EDITORIAL

"Chaos (fasad) has appeared on land and sea because of what the human hands have earned. That Allah may give them a taste of some of their deeds, in order that they may turn back (from evil)" (Al-Quran; Al-Rum- XXX: 41).

Human beings and the world economies are caught up, as a whole, in turmoils, misfortunes and catastrophes and no solution seems to be in the minds of policy makers in the foreseeable future. The chaos and the mess are more critical and complex in the areas of economics and finance; and the greater the size of an economy and more it is advanced, grimmer are its problems. The greed and the cut-throat competition are the main feature of the prevalent system due to which the fabric of societies has been severely damaged and the human society is at the verge of devastation. It can be deduced from the holy verse quoted above that the cause of chaos, falling of calamities, business losses and systems breakdowns in the world is commission of sins and other evil acts by the human beings themselves. The situation calls for deep commitment of every individual, organizations and the States for turning to the divine law and to justice, brotherhood and social welfare.

The global financial turbulence is systemic in nature reinforced by the built-in faults and flaws. Money creation and monetary system based merely on debt proliferation and speculative finance is one of the major causes of the chaos in the global economy and finance. The debt based financial systems and the public deficit in both developed and developing countries add to the vulnerabilities of global economy. A labyrinth of financial institutions, namely, the commercial banks, investment banks, asset management firms, hedge funds, mutual funds, savings banks, insurance companies, etc are intensifying the process of widening the gap between the wealthy and the poor. These institutions have been the source of hefty profits and personal wealth for speculators and firms that are active in it. But they serve little, if any, socially useful purpose or function and do not contribute to the betterment of society or the world.

Business principles enshrined in the holy Quran and Sunnah offer an alternative vision of the society. The divine laws are designed to facilitate improvement and perfection of mankind and attainment of the ultimate happiness (*falah*). Already, some serious and wise people are talking of 'ethical' finance that comprises a number of attributes that may have certain impacts on the society and the human beings. The stories about corporate misconduct and financial scandals like that of Enron, Tyco, World Com, ABB, Parmalat, etc tend to relate ethical finance only with disclosure levels and corporate governance focusing on ethical business practices, corporate responsibility and consultative decision-making.

Islamic systems of economics, business management and finance which seek to build a model society and enhance the general welfare of human beings is much more than the main stream ethical finance. A crucial factor missing in all variants of 'ethical finance' is the element of distributive justice and equity, which may be considered as the corner-stone of *riba* and *gharar* free Islamic system. As provided in the Islamic system of finance, enhanced supply of risk-related capital, restricted risk taking, balanced return rate structure based on the real assets backed economic activities, and supply of money commensurate with prospects of growth in an economy, provide a sound basis for sustainable development and evenly shared incomes for socio-economic benefit of the mankind as a whole. Further, Islam's system of corporate governance based on accountability of all to Allah (SWT) is unique and key to many of the present day problems.

For smooth functioning of the global financial system and welfare of the mankind, there is a need for changing the basis of income entitlement from risk-free to risk based techniques and effectively closing all channels of excessive uncertainty (*gharar*) based and other unjust earnings. The system that will emerge from the broader scope would have better ability to sustain in the hard times and help in solving the national and global economic problems. The balanced and pragmatic approach offered by Islamic finance needs to be adopted to cater to the socio-economic needs of the human societies suffering presently due to value and ethics neutral institutions and markets. The Holy Quran proclaims, *"He it is who hath sent His messenger with the guidance and the Religion of Truth, that He may cause it to prevail over all religion, however much the pagans / idolaters may be averse" (IX: 33).*

Over the last three decades Islamic financial system has developed rapidly and a large number of multinational conventional groups are in queue to offer 'Islamic' products. Islamic banking is considered as a must for each bank to be able to remain competitive and to expand customer base. In recent years, it gained popularity even in countries like Japan, France, Italy, Canada, Spain, CIS states, China and Australia.

