

Session on EFFICIENCY OF ISLAMIC BANKS	
Performance Evaluation of Islamic Commercial Banks in Indonesia after the Financial Crisis	Ahmad Affandi
The Potential Of Liquidity Risk Problems In Indonesian Islamic Banking Industry	Rifki Ismal
Efficiency Of Islamic Banking In Indonesia	Rahmat Hidayat
Assessing Cost and Profit Efficiency of Islamic Banks	Sudin Haron
Session on BANKING AND FINANCIAL STABILITY	
Risk Identification of the Islamic Banks in Indonesia: A VAR Modeling Approach	Rahmatina A. Kasri
Transmission Mechanism On Dual Monetary System In Indonesia: Comparison Between Shari'ah And Conventional Monetary Instruments	Aam Slamet Rusydiana
The Impact Of Credit Channel Of Islamic Banks In A Small-Open Economy	Wisam Rohilina
How Resilient Is the Islamic Banks to Financial Crisis? The Malaysian Experience During the Asian Crisis 1997 and the US Crisis 2007	Shabri Abd. Majid
Session on EFFICIENCY OF ISLAMIC BANKS	
Measuring the Efficiency of Islamic Banks in Indonesia and Malaysia using Parametric and Nonparametric Approach	Ascarya
Cost, Revenue, and Profit Efficiency of Islamic versus Conventional Banks: International Evidence Using data Envelopment Analysis	Mohammad Bader
DEA/C&R :DEA with Classification and Regression Tree: A Case of Banking Efficiency	Abdel Latef Anouze
Measuring Service Quality of Malaysian Banking Industry : A Comparison Between Islamic and Conventional Banks	Mukesh Kumar
Session on SHARI'AH ISSUES	
Shari'ah Compliance Process and Corporate Governance in Islamic Banking Institutions (IBIs): A Proposed Model	Rusnah Muhamad
The Process of Shari'ah Assurance In The Product Offering; Some Important Notes For Indonesian And Malaysian Islamic Banking Practice	Agus Triyanta

The Responsibility and Independence of Shari'ah Supervisory Boards of the Indonesian Islamic Banks	Ade Wirman Syafei
Shari'ah non-compliance risk in Islamic banking and finance	Ahcene Lahsasna
Session on RISK MANAGEMENT	
Assets Liabilities Management in Islamic Banking	Mahmoud Allahyarifard
Financial Stability and Early Warning Systems: Implications for Islamic Finance	Kazim Yavari
An Integrated Framework For Operational Risk Measurement In Islamic Banking	Hylmun Izhar
Session on RISK IN ISLAMIC BANKING & FINANCE	
Challenging Risks Of Islamic Banking- A Case Of Islamic Banking In Pakistan	Muhammad Mazhar Manzoor
The Effectiveness of Rating System to Measure Default Risk in Islamic Bond : The Case of Islamic Bond Rating System in Indonesia	Abdul Qoyum
Appraisal Of Islamic Derivatives	Anita Priantina
FEBRUARY 24, 2011 (BUSINESS DAY-2)	
Session on SUPERVISORY ISSUES	
Exploring Corporate Social Responsibility Disclosure of Islamic Banks With Special Reference to Disclosure Practices Under the AAOIFI Standards	Abul Hassan
The Disclosure Evaluation of Islamic Banking Reports: Evidences from Middle East and Asia	Rifqi Muhammad
Regulating Islamic Finance in Secular Countries : A Case study of India	Syed Kamran Razvi
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BOOK REVIEW

BOOK REVIEW

Mohammed Obaidullah and Tariqullah Khan (2008), *Islamic Microfinance Development – Challenges and Initiatives* Jeddah, Kingdom of Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank, Dialogue Paper No. 2, 81p.

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This is a book that discusses endeavours in alleviating poverty through Islamic microfinance. It holds to the premise that the major factor attributing to the poor's inability to participate in development process is their exclusion from the financial system. Microfinance, therefore, is seen as a powerful tool for poverty alleviation. It is due to this belief that, the authors argue, development of inclusive financial systems becomes a central goal of policy makers and planners across the globe.

This book actually aims to form the basis for a dialogue among various stakeholders, including scholars, academicians, regulators, policy makers, the Islamic Financial Services Industry (IFSI), the Islamic Development Bank (IsDB) and other multilateral institutions. It arises subsequently from the development of two key strategic objectives of the IsDB, namely poverty alleviation and development of the IFSI, as reflected in the IsDB Vision 1440H, the OIC 10-Year Work Plan, and refined in Islamic Research and Training Institute (IRTI) lead initiative "Ten-Year Framework and Strategies (TYFS) for Development of the Islamic Financial Services Industry" (jointly prepared with IsDB Group and Islamic Financial Services Board (IFSB)). It is generated by the lacking of IFSI in addressing the challenge of poverty alleviation by making financial services accessible to the poor, though Islamic Microfinance Development has been considered as top priority initiative in order to align IFSI development with poverty alleviation.

The book highlights, *inter alia*, at least four important insights.

1. The importance of microfinance to fight poverty, especially through the "best practices" models and the consensus principles of microfinance industry.

2. The needs of the poor for interest-free micro-credit.
3. Introduction and division of the three levels of Islamic microfinance, namely micro-, meso- and macro-level, with policy suggestions for each.
4. The stance that multilateral institutions have a major role in strengthening the Islamic microfinance industry at all the three levels.

Firstly, the importance of microfinance to fight poverty, especially through the “best practices” models of microfinance and the consensus principles of the microfinance industry. The authors highlight four models of mainstream microfinance system, namely the Grameen Bank model originating in Bangladesh, the Village Bank model practiced widely in Latin America and Africa, the Credit Union model that has been popular in Asia notably Sri Lanka, and Self-Help Groups model originating in India.

It is observed that the mainstream system adopted by models such as above has experienced a paradigm shift, from the traditional donor-based approach to a for-profit approach, or in simple words, from charity to profit. To the present reviewer, this is not surprising indeed. Inclusion of the poor into the financial system is equal to the inclusion of the poor into the dominant capitalistic profit-oriented system. Detachment from the urge for profit is thus peculiar. But the interesting curiosity is, how could the Islamic microfinance system overcome this problem?

The answer to this perhaps lies in the belief of the authors that building inclusive financial systems certainly requires integration of microfinance with Islamic finance. The following nature and principles of Islamic finance seems to have elements that could safeguard such a problem. The said elements are: ethics, morals, social orientation, religious duties, equality, fairness, risk sharing, individual rights, individual duties, property rights, sanctity of contracts, entrepreneurship, developmental and social goals, partnership, and participation by the poor.

The *second* important insight highlighted in this book is regarding the needs of the poor for interest-free micro-credit. The authors refer their examples to *qard al-ḥasan* with recovery of actual costs of service, *murābahah* with *bayʿ-bithaman-ājil*, *ijārah*, *bayʿ-salam*, et. cetera; micro-savings with high returns and guaranteed safety, security and liquidity; micro-transfers especially for the benefits of migrant-workers, as well as for domestic and international transfers among the poor; and micro-insurance such as *micro-takāful* to lighten the burden of the poor resulting from shocks such as the death of a family breadwinner, severe illness, or loss of an asset including livestock and housing.

These are explained in more details when Sharī'ah-compliant instruments of microfinance are discussed, namely the instruments for mobilization of funds, the instruments of financing, and the instruments for risk management.

The authors divide the instruments for mobilization of funds into three types, that is charity (such as *zakāh*, *ṣadaqah*, *awqāf*, gifts that include *hiba* and *tabarru*), deposits (in the form of *wadī'ah*, *qarḍ al-ḥasan* and *muḍārabah*), and equity (in the form of classical *mushārah* or the modern stocks). Instruments of financing are divided into four types, that is participatory profit-loss sharing modes such as *muḍārabah* and *mushārah*, sale-based modes such as *murābahah*, lease-based modes or *ijarah*, and benevolent loans or *qarḍ* with service charge. Instruments of risk management and insurance are divided into three, that is guarantee (*kafālah*), collateral (*ḍamān*), and micro-*takāful*.

However, the authors have made a fair and right caution relating to these financial services. They note that the microfinance is not the sole solution for poverty reduction. The poor need to have access to such services, and the destitute such as those who go hungry or without a cash income are not usually appropriate for the financial services, especially credit since credit means loans, hence debt. Without a cash flow essential to repay the loans, the destitute could become poorer. In such a condition, other basic needs such as food, shelter, and employment are said to be more urgently needed than the financial services. The authors urge government and donors to fund these basic needs more than the financial services. Similarly, microfinance is argued as not a substitute for investments in basic education, health, and infrastructure.

The *third* insight that has been highlighted by this book is the introduction and division of the three levels of Islamic microfinance, namely micro level (microfinance institutions, contracts/products and resources), meso level (financial infrastructures) and macro level (policy and regulatory framework), with the following suggestions. At micro level, the authors insist, there should be a move towards collective resolution of Sharī'ah issues, enhancement of product range through research and financial engineering and increased participation of banks in microfinance through provision of credit guarantees and safety nets. At meso level there should be provision of education and training, better coordination and networking, technical assistance through *Awqāf* and *Zakāh* Funds, provision of rating services specific to Islamic microfinance institutions in view of their unique risks through creation of a rating fund. At macro level

there should be development of an enabling regulatory and policy environment.

A chapter each has been devoted to the detailed discussions of these levels.

For the chapter on the micro-level, discussions are concentrated on the informal microfinance providers (such as individual informal providers, collective forms of informal service providers), member-based organizations, non-government organizations and formal financial institutions. In addition, Islamic microfinance providers across the globe are also deliberated. They are, *inter alia*, the *Mit Ghamr* project in Egypt, the *Jabal al Hoss "Sanadiq"* (village banks) in Syria, the *Mu'assasat Bait Al-Māl* in Lebanon, the *Hodeidah* Microfinance Program in Yemen, Islami Bank Bangladesh, Social Investment Bank Bangladesh, and *Al-Falah* and *Rescue* in Bangladesh, *Akhuwat* in Pakistan, AICMEU and *Bait-un-Nasr* in India, *Tabung Haji* in Malaysia, *Baitul Māl wal Tamwīl* in Indonesia, and FINCA in Afghanistan.

These are followed by a discussion on challenges faced by the microfinance system at this micro-level. They are diverse organizational structures, the need for Sharī'ah compliance (including Sharī'ah Board, *Fiqhi* issues, and divergent perceptions), lack of product diversification, and the importance of strong linkages between microfinance with banks and capital market. In order to face these challenges, the authors propose four strategic responses, namely collective resolution of Sharī'ah issues, diverse range of products, bank's participation in microfinance, and capital market participation.

For the chapter on the meso-level, the pattern of the discussions is similar to the chapter on the micro-level, concentrating on the challenges and strategic response. For the former, three challenges are highlighted, namely the payment systems, the transparency and information infrastructure, education and training, and networking. For the later, the problem of the payment systems is proposed to be overcome by working through the larger finance institutions by forging alliance with them; the problem of transparency and information by using conventional rating agencies that are willing to develop rating methodology for Islamic microfinance instruments with the help of institution like Islamic Development Bank; and the problem of education and training by imparting training to persons with diverse experiences such as in banking, finance, investments, entrepreneurship development, community development, accounting and management; the problem of networking by establishing a coordinating body dedicated to development of the Islamic microfinance sector. In

addition, the authors also suggest technical assistance to be created through *awqāf* and *zakāh* funds so as knowledge and skills in entrepreneurship development among the poor could be imparted, and their status as “unbankable” group could be eliminated.

For the chapter on macro-level, emphasis has been given to the discussion on the Islamic microfinance regulatory and policy framework. Taken into consideration the challenges in sustaining macroeconomic stability, liberalized financial market rates, banking sector regulation and supervision, issues in prudential regulation and supervision, and issues related to dual system, the authors suggest development of a regulatory system for the Islamic microfinance sector in three stages. In the first stage, the Islamic microfinance institutions have to be made appreciating the need for certain common performance standards. Subsequently, is to make it mandatory for the Islamic microfinance institutions to get registered with identified or designated institutions. Lastly, is to encourage development of network of Islamic microfinance institutions which could function as quasi Self-Regulatory Organization at a later date or identifying a suitable organization to handle the regulatory arrangements.