But the system is currently facing several challenges, the most serious of which is lack of credibility and getting general acceptance from the jurists as well as the general public. Islamic bankers have a general tendency to wrongly exploit the flexibilities that the *sharī´ah* scholars provided them to facilitate entry into the financing field with the risk based modes of real sector business. Particularly since 2001, Islamic finance expanded as an industry to a wider domain to provide derivative products and hedging instruments that are used conventionally for speculation and that were initially considered among the prohibited areas for Islamic finance. With increasing use in the conventional finance during late 1990s, derivatives came into the grey area since 1997 and subsequently permitted since 2004-05. A notable move had been transforming the accessory nature of *w´ad* to the full-fledged contractual structures comprising complicated contracts and deals like swaps and options. Even *musharakah* and *mudarabah*, and almost all equity based *sukuk* structures, got the feature of guaranteed capital and profit. This strikes directly at the foundations of the philosophy and the objectives of the sharī´ah. As a result, *sukuk* have evolved overtime into debt based obligations and the conventional finance experts deem them at par with fixed income conventional bonds. There is a growing feeling that the 'Islamic finance industry' is more about the form than substance and has not lived up to its original ideals.

As a divine system, Islamic finance has to present a new identity based on the *maqāṣid al sharī´ah*. The emerging trends of Islamic finance imply that money creation and monetary management under Islamic framework would also base on debt creation. Pioneers like Nijatullah Siddiqi, and economists like Abbas Mirakhor and many others have already cautioned that mere debt proliferation by IFIs would accentuate inequality by diverting wealth to the supplier of finance irrespective of actual productivity of the supplied finance.

Islamic norms relating to economics, business and finance have the potential to lead the global economy to resolve the problems created by the man-made systems. Practically, however, *sharī´ah* norms are being stretched to meet demands of the conventional system. Islamic financial institutions (IFIs) have opted to apply Islamic principles only in their legal form by employing some stretched juristic rules while the substance has been neglected. Engineered financial products developed by wrongly invoking the tools of '*maslahah*' or '*ḍarurah*' distort the vision of Islamic business and economics as these are leading to the same economic problems as conventional products are already creating. As explained by the jurists, application of both *maslahah* and *ḍarurah* is subject to certain parameters and could provide a legal excuse to commit the forbidden barely what is indispensable for one's survival, spiritually and physically –

for preservation and protection of the faith, life, intellect, posterity and *mal*. Very concept of banking itself is not indispensable for one's survival because if such need hypothetically exists, it could rather legitimize conventional finance itself. In the words of Ibn Taymiyyah, "What constitutes a *maslahah* or a *mafsadah* is subject to the tenets of the *sharī´ah*". Any policy to achieve well-being of mankind must base on the principles and doctrines prescribed by the Creator of the Universe – The Lawgiver himself. What is harmful to be avoided, and what is useful to be adopted, cannot be left to the human mind and reasoning alone.

The only way-out of the present situation could be that the restrictive approach to achieve sharī´ah compliance in letter be substituted with equal focus on the substance. It is possible by application of the AAOIFI standards in true spirit and developing the monetary systems in the light of those standards. AAOIFI has done a great service by providing the Sharī´ah Standards for almost all transactions as per Islamic law of contracts. *Sharī´ah* scholars associated with the IFIs will have to change their policy and sanction only those products whose economic substance is helpful in achieving the objectives of *sharī´ah*. Due consideration must be given to the substance and consequences of the contracts.

The business institutions and the scholars also need to study the Islamic business ethics particularly in the context of various contemporary management theories, corporate governance issues and the concept of social responsibility. In order to develop Islamic business ethics, we need to develop a systematic body of knowledge about their relevance and significance in the contemporary business management and financial operations. As business management is a crucial part of the overall economic activity, we request contributions from scholars and the corporate leaders on various aspects of Islamic business ethics and governance characterized with divine principles of Islam. Particularly, they may focus on how to relate Islamic business ethics to human economic behavior and how to enforce these ethics in the contemporary business world. A section of the RCIB Journal will be devoted to the values-based discussions on human behaviour with regard to economy and business management and to the consideration of ethical values and governance issues. In the present Issue of the Journal we had to cover the Papers and Addresses made in the 1st international Conference on Islamic Business (ICIB-2011) which brought together a large number of scholars, experts, researchers and practitioners from around the. Allah Almighty may guide us to the right path – *Aameen*.