The *fourth* and final insight that this book has highlighted is the stance that multilateral institutions (donors and development financial institutions) such as IDB has a major role in strengthening the Islamic microfinance industry at all the three levels of microfinance categorized above – the micro-, meso- and macro-levels. A chapter of its own has been devoted to this. It is mentioned that in the domain of Islamic microfinance, the IDB is perceived to be the most important player. Others that have been instrumental in initiating Islamic microfinance programs include United Nations Development Program (UNDP) in Syria and Palestine, Kreditanstalt für Wiederaufbau (KfW) in Northern Mali, and FINCA in Afghanistan. These are made possible through a variety of mechanisms such as policy support, technical assistance, grants, loans, quasi-equity, equity investments and guarantees. These mechanisms are *Shari'ah* compliant and more diverse and inclusive of those directed at the extremely poor and the destitute. In addition, the authors provide a list of specific initiative that would strengthen the Islamic microfinance at all the three levels.

All in all, with its informative though brief nature, this book has accomplished its objective in providing the foundation not only for a dialogue among various microfinance stakeholders, but also for all people who are interested in the development of the *ummah*, in particular in alleviating poverty. It would be more interesting if, before getting into the discourse on the microfinance, the poverty that is meant to be alleviated by

the Islamic microfinance system could be conceptualized from an Islamic perspective. It is definitely the problem of poverty that has been understood from the Islamic perspective that what is trying to be overcome by the Islamic microfinance system here. In addition, though this book is a result of an empirical research, it would be helpful, especially for those who are interested in pursuing into the dialogue, to list down relevant references or bibliographies, as well as to include all the missing acronyms such as AICMEU and FINCA into the list of abbreviations. These suggestions, however, do not indicate serious deficiency of the book, as they are not only minor in nature, but also might be out of the scope of the book, especially pertaining to the conceptualization of poverty.

BOOK REVIEW

M. Umer Chapra (2008), *The Islamic Vision of Development in the Light of the Maqāṣid al-Sharīʿah*, Jeddah, Kingdom of Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank. 79 pages.

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This is the first book of its kind that attempts to link development with, and position it within the *maqāṣid* Sharīʿah (objective of Sharīʿah). It tries to show how, in the context of the *maqāṣid* Sharīʿah, a development that is in line with the vision of Islam could be formulated and realized.

Development in this book refers to the real well-being of all human beings which the author terms as *al-falāh*, while the *maqāṣid* Sharīʿah is considered as the very basis of the framework to accomplish *al-falāh*. *Al-falāh* is regarded as one of the indispensable ways to realize the ultimate goal of all Islamic teachings, that is, to be a blessing for mankind, irrespective of race, colour, age, sex or nationality.

This, however, differs a little bit from the opinion of the present reviewer. It is not *al-falāh*, but instead, it is *mardhatillah* (the pleasure of God) that should be the ultimate goals of all Islamic teachings and human endeavours, development included. *Al-falāh* is indeed just one of the outcomes of the *mardhatillah*. It is the *mardhatillah* that justifies the bestowing of *al-falāh* by Allah s.w.t. upon His slaves whenever He pleases. In the absence of *mardhatillah*, accomplishment of *al-falāh*, moreover eternal *al-falāh* in the Hereafter, is not possible. Endeavours for development thus should aim at the accomplishment of *mardhatillah* as the ultimate goal, and *al-falāh* reduces to be the immediate goal and the end product of *mardhatillah*. *Mardhatillah* indeed is the key to not only the provision of *al-falāh*, but also all other gifts by Allah s.w.t.

However, the author's inclusion of intangibles in the measurement of development is worthy of note. Development to him could not be measured by only income and wealth, rather by a comprehensive vision of human well-being for at least two reasons. Firstly, the income and wealth could not emanate happiness beyond the fulfilment of basic biological needs.

Secondly, there are many other needs that are spiritual and non-material in characteristic, such as mental peace and, even the happiness itself. These, according to the author, require other needs such as justice and human brotherhood, spiritual and moral uplift. For a sustainable well-being, they need security of life, property and honour, individual freedom, moral as well as material education, marriage and proper upbringing of children, family and social solidarity, and minimization of crime, tension and anomie. New development paradigm does recognize some of these, says the author, but the spiritual foundation does not become its emphasis, although spiritual and non-material needs have to be satisfied to ensure true well-being and sustainability of economic development over the longer term.

This would definitely add to clarity if firstly, the author could have explained what are actually meant by spiritual and, secondly, a deliberation could have been made on how the spirituality could be measured. This would bridge the gap that has been ignored by writers many of whom simply mention spirituality but leave it out undefined, let alone discussing it in depth. It would be helpful if there is an explanation on the spirituality in relation to the fundamental elements of it, for instance the *iman* (faith) and *taqwā* (piety), the *mazmumah* (evil attributes) and the *mahmudah* (good attributes), as well as the *qalb* (heart) and the *nafs* (desire), as well as the relations of all these spiritual elements with, and their implications on development. As for the second question, at least there should be a clearer emphasis that not all that are unquantifiable and tangibly immeasurable such as the spiritual and non-material needs, are not relevant. They are real and relevant and cannot be ignored just because they are unquantifiable or presently immeasurable.

The other suggestion is on the essential deliberation on the meaning of the *maqāṣid* al-Sharī'ah itself. The author does not actually give any clear definition of the *maqāṣid* al-Sharī'ah, other than explaining what these *maqāṣid* or goals are, how they are mutually interrelated, what their implications are, and in what way they can together help promote real human well-being. Instead, discourse on the meaning of the term *maqāṣid* al-Sharī'ah itself is focused more on the categories of the *maqāṣid*, as classified by Imam Abu Hamid al-Ghazali. The author highlights al-Ghazali's explanation of *maqāṣid* al-Sharī'ah. That is, the very objective is to promote the well-being of the people which lies in safeguarding their faith (*din*), their self (*nafs*), their intellect (*'aql*), the posterity (*nasl*) and the wealth (*māl*), and whatever serves to safeguard these five is in public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.

Despite what has been stated above, the author undeniably has contributed much to the reinterpretation of al-Ghazali's thinking. This is done in at least three ways.

Firstly, the author argues that the *maqāṣid*, apart from the five mentioned by al-Ghazali which is considered as primary (*al-asliyyah*), also consists of other categories which the author terms as corollaries (*tabī'ah*). These corollaries, though not specified by the author at this stage, are said to have been indicated by the Qur'ān and the *Sunnah* or inferred from these by different scholars. They ease the realization of the primary *maqāṣid* and their realization therefore is also indispensable. The author bases this stance on the *fiqhi* principle that means (*wasail*) enjoy the same legal status as that of the *maqāṣid*. Accordingly, he says, legal maxim (*al-qā'idah al-fihiyyah*) stipulates that "something without which an obligation cannot be fulfilled is also obligatory". Based on the richness and dynamism inherent in the teachings of the Qur'ān and *Sunnah*, the author says, these corollaries could be expanded and refined to ensure that all human rights are duly honoured and that all the different human needs are adequately satisfied.

Secondly, the author also redefines the word safeguarding used by Imam al-Ghazali as not only implying the preservation of the status quo, but also striving for continued enrichment of the primary *maqāṣid* and the corollaries. By this, the author says, sustained development and well-being could be keeping on improving continuously in keeping with the changing needs and environment for individuals, society and mankind. *Maqāṣid al-Sharī'ah*, therefore, he argues, needs to be discussed within the context of our own times.

Thirdly, the author rearranges the sequence of the *maqāṣid al-Sharī'ah*, by putting the human self (*al-nafs*) on the top as what has been done by Fakhr al-Din al-Razi (d.606/1209), a prominent jurist writing around a hundred years after al-Ghazali. Moreover, Al-Shatibi, the author contends, has not always followed the sequence outlined by al-Ghazali. He argues that the sequence essentially depends on the nature of the discussion, hence perhaps his rearrangement. This seems to be more logical to the author in the discussion of sustainable development for human beings, as *khalifah* or vicegerent of God, are the end as well as the means to development. The human themselves to the author are the architects of their development or decline.

With this premise, the author explains the way how the human self, as one of the pillars of the objective of *Sharī'ah*, could be invigorated. The

major needs of human beings that must be satisfied, to the author, which he terms as corollaries of the primary objective of strengthening the human self and ensure a sustained well-being, consist of 14 things as follows: (1) dignity, self-respect, brotherhood and social equality; (2) justice; (3) spiritual and moral uplift; (4) security of life, property and honour; (5) freedom; (6) education; (7) good governance; (8) removal of poverty and need fulfilment; (9) employment and self-employment opportunities; (10) equitable distribution of income and wealth; (11) marriage and stable family life; (12) family and social solidarity; (13) minimization of crime and anomie; and (14) mental peace and happiness.

With the fulfilment of these 14 corollaries, the author argues, the four primary objective of Sharī‘ah, that is faith (*Din*), intellect (*‘aql*), posterity (*nasl*), and wealth (*māl*) could be ensured, and eventually entail with human well-being, the *falāh*.

The rest of the sections of this book have then been devoted to the explanation of these 14 corollaries of the human self (*al-nafs*) as the first objective of the Sharī‘ah, followed by the explanation of the corollaries of the other four primary objectives of the Sharī‘ah, that is the strengthening of faith (*Din*), enrichment of intellect (*‘aql*), enrichment of posterity (*nasl*), and development and expansion of wealth (*māl*).

In doing this, amongst important points highlighted by the author in explaining the strengthening of human self (*al-nafs*) as the first and most important primary objective of the Sharī‘ah are as follows:

1. That the inherent nature of human beings (*fitrah*) is good and free from any spiritual flaw. Human-beings are obliged to preserve these true nature or innate goodness, hence the enjoyment of *dignity, self-respect, brotherhood and social equality*.
2. That *justice*, especially socio-economic justice, is a pre-requisite for accomplishing the goal of dignity, self-respect, brotherhood and social equality. The author quoted al-Mawardi that relates comprehensive justice to the inculcation of mutual love and affection, compliance with norms, development of the country, expansion of wealth, growth of progeny, and security of the sovereign, Ibn Taymiyyah that regards justice towards everything and everyone is an imperative for everyone, and Ibn Khaldun that believes that justice is a compulsory ingredient for a country to develop.
3. That *spiritual and moral uplift*, through a faithful observance of moral values, could lead to mutual trust and cordial relations among people,

and motivate them to fulfil their mutual obligations and to help each other, thereby promoting family and social solidarity, tolerance and peaceful coexistence, and curbing the spread of anomie. In consequence, these will entail with an increase in social capital, which is necessary for promoting efficiency and equity and, accelerated development and human well-being. For all these, a proper motivating system is necessary.

4. That *security of life, property and honour* are imperative in fulfilling the dire need of the human personality as Islam calls for the respect of life and brotherhood of mankind.
5. That *freedom* is necessary as it generates initiative and drives for necessary creativity and innovation and consequently, for human development and well-being. However, freedom here does not mean absolute freedom. Instead, it is bounded by moral values to ensure not just their own well-being but also the well-being of all God's creatures. This is possible through three important assets that have been bestowed by God, that is conscience (reflection of man's true nature, the *fitrah*), Divine guidance, and intellect. The freedom therefore is an outcome of man's conscience as *Khalifah* of God, within the bounds of the guidance provided by Him, used wisely according to man's intellectual capability.
6. That high quality *education* is essential for one's enrichment of intellect. It has to entail with two results, firstly the enlightening of one's worldview, moral values of Islam, and mission as *khalifah* of God; and secondly, the expansion of knowledge and technological base, so as to enable not only the enrichment of the intellect, but also the accomplishment of an accelerating and sustaining development.
7. That *good governance* is an indispensable need, for without good governance and hence political stability, the enforcement of the society's rules of behavior is not possible.
8. That *poverty* must be removed and *needs* for all must be fulfilled through an efficient and equitable use of all resources because of its negative consequences such as incapacity, helplessness and dependence, and capacity to drive a person close to disbelief.
9. That all individuals have to realize their need fulfilment through their own effort (*employment*), while a Muslim society through its management of the economy, provides *self-employment opportunities*

for the people to earn an honest living in keeping with their ability and effort.