MUHAMMAD AYUB

Remedies of the Financial Crisis: Evaluation from Islamic Finance Perspectives

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Abstract

The paper examines the adopted remedies and actions that deal with the current global financial crisis and evaluates them from the perspective of Islamic finance. For this purpose, it is divided in three sections. Section One gives a bullet points exposé of the basic axioms of Islamic finance. These are: Redefining the finance profession, finance can be provided for profit or for no-profit, Islamic finance is asset based, securities are only seen as representatives of assets, realism and the moral screen in Islamic finance. Section Two discusses the financial crisis and adopted solutions and remedies. Section Three calls for a return to the fundamentals of finance and suggests a road map for the short and long term measures to achieve this purpose. In Section Three we call to reassessing the role and function of the financial sector and suggest reform steps in the short run that consist essentially of taming speculation and eliminating virtual assets and zero sum transactions from the financial markets. And in the long run we call for a four-pillar reform which eliminates speculation and all speculative contracts, provides finance through principles and methodologies based on real ownership, creates a financial ombudsman and set stand-by financial providers.

Keywords: Financial crisis, Islamic finance, Speculation, Zero-sum transactions, Virtual assets, mortgage-backed securities, Financial ombudsman.

1. Islamic finance in a nutshell

Islamic finance is simply a generic name because it happened to be proposed and several of its components experimented by Muslims especially in the Middle East and South East Asia. The fact is: ***Islamic finance is simply a set of rules and axioms*** in finance that have nothing to do with the faith or level of religiosity of persons who use them. This set of rules and axioms is applicable on its own virtue. It does not require any statement of faith and have in fact no religious tint or colour. In other words, the fact is: Islamic finance is purely a civic or secular matter. We do not argue that the origin of this set of axioms and rules is the Islamic *sharī´ah* but we argue that the nature of the *sharī´ah* itself is that it is a set

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of rules and axioms in transactions that do not put forward the faith or religiosity of transactors as an element in contractual relationships. Faith and religiosity are matters that can only be judged by God alone.

Five broad axioms define the pillars of Islamic finance. These are: i) redefining finance to include provision of goods and services on credit, ii) inclusion under the banner of finance of profit and non-profit financial activities, iii) finance must always be asset-based, iv) securities and financial assets are mere representation of whatever they stand for realism; and v) moral screening. The following is a brief statement of these five axioms:

i) **Finance is redefined**: instead of being provision of credit as means of payments, finance becomes provision of goods and services and means of payments without requiring the counterpart to be delivered at the same time. Finance, *á la sharī´ah*, is provided by ways of sale of goods, lease of assets and venture capital. What matters in the definition of Islamic finance is the nature of contract that is used for financing as long as the contractual counterpart is not required to be paid at the contracting time.

   We argue that this definition of finance is more realistic and closer to actual practice than the conventional definition. In fact, it is financing when a company provides goods or services to another company and they agree that payment will be made after a period of time. It is also financing when a customer pays the price in advance for goods that it will receive sometime later and leasing is also a form of finance.

   This redefinition of finance should not be conceived as a negation of the profession of financial intermediation. Financial intermediation is the function of obtaining resources from the surplus units, usually income earners and providing them to deficit units, usually businesses. Rather we argue that financial intermediation is a great invention of modern ages and specialization in finance activities has its great merits as explained by the Founder of Western Economics.[1]

ii) **Finance can be provided for profit or for no-profit:** Non-profit finance is basically financing through the loan contract as well as through donations, gifts, grants and the like. All these transactions transfer ownership of the given object. In the case of lending the transfer is associated by a condition of returning an equivalent object

[1] In Islamic economics we argue that the founder of the Science of Economics is Ibn Khaldun (Circa 1406 CE) who devoted chapter 5 of his *Muqaddimah* to economics.

in the future while in the case of donations, gifts, grants and charities finance is provided without such a condition.