10. That there should be an *equitable distribution of income and wealth* in order to avoid degrading the extremely poor and enable them to utilize their full potential.
11. That *marriage and stable family* life must characterize a congenial partner-in-life, affectionate and caring relationship of husband and wife to ensure stable families that emanates loving care and upbringing of the future generations as well as the development and survival of the society itself.
12. That women rights must be fulfilled as they are 'sisters of men', a 'trust from God' and men must not take advantage of the women's weaknesses nor humiliate them. They have equal, and not inferior, status, with ability to complement the role of men in promoting human well-being. Indeed, nobility of character, good husband-wife relationship and loving care of children by their parents could lead to *family and social solidarity*.
13. That an enabling environment for the *minimization of crime and anomie*, and consequently *mental peace and happiness* could be created by the fulfilment of the above twelve needs of the human personality.
14. That all the above needs, if satisfied, will have a positive effect on all the five primary *maqāṣid* al-Sharī'ah mentioned by al-Ghazali, that is the human self, intellect, posterity and wealth, as well as on faith by creating a more congenial environment for its better understanding and implementation. Faith here seems to be regarded as an outcome of the fulfilment of the above needs of the human self, not faith that becomes the determinant of the needs. Rethinking on this would definitely necessary. Is it the faith that moulds the way of life of a human being or the way of life that becomes the mould of his faith? It could be both ways but it would be much interesting and clear if this is discussed in details. Whichever ways this discussion could be, the yield, the author says, is the promotion of sustained development in all sectors of the society, economy and polity.

In strengthening the other four primary objectives of Sharī'ah (faith, intellect, posterity and wealth) that could in turn enrich the human self as the human self itself mutually strengthening them, the author has the followings to say:

1. In strengthening the faith, the author proposes six elements, that is religious worldview, values, proper motivation, education, enabling environment for righteousness and family and social solidarity, and the role of the state. The religious worldview is important and faith thus is arranged second after the human self, for it is the religious worldview that carries greatest potential of ensuring the reform of the human self in a way that would help ensure the fulfilment of all the spiritual and material needs of the human personality. One of the important needs is the moral uplift which has two requisites, namely existence of values or rules of behaviour and observance of these rules by everyone. One, and the only One, that could ensure the observance of these rules, says the author, is God. The stimulant that motivates the sacrifice of one's self-interest is the faith that stretches the fulfilment of the 'self-interest' beyond the span of this finite world, to the eternal Hereafter, along with the individual's accountability before the Supreme Being and the reward and punishment in the Hereafter. This Islamic worldview has to be accomplished by education which must also include the existing knowledge base and technology, leading the Muslims to employment and self-employment opportunities, uplifting of dignity, acceleration of development, reduction of poverty and inequalities in the distribution of income and wealth. Such an environment becomes an enabler for righteousness, the strengthening of family and social solidarity, and the promotion of mutual care and cooperation among individuals, as well as the desired qualities in individuals, humanitarian social goals, simple living, and the reduction of wasteful and conspicuous consumption. In all these, the author says, the state must play a complementary role, amongst others, by having effective checks and balances through institutions such as *shūra* (parliament), an honest judiciary, a free press, and properly conceived laws and regulations.

2. In enriching the intellect (*‘aql*), intellect-faith interdependency faith plays an important role. Faith leads the intellect to the right direction, while intellect helps to maintain the dynamism of faith, to respond successfully to the changing socio-economic and intellectual environment, to develop the kind of technology that can accelerate development, and playing crucial role in the realization of the *maqāṣid*. The later needs an ability to exercise *ijtihād* and evaluate rationally and rightfully all interpretations of the Qur'ān, *Sunnah* and *fiqhi* verdicts, in harmony with the *maqāṣid*. This could be realized through a high quality religious and science education, a combination of which could lay a proper ground to know the values of their society, raise skills to

enable to earn livelihood in a morally lawful way, and making possible the contribution to the development of science and technology and the realization of the *maqāṣid*.

3. In enriching the posterity, four factors have to be endeavoured. They are moral development and proper upbringing and family integrity, intellectual development, need fulfilment and healthy environment, and freedom from fear, conflict and insecurity, and the debt-servicing burden created by the present generation's borrowing for consumption purposes.
4. In developing and expanding the wealth, faith, through its values and motivating system, has a crucial role to play. It avoids wealth to become an end in itself, promotes unscrupulousness and accentuates inequities, imbalances and excesses, helps inject a discipline and a meaning in the earning and spending of wealth, thereby, enable it to serve its purposes more effectively. The results are poverty removal, needs fulfilment of all, comfortable life for everyone, promotion of equitable distribution of income and wealth. In addition, creation of wealth would also include minimization of inequalities of income, enlargement of national pie, strengthening of human resources, reorientation of monetary, fiscal and commercial policies, promotion of micro-enterprises, and provision of microfinance to the very poor on a humane interest-free basis.

All these important conceptions of the Islamic vision of development in the light of *maqāṣid* al-Sharīḥ could have been strengthened if there is a discussion on the issue of the scarcity of resources which the author seems to believe in but has not discussed in a clearer manner. The questions that have been lingering in the mind of the present reviewer are as follows: what is the difference between the so-called scarce resources concept held by the author with the very assumption of the mainstream economics that resources are scarce while wants are unlimited? Could the resources be regarded as scarce due to their physical nature that reduce by utilization and consumption as well as due to human's inability to redistribute resources and their yields justly and to explore the unexplored resources efficiently? If so, how one relates them to the concept of *rizq* (provision from Allah s.w.t) that is believed to have been allocated by Allah s.w.t. to every living creature and *barakah* (blessing from Allah s.w.t.) that influences greatly on one's satisfaction and happiness irrespective of quantified amount?

Another thing that would probably enlighten readers of this book is the deliberation on the statement that a Muslim country could benefit from other countries as long as it is not in conflict with Sharīḥ. It undeniably

sounds very clear and has become an axiom among many Muslims. However, it has been stated as a generalization, without in-depth explanation. It would be enlightening therefore if deliberation on the statement could be made, for instance by differentiating the benefits at an operational level without compromising the philosophical underpinnings of the Islamic development.

The quality of the book too would have been better if there were no typographical and editorial errors that are prevalent in some parts of this book (such as blank pages, tables and figures without titles, et. cetera), as well as the missing of some references in the list of references at the end of the book, such as Masud 1977 and Nyazee 1994 (p.11, fn 7).

As a whole, however, this book is commendable and praiseworthy, for majority of other books on Islamic development usually confine themselves to economic development alone rather than a comprehensive development. In this book the author has been able to paint the relationship of the *maqāṣid* al-Sharī'ah in realizing the Islamic vision of a holistic development as he intends to do. The ingredients of human-being, that is faith, intellect, posterity and wealth, along with their corollaries, are well explained in a systematic manner. Although the points that have been raised in this book may not be new to some, the author however has managed to place them systematically in right places with strong support of references.

**ABSTRACTS OF ARTICLES
PUBLISHED IN *DARASAT
IQTISADIAH ISLAMIAH***

من الهياكل المدعمة بالأصول إلى الهياكل المخففة الدعم بالأصول: التاريخ المعقد للصكوك رفيع حنيف¹ ترجمة محمود مهدي

ملخص:

تسعى هذه الورقة إلى تتبع تطور سوق الصكوك من خلال دراسة حالات محددة . تبدأ الورقة بمناقشة نشأة الصكوك كهيكل تمويلي مدعم بالأصول تكون في ظله لحاملي الصكوك حقوق ملكية في الأصول الداعمة، ثم تتناول الورقة تحول الصكوك إلى هيكل تمويلي مبني على الأصول يصبح في ظله حاملو الصكوك في نفس درجة الدائنين غير ذوي الضمانات. وتنتقل الورقة بعد ذلك إلى الحديث عن ظهور الصكوك المخففة الدعم بالأصول حين أصبح متطلب دعم الصكوك بالأصول المحسوسة يُستوفى بالحد الأدنى . وتناقش الورقة أيضاً المخاوف الشرعية التي تثار حول هياكل الصكوك المخففة الدعم بالأصول .
الكلمات الأساسية: الشريعة، الصكوك، مدعمة بالأصول (Asset-backed)، مبنية على الأصول (Asset-based)، مخففة الدعم بالأصول (Asset-Light) .

From Structures Supported by Assets to Structures Slightly Supported by Assets: The Complicated History of *Ṣukūk*

ABSTRACT

This paper traces the development of the ṣukūk market through ṣukūk case studies. It discusses how ṣukūk has evolved from an asset-backed structure, where ṣukūk holders have ownership rights over the underlying asset, to an asset-based structure, where ṣukūk holders rank pari passu with unsecured creditors. This paper subsequently highlights the emergence of the asset-light structure, where the requirement of having tangible assets seems to be rather minimal. It also discusses the Sharī'ah concerns that arise in the asset-light structure.

Key words: Sharī'ah, *ṣukūk*, asset-backed, asset-based, asset-light.

¹ . رفيع حنيف يشغل في الوقت الراهن منصب المدير العام لشركة المساهمة العامة المحدودة فجر لرأس المال (Fajr Capital plc)، وهو أيضاً زميل بحث لدى الأكاديمية العالمية للبحوث الشرعية في التمويل الإسلامي (The International Sharī'ah Research Academy for Islamic Finance)، ويمكن الاتصال به عبر البريد الإلكتروني عن طريق العنوان التالي: rafe.haneef@fajrcapital.com .

بيع الدين بالعروض في المؤسسات المالية: دراسة فقهية تقويمية د/ عبد الرزاق عبد المجيد الأرو^٢

المقدمة

بسم الله الرحمن الرحيم، والصلاة والسلام على نبينا محمدٍ وعلى آله وصحبه
لقد تطوّر العمل المصرفي التقليدي فأوجد لمشكلة مخاطر الائتمان ومخاطر السيولة
حلاً يتمثل في بيع الدين، فأصبحت محفظة البنوك التقليدية عالية السيولة؛ لأنّ الديون فيها
قابلة للبيع في أي وقت، في حين أنّ بيع الدين -في الجملة- يعتبر مناقضاً لما قامت عليه
المؤسسات المالية الإسلامية من التعامل اللاربوي.

والدارس لحال هذه المؤسسات يدرك أنّ جلّ عملياتها تتسم بصفات العقود المنشئة
للديون، من مباحة، والبيع بثمن آجل، وإجارة، وسلم، وغير ذلك . فهي بذلك عرضة
للمخاطر ذاتها التي تتعرض لها نظيراتها التقليدية بل قد تفوقها، نظراً لأنّ المؤسسات
التقليدية غالباً ما تتبنى أسلوب الإقراض مقابل فائدة ربوية، بصرف النظر عن ربحية
المشروع المستقرض من أجله أو عدمها.

لقد طرحت -وما تزال- عدّة بدائل لبيع الدين وسيلة لإدارة المخاطر في ال مؤسسات
المالية الإسلامية، بيد أنّ التجارب أثبتت أنّ هذه البدائل هي الأخرى بحاجة إلى تحليل وتقويم
فقهيين قبل الجزم بإسلاميتها من كل الوجوه. ولما كان بيع الدين بالعروض -بدلاً من بيعه
بالنقود- من أهم وأشهر ما تبنته الفقهاء المعاصرون، بل والمجامع ا لفقهيّة وهيئات الفتوى
المختلفة، فقد سلّط الضوء في هذا البحث على مسائل تتعلق بهذا البديل، مبرزاً أهمية مراعاة
الضوابط الشرعية في تطبيقه، وإمكانية توسيع نطاق هذا التطبيق . وقد اشتمل البحث على
ثلاثة مباحث رئيسة، هي:

- المبحث الأول: المسائل الأساسية في بيع الدين بالعروض
- المبحث الثاني: بيع الدين والأسهم
- المبحث الثالث: بيع الدين بالخدمات (المنافع).

وهذا أوان الشروع في المقصود، بعون الغفور الودود.

^٢ أستاذ الشريعة الإسلامية بكلية القانون، جامعة الورد، نيجيريا.

**Selling Debts by Goods in Financial Institutions: Evaluating Jurisprudence
Study by Dr. Abdul Razzaq Abdul Majid Alaro³**

INTRODUCTION

In the name of Allah the Merciful, the Beneficent, and Peace and Blessing of Allah
be upon our Prophet Muhammad, His Family, and Companions.

Traditional banking work has developed so that it found a solution to the problem of the credit and liquidity risks, which is the selling debt. Therefore, the portfolio of the traditional bank has more liquidity, since its debts are saleable in any time, whereas the selling of debts – in general – is contradictory to the prohibition of *Ribā* that characterizes the activities of the Islamic financial institutions.