Although it transfers ownership, lending is not an act that produces value. Rather it only transforms the property owned by the lender from cash to debt (it balances outs the liability and asset on the part of borrower). This is why the *sharī´ah* does not accept assigning a return to the lender or in general any debt owners. Whenever there is a loan no return can be earned by the finance provider.

Since the finance sector's activities are profit seeking actions, Loan and other non profit contracts are taken out of the whole picture in Islamic finance. The only use of loan contracts in today's Islamic banking is in deposits in current account. Current account deposits are based on the loan concept. This is why they can be withdrawn on demand and do not earn any return.

iii) **Islamic finance is asset based:** It is asset based because it provides finance through sale, lease and sharing contracts. In all these methodologies the finance provider has to own goods/assets/services, then sell them or lease them or keep them to sell goods or services produced by them.

Sale and lease based finance contracts provide for either party to finance the other. This means that we can finance producer, user or consumer by means of sale or lease contracts. Sharing contracts accommodate a financing partner to contribute to management (*musharaka*) or to stay as a dormant partner (as in *mudaraba*). Sharing also accommodates contracts in which net profit or gross revenue to be the focus of distribution between the finance provider and the user.

This axiom has two important implications:

a) **Earning in Islamic finance is air-tied to ownership:** Finance provider has to own in order to justify any earning or return. Further, whatever is owned must be an asset that can create increment on its own nature in order for the owner to expect a return. An immediate outcome of this is: Owning assets that by their nature do not produce increases does not qualify owners to get any return. This applies to cash kept idle and debt although both are real assets being a claim of the society or a claim on an individual person/entity.

b) **Virtual or non-real assets/goods/services cannot be sources of earning:** Simply because virtual assets are not real and consequently not able to augment or generate increments except in the imagination, virtual assets are totally not recognized in Islamic finance not only for the purpose of financing (producing increases) but also for buy, sell or own.

Accordingly, assets that are not productive by themselves such as units of indexes or options are not recognised as a source of earning. Also all virtual contracts or derivatives that do not make real sale or are not based on ownership of real productive assets are not recognised for trading. This includes some of the well-known contracts in Western exchanges such as CFD and currency betting.

iv) **Securities are only seen as representatives of assets:** This applies to all financial securities. They are only accepted for what they represent. They are just veils or *burka*'s that are considered only for what is behind them or what they stand for. This can be stated in other words to means that *sharī´ah* does not recognize purely financial assets or does not accept the full separation of financial assets from the actual reality.

Accordingly, a promissory note, a bond and a bill of exchange are treated as debts and to them all the rules of debts apply with no exceptions. A share in a company is considered a partial ownership or in common of the composite of the assets (minus liabilities) of the company including its market evaluation. All securities that do not represent real assets, such as indices, options and insurance derivatives are not recognised as return-producing assets and cannot be purchased, owned, sold while securities that represent debts are only tradable at face value on the ground that they are just debts. This means that a large mass of trades in conventional markets are considered inappropriate from *sharī´ah* point of view.

Realism is another essential axiom of Islamic finance**:** realism means that transactions should be meant for what they are. This applies to finance contracts as much as it also applies to assets.

For instance, finance through a sale contract must intend to transfer the ownership of the goods to a purchaser who means to obtain them. A violation of this axiom would be if the purchaser uses the contract to obtain cash instead of the goods themselves.

This axiom puts all speculative transactions that take place in regulated exchange markets in a corner of doubt. It is difficult, within the

Islamic precepts of finance to accommodate most of what is called "trades" or "investment" in stock, commodities, metals and currencies markets.

On the basis of this axiom all zero-sum transactions are completely ruled out. Additionally financial assets are also screened for realism and all "non-real" assets are removed from the basket of Islamic finance.

v) **The moral screen in Islamic finance:** Islamic finance is committed to a given moral screen defined strictly by what is humanly confirmed harmful in contrast to what is humanly confirmed beneficial. Any substance that is confirmed, according to human knowledge as harmful cannot be owned and consequently cannot be financed. This includes things that are prohibited in the Qur'an and things that are not mentioned in the Qur'an. Activities that are outside the basket or portfolio of Islamic finance include: alcoholic drinks, drugs, porno industry, gambling, tobacco industry, adult entertainment, military industry and the list may increase.

2. The financial crisis and its remedies

I will begin from the end, from the reform measures which we hoped they should deal with the financial crisis in a way that not only cures the crisis effects but may also prevent its recurrence in the future. This was probably the same hope of reformists of the 1930s who thought they were going to achieve after the 1929 crisis. Actually that hope never materialized and I am afraid now again we are not tackling the real causes and issues. The real issue is to come back to truth with ourselves regarding the role, function and nature of the financial sector. This I will come back to later in this paper.

In this Section, I will focus on the bail-out and rescue efforts that have taken place over the past two year since the fall of Lehman Brothers in the Fall of 2008. I will look into the measures of remedies and the endeavors of reform in the United States over the past 2 years… Three major Bills make the subject of this Section: The rescue and bail-out Bill of the Bush Administration that was adopted hastily in Oct. 2008, the Economic Stimulus Bill of the early time of Obama and the financial restructuring Bill that was finally adopted in the Summer of 2010.

The first step taken by the Bush Administration was bailing out the big 'Financial Wrong Doers' by buying their illiquid mortgage-backed securities and other bad assets for about Seven hundred billion dollars.

Was it a reward for what they did? Or was it a use of tax-payers money in order to retain and keep their big hand over the American economy?

Under the Emergency Economic Stabilization Act of 2008 (the official name of the Bush Bill) little restrictions were imposed on the big wrong doers in the bill and no changes were introduced in the financial system of Wall Street. Rather, the big banks were further rewarded by accelerating the start of interest payment on their required and accrued reserves with the Federal Reserve System that was made to begin on Oct. 6th 2008 instead of the previously scheduled date in the year 2011. This increased the bank liquid reserves deposited with the FRS from about US$ 10 billion at the end of august 2008 to 880 billion on the 2nd week of Jan 2009. Just 88 times in four and a half month! This liquidity increase happened at the time when the funds were withheld from industrial companies, a fact that lead to huge increases in layoffs and unemployment.

This Bill also increased the public debt of the American people to a record of 11.3 trillion (the American public debt had to soar further to 14.3 trillion in Feb 2010, just in a year time, thanks for more bailouts and more wars' spending by the Nobel Peace Prize Winner!).

In Feb 26, 2009, just one month after he assumed his responsibilities as president, the Associated Press reported that "President Barack Obama anticipates another $750 billion in bank bailouts this year (2009), a step that would more than double the direct infusion of taxpayer money into the reeling financial sector."

Then came the American Recovery and Reinvestment Act on Feb. 2009 with a US$ 787 billion stimulating package to help relieve the economy from further bankruptcies caused by the "financial wrong doers." This package is almost evenly divided between tax reductions, extended employment benefits and enhanced job creation Federal contracts and grants with the aim of stabilizing the real side of economy and halting further layoffs and drops in employment rates. This Stimulus Bill, as commonly known, was introduced by the new team of the Obama administration and was made required to remedy some of the setbacks caused in the American real sector by the financial mishandling of the Wall Street Firms. The total anticipated spending of US$ 787 Billion is distributed over ten years but more than one third of it was actually spent by Oct. 2009 and a total of 720 billion is to be spent by Oct. 2011, almost 92% of the entire amount of the bill in the first two and a half years.

The last major remedy was the Bill of Financial Services Reform which aimed, at the beginning, to completely overhauling the American financial system. But since it was introduced in the House, it had one set back after the other and finally lamely passed in the House in Dec. 2009 and in the Senate in June 2010. Interestingly in Late 2009 G. A. Miller on minst.com reported that lobbyists have spent more than $300 million that year trying to shut the bill down). One of the last watering down of this reform bill was dropping the idea of the governmental unified council that was to supervise the finance industry.

It is very clear that financial institutions and their lobbyists have had a heavy hand in reshaping this bill of reform in order to make it a shadow of its former self. It has become unclear whether the consumers and taxpayers will be better off after the bill passed by the Senate in early June 2010.

This new legislation is described by President Obama as it "brings us another important step closer to necessary, comprehensive financial reform that will create clear rules of the road, consistent and systematic enforcement of those rules, and a stronger, more stable financial system with better protections for consumers and investors," The Speaker of the House Nancy Pelosi said: "We are sending a clear message to Wall Street, the party is over. Never again will reckless behavior on the part of the few threaten the fiscal stability of our people" and "The legislation will finally protect Main Street from the worst of Wall Street."

The way it was approved lastly, this Reform Bill has three main features 1) creating a consumer financial protection agency that will deal specially with credit card and mortgage financial products from the point of view in forming and protection consumers especially in the area of changing phase and interest charges; 2) increasing the power of a governmental supervisory board to become able to dismantle failing large financial firms; and, 3) putting some caps on certain derivates through increasing the power of the federal reserve board and the Security and Exchange Commission to scrutinize derivatives. The bill also provides for a very modest emergency fund of only US$ 30 Billion that can be tabbed when troubled companies need to be dismantled or acquisitioned.

2.1 Analysis of the Reform Measures

It is apparent that the bailout Act of Oct. 2008 was adopted hastily within three weeks after announcement of the crisis and many economists as well as politicians later declared that the Bailout of big financial wrong doers should not be an approach the government should take. There were many cries that if a company fails then let it vanish and disappear. Nancy Pelosi declared upon voting the Financial Reform Bill in Dec. 2009 that protecting the Main Street from the "worst" of Wall Street is an essential aim.[2]

The Bailout was a Bill of rescuing the wrong doers not the economy. Alternatively using seven hundred billion Dollars for direct retail finance to companies on the real side of the economy could have reduced the speed of layoffs, preserved the incomes of more than ten million employees and saved the real economy from further dives down. In early March 2010 the news brought us a move by President Obama indicating that we seem to have begun realizing the need to directly finance the real economy. It was a meager start with only US$ 30 billion in funds apportioned for helping companies avoid laying off employees. This is in sharp contrast with the 750 billion of the Bush administration that was given to the Wall Street firms, for neutralizing the Wall Street wrong players' finance-withholding effect on the real economy. This new Fund is announced to implement the idea of directly financing companies, should finance from the big banks be withheld.

The Obama Stimulus Package of early 2009 is a step in the Keynesian economics direction to increase incomes of the middle class and to create jobs using federal government's deficit. A deficit that has already been fattened may be to an irreparable level by the effect of the Bush Administration wars' spending and previous bailouts.

Finally the Financial Reform Bill was toned down in the house and later in the Senate. It was greatly watered down before it could become a law. While creating consumer protection emergency, taming derivates and increasing the government power of intervention to break up 'the Worst of Wall Street Wrong Doers' are steps in the direction. They are neither sufficient to bring about healthy recovery to the American economy nor adequate to enhance the world economy because they do not deal with the fundamental issues of redefining the financial sector and putting it in its right and appropriate track in the grand puzzle of the socio-economic setting as a whole especially in a world that has become a mere small village with interlocked economies that are polarized around one leader.

To bring the financial sector to its real function in the economy as a sector that serves the real side of the economy which in its turn takes

[2] CNN Money.com Dec.11.09

charge of producing wealth and creating surplus we need more fundamental changes and more rigorous approaches that seem to be still far away from the Anglo-Saxon ideology of economics and finance.

3. *La solution Islamique*

I like to begin this section with a short-story.

Once upon time, there was a very proud king and two very smart tailors who announced that they were going to make an extraordinarily gorgeous, marvelous and unique cloak for the king that he can wear only at the parade celebration on the National Day of his assuming the throne of the kingdom. The two tailors worked hard day and night on their claimed exceptional suit but actually worked harder on creating an image and propaganda of their great job putting announcement on newspaper, advertisement on the internet, radio and T.V. and on street boards with all side attraction such as girls in bikinis about their spectacular-to-be costume of the king. On the day of the parade and exhibition the two tailors stood proud by the king and with their own hands helped the king wear the incredible dress. As the king started parading everybody in the crowded lines around was admiring the beautiful suit of the king until a child climbed his father's shoulders and noticed that the king was in fact naked then the word passed through from one person to another like a thunder. It was an eye opener and everybody realized that the king was in bare exposed and that they were living under the illusion of advertisement and propaganda!

3.1 What is finance and what is the function of the finance sector?

We have created so much of virtual economy by our un-limited imagination of what we call "financial engineering" and we have created around this virtual finance images of wealth creation, wealthy people and highly paid senior professionals and CEOs. We went on playing with virtual wealth so much so that we believed our own imagination and illusionary creation. We thought that creating virtual wealth is an economic function and that the financial sector, on its own, is a place where wealth is created.

We have built virtual assets and virtual wealth and continued building them. We were so much over-ridden by the beauty of structured and later standardized financial derivatives that we refused to accept even simple facts such as "fictitious assets are not assets." We regarded trading indexes as best way of trade although indices do not represent assets. We continued to believe our fiction-created wealth until an eye opener came in the form of major crises of wealth vanishing and meltdown, laying off workers in the millions, decline of production and increase of poverty. One crisis after the other that roam the whole world from South East Asia, to Russia, to Brazil, to America, to Iceland, to the UK, to Greece Ireland and Portugal and to cover the whole world!

Unfortunately even these eye openers did not yet show us the basic underlying truth of what went wrong. Is it a failure of the market system itself, inadequacy of regulations, imperfection of human rationality, lack of self discipline on the part of economic/finance players, or is it drifting from real economy to virtual economy?

One of the plain realities is that “lending does not create wealth” regardless of whether lending takes the form of short sale, debt securitization or interbank transaction. A loan contract only transfers ownership with neither increase nor decrease in its amount. This naked truism is as simple and as basic as if we all work as lenders/borrowers one to the other, who is going then to increase real-life wealth and create an added value and from where would the due interest, one on the other come from?

Furthermore, finance is useful in as much as it helps increase the ability to create wealth in the real sectors of production and exchange. The only way for finance activities to achieve this goal is by augmenting embodied and non-embodied capital. This is done exclusively by increasing goods, assets and services (like education).

Finance becomes destructive and harmful when it withdraws resources from production and exchange. This means that the very foundations of finance provision should be such that they can connect finance activities forcefully and exclusively to the production and exchange sectors.

It is necessary to change our basic philosophy of this relationship between finance and wealth creation in such a way that makes any financial earning strictly a reward for contribution to production and exchange, i.e., to wealth creation.

3.2 Let us come back to basics

The most serious foundational problem was a result of a persistent and intensive disorientation of the finance sector by confusing its support and service functions with the wealth creation function that is carried out only in the real production and exchange sectors. We confused “wealth transfer” with “wealth creation” and we thought that lending and virtual based activities that only transfer wealth actually create wealth. The assignment to finance of an unfair, incorrect and resource-diverting “wealth-transfer” task through a quasi gambling approach is in the heart of the financial crisis or rather crises. The solution must be in the direction of taking back the finance sector to make it play its supportive role and re-diverting financial and human resources again out of speculation back to enhance and help wealth creation activities.

The fundamental issue is to bring back the finance sector to play its appropriate role that is a role of financing. We want a finance sector that helps rather than disturbs, distorts and distracts. We need a finance sector that facilitates the channelling of funds to the productive sectors instead of attracting funds and other financial and human resources from the productive sectors to speculation. Eliminating speculative contracts and removing zero-sum contracts do not mean that we will sacrifice the hedging needs of financial and other institutions. Of course, I do not call for neglecting the needs of economic units and financial institutions to hedge the risks, manage risk distribution and deal with liquidity challenges.

The worst of dangers of the cancerous over-growth of the finance sector and the transformation of industrial capitalism into financial capitalism is the creation of a mentality of “getting a quick buck.” If you can become wealthy by a click on the computer why should you invest in creating new companies, new products and new productive facilities and establishments? This has devastating effects on the economy similar to the effects of corruption of which economies of the world ache today!

From this angle the Reform Bill brings a good change by its curbing on derivatives but it does not go far enough to make us expect a visible or substantial reduction in the virtual economics of the Wall Street financial establishments.

Going back to basics should also mean tearing down the illusions that made the finance sector attract and withdraw resources, financial and human alike, from the sectors that create wealth to activities that are merely speculative and wealth transferring. To go back to basics, we need to tame out all activities that are not related to or in support of the channelling of financial resources to the wealth creating lines.

While effective regulatory and supervisory powers over the Wall Street type of economy are an important and useful step in a process to tie the knots of financial practices, elimination of the cancerous cells (contracts) that have over grown the whole body of finance sector is more important and more essential.

3.3 Fundamental rules of the financial reform

The ideology of financial capitalism needs to be changed or discarded all together and we need to create different convictions and different foundations of our eco-financial thinking. We need to re-structure our ideology around the simple and fundamental truism that the function of the finance sector is only and strictly to help and service the production and exchange sectors. This can only be done through functionally integrating finance into the productive activities of production and exchange.

A few basic principles/rules should make our fundamental guidance as well as our driving financial ideology to a healthy integration of finance into the productive sectors:

The rule No. 1 of financial reform should be: “you can only earn if you own an asset that creates wealth”. This reflects the factual truism of real life that only real assets create wealth. A transfer of debt from one person to another does not increase wealth in the economy nor does it increase the wealth of either party in the deal. It is therefore not a productive transaction and it should not be a source of earning. In other words, debt secularization transfers risk but does not create wealth and we must not mix up a process of wealth transfer with a process of wealth creation.

Besides, debt transfer and debt securitization reduce the risk of the debt creator/initiator especially when you add to it debt insurance and debt insurance derivatives. This process relieves the debt creator from the hook and creates a low level of responsibility and reckless due diligence.

Additionally, debt securitization and debt trade create a domino effect from which we suffered a lot to an extent that convinces us to better live without it in finance.

Another kind of Wall Street practices not based on owning real assets that create value is speculation. Speculative contracts that are zero-sum contracts do not create wealth. Therefore speculation should be tamed. Purely speculative contracts should be removed from the financial market. In a world of a hundred year ago that had no quick, easy and direct contracts we may have needed market makers and speculators to help reveal prices but in the world of today with its modern communication facilities where producers and users of all kinds of goods can meet on the internet we need not these market makers that profiteer from shouting prices! Our time and communication facilities had already surpassed them. Get them out of our way!

The rule No. 2 of finance reform should be: "trading fake assets only transfers wealth but does not produce it." Therefore, we should remove from the financial markets all fake assets and all fake transactions. What increases in wealth we produce, if we place in a warehouse hundred tons of wheat and a few hundred people sit there shouting prices around the wheat pile all day long, then at the end of the day they go back home only with a distribution of same amount of cash among themselves, different from that they started with in the morning? Do we really need a hundred fake transactions in the wheat market in order to discover the price of one transaction that will move ownership of the product from farmers to the flour mill's owner?!

Because we changed the objective/function of the finance market from supporting and servicing farmers and flour mills' owners to a 'manipulated or not' redistribution (transfer) of wealth among speculators, it has become only logical to do away with the wheat pile all together and instead we trade any virtual imaging or mirroring or even 'presumed' pile of wheat that allows us to speculate or shout prices. This is what has been called in the classical Islamic centuries-old literature "trading thin air." Consequently, instead of trading commodities we went on to trade indices, options, CFD's and futures. I wonder, if we believe our illusion that this kind of transactions creates wealth, why don't we supply farmers with internet connections instead of land and seeds so that they trade futures instead of cultivating food stuff?

The rule No. 3 of finance reform