The examiner of the status of these institutions would recognize that most of their operations have the characteristics of contracts instituting debts. Such contracts include *Murābahah*, sale with deferred price, lease, selling, etc. Hence, they are subjected to the same risks like their traditional counterparts, and even more, since these traditional institutions usually adopt the method of lending money in return of usury (*Ribā*), regardless of the profitability of the project for which such loan was taken, if any.

Several alternatives have been presented for the selling of debts, as a means of risk management in the Islamic Financial Institutions. However, experiences have shown that these alternatives need also to be analyzed and evaluated from the *Fiqh* point of view for rendering them Islamic in their entirety. In view of the fact that the selling of debts by goods – instead of selling them by money – is amongst the most important and famous ideas adopted by contemporary *Fuqahās*, and even by various *Fiqh* academies and Fatwa bodies, as issues related to this particular alternative have been underlined in this research, demonstrating the importance of observing Shari‘ah rules regarding its application along with the possibility of expanding the sphere of this application. The research includes three main themes:

- First theme: Main issues in the selling of debts by goods
- Second theme: selling of debts and shares (equities)
- Third theme: Selling debt by services (benefits).

This time is the starting time to reach our goal, with the help of Allah, the Forgiving, Full of Loving - kindness

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زكاة أسهم الشركات المعاصرة

د. عبد الله الديرشوي، د. عبد الله السماعيل، د. محمد الديرشوي*

المقدمة:

الحمد لله رب العالمين، وأفضل الصلاة وأتم التسليم على خير خلقه سيدنا ونبينا محمد وعلى آله وصحبه أجمعين،،، وبعد

فإن الزكاة أحد أركان الإسلام الخمسة، ومفخرة من مفاخره العظيمة، تتميز عن غيرها من الأركان بتعدي نفعها المباشر إلى الآخرين من أبناء المجتمع المسلم، وبتعلقها بالمال الذي هو عصب الحياة، ومن أهم ضروراتها، وبدورها الكبير في تحقيق التكافل الاجتماعي، والتضامن الأخوي.

ونظراً للتطور الهائل الذي شهده عصرنا في مجال العلوم التجريبية والتقنيات، وما نشأ عنها من ثورة في عالم الاتصالات والمواصلات حتى أضحت العالم معه - كما يقال - قرية صغيرة؛ فقد طرحت ألوان جديدة من ألوان الاستثمارات، تمثلت في الشركات التجارية، وفي مقدمتها ما عرف بالشركات المساهمة، التي لقيت رواجاً عظيماً بين الناس، وإقبالاً لا مثيل له.

ويعود السر في ذلك إلى الخصائص والميزات الفريدة التي اتصفت بها هذه الشركات على نحو لم تتوافر في شركات أخرى، بل في أسلوب من أساليب الاستثمار من قبل كتمكين مختلف شرائح المجتمع من المشاركة فيها مهما كانت مدخرات أحدهم محدودة، وكتمكينهم من بيع حصصهم فيها في الوقت الذي يرغبون، وللشخص الذي يحبون دون قيود أو شروط.

ولما كانت هذه الشركات شركات أموال، وكان الله جلّ في علاه قد فرض في المال حقاً للفقراء والمساكين... بضوابط وشروط معينة، وجب على مالكي هذه الشركات والقائمين على إدارتها التعرف على الأحكام الشرعية المتعلقة بزكاة هذه الأموال، ليتمكنوا من إيصال الحقوق إلى ذويها، وليبرؤوا ذمهم أمام الله سبحانه.

والبحث الذي بين أيدينا يُعرّف بتلك الأحكام الشرعية، ويقدم الإجابة على كثير من الاستفسارات المتعلقة بزكاتها، في ضوء نصوص كتاب الله سبحانه، وسنة نبيه المصطفى عليه الصلاة والسلام، واجتهادات أئمتنا الفقهاء رحمهم الله تعالى. فإن أصبنا فمن الله الفضل وله المنّة، وإن أخطأنا فمننا ونستغفر الله، ونسأله سبحانه أن لا يجرمنا أجر ما بذلنا من جهد،

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وَأَنْ يَدْخُرَهُ لَنَا لِيَوْمٍ لَا يَنْفَعُ فِيهِ مَالٌ وَلَا بَنُونَ إِلَّا مَنْ أَتَى اللَّهَ بِقَلْبٍ سَلِيمٍ , وَهُوَ حَسْبُنَا , وَعَلَيْهِ
وَحَدَهُ اتَّكَلْنَا .

***Zakāt* of the Equities of Contemporary Companies**
Dr. Abdullah Alderschoy, Dr. Abdullah Ismail, Dr. Mohammed
Alderschoy⁴

INTRODUCTION

Praise be to Allah, the Cherisher and Sustainer of the Worlds, and best blessings of Allah be upon our Prophet Muhammad, his Family and Companions

Zakāt is one of the five pillars of Islam, and one of its great attributes, as its direct benefits reach every member of the Muslim society. It deals with money, which is one of the most necessities of life. *Zakāt* has a great role in achieving social unity and fraternal solidarity.

In view of the enormous development witnessed by our time in the field of experimental sciences and technologies, and the resulting revolution in communications, transportation, by which the world has become, as said, a small village. New kinds of investments has been developed, embodied mainly in commercial companies, headed by what is known as joint-stock companies, that received great unprecedented acceptance among peoples.

The reason for that is attributable to the unique features and advantages that these companies have, unlike others, in addition to an unprecedented mode of investment, such as enabling various society groups to participate even with little savings, allowing them to sell their shares at any time they want, and to whom they wish without any limitations or conditions.

Since those companies are association of capital in which Allah Almighty has designated monetary rights for the poor and needy ... according to specific rules and conditions, then the owners and administrators of those companies should learn the Sharī'ah rules regarding the *zakāt* of those funds, in order to be able to deliver such rights to their beneficiaries and fulfill their duties before Allah Almighty.

This research identifies those Sharī'ah legal provisions, and provides the answer to many inquiries about *zakāt*, in light of the provisions of the Book of Allah Almighty and the *Sunnah* of His Prophet "Al-Mustafa" (PBUH), along with the independent reasoning and judgment of the top Jurists (*Fuqhās*) may Allah

⁴ Professor of *Fiqh* and its Principality Islamic Studies Section, Faculty of Arts, University of King Faisal

grant them mercy. If we happen to be right, it is because of the guidance of Allah, and if we are wrong, it is because of us and we ask Allah for forgiveness. We also ask Allah Almighty not to deprive us from the reward of our diligence and to save it for us till the day of judgment, wherein neither wealth nor sons will avail, except him who brings to Allah a clean hearty. Allah alone is Sufficient, and on Him Alone we depend.

مدى تأثير الأزمة المالية العالمية في الاقتصاد السعودي؟ تحليل عبر نموذج بنيوي SVAR د. حسن بلقاسم غصان*، أ.د. فريد بشير طاهر*، د. سلمان صالح الدحيلان♦

الملخص

يهدف هذا البحث إلى دراسة تأثيرات الأزمة المالية العالمية في الاقتصاد السعودي من خلال القنوات الاقتصادية والمالية التي تربطه بالاقتصاد العالمي . وبناء على آلية السيولة الدولية وعلاقتها بصافي الصادرات وبالنواتج المحلي الاجمالي، وانطلاقاً من قاعدة بيانات تمتد من 1968 إلى 2009، تم تقدير نموذج حركي بنيوي . وتم استخدام منهجية دوال الردود الاندفاعية (IRF) بغية تأويل ما نجم عن الأزمة المالية العالمية من صدمات بنيوية في السيولة الدولية السعودية كصدمة في الأسواق المالية العالمية، وكصدمة في السياسات النقدية والمالية.

أوضحت النتائج أن حدوث صدمة سالبة في السيولة الدولية، بمعنى تخصيص مزيد من الأصول الاحتياطية في الخارج لصالح الاقتصاد المحلي، تؤدي إلى نمو الناتج الحقيقي على المدى البعيد بعد تراجع السرعة على المدى القريب . وقد يتيح هذا النمو إمكانية زيادة صافي الصادرات مع احتمال خفض الواردات . ومن المتوقع أن تخفض الصدمات السالبة المفتعلة من طرف السلطات النقدية من أثر التخمة الادخارية (Saving Glut Effect) في الاقتصاد السعودي وتحويله إلى أثر الاستيعاب . بالرغم من أن الصدمة السالبة للأزمة المالية العالمية الأخيرة كان لها آثار عابرة على الناتج، فمن المحتمل أن يكون أثرها دائم في أفق المستقبل .

ترتيب JEL: G1, F3, E6, C5, C32

الكلمات الأساسية: الأزمة المالية، صافي الصادرات، السيولة الدولية، الصدمات، الهزات، نموذج SVAR، المملكة العربية السعودية.

* أستاذ مشارك، قسم الاقتصاد، كلية إدارة الأعمال، جامعة الملك فيصل .
* أستاذ، قسم الاقتصاد، كلية إدارة الأعمال، جامعة الملك فيصل .
♦ أستاذ مساعد، قسم الاقتصاد، كلية إدارة الأعمال، جامعة الملك فيصل .

How the Global Financial Crisis has Impacted the Saudi Economy?**ABSTRACT**

The objective of this paper is to analyze the impact of international financial crisis on Saudi economy through economic and financial channels linking this economy with the global economy. Based on the mechanism of international liquidity in relation to GDP and net exports, and a data base span over 1968-2009, a structural dynamic model is estimated. The framework of Impulse Response Function (IRF) is used to interpret the impact of structural shocks of total reserve assets as a shock on both of international financial markets and monetary and fiscal policies.

The findings indicate that the negative shock in international liquidity i.e. more allocation of total reserve assets abroad, leads to an increase of GDP in the long run, after a rapid decrease in the short run. This growth might stimulate net exports with a possible decrease in imports. The discretionary negative shocks made by monetary authorities may reduce the impact of Saving Glut Effect on the Saudi economy, to transform it instead to an absorption effect. Although the last international financial crisis had temporary effects on GDP, it is likely to have a permanent effect in future horizon.

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 The occasional paper studies the role of *zakat* and *awqāf* in mitigating poverty in Muslim communities. The study addresses the issue by studying the institutional set-up and mechanisms of using *zakat* and *awqāf* for poverty alleviation. It discusses how these institutions can be implemented successfully to achieve the results in contemporary times using theoretical arguments and empirical support.

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Salman Syed Ali
 The paper will serve to increase the understanding in developments and challenges of the new products for Islamic financial markets. The ideas explored in it will help expand the size and depth of these markets.
- HEDGING IN ISLAMIC FINANCE (Occasional Paper No. 10), (2006), pp.150** **Price \$ 5.0**
Sami Al-Suwailem
 The book outlines an Islamic approach to hedging, with detailed discussions of derivatives, *gharar* and financial engineering. It accordingly suggests several instruments for hedging that are consistent with Shari'ah principles.
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 The research presents some issues concerning capital structure of firms under Islamic finance.
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- ISLAMIC ECONOMICS IN A COMPLEX WORLD: AN EXTRAPOLATION OF AGENT-BASED SIMULATION (), (2008), pp. 149**
Sami Ibrahim al-Suwailem
 This research paper (book/occasional paper) discusses the possible use of recent advances in complexity theory and agent-based simulation for research in Islamic economics and finance

- **ISLAMIC MICROFINANCE DEVELOPMENT: INITIATIVES AND CHALLENGES (Dialogue Paper No. 2), (2008), pp. 81.**

Mohammed Obaidullah and Tariqullah Khan

This paper highlights the importance of microfinance as a tool to fight poverty. It presents the “best practices” models of microfinance and the consensus principles of microfinance industry.

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Traductions

- VERS UN SYSTÈME MONÉTAIRE JUSTE, (1997)**, 352 pages **Prix \$ 10.0**

Mohammad Umer Chapra

Ce livre développe avec habileté la logique islamique de la prohibition du *Ribā*, et démontre avec rigueur la viabilité et la supériorité du système de financement basé sur la participation au capital.

Documents occasionnels

- DEFIS AU SYSTEME BANCAIRE ISLAMIQUE, (1998)**, 90 pages **Prix \$ 5.0**

Munawar Iqbal, Ausaf Ahmad et Tariquallah Khan

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ISSN 1319-1616

LDN 14-0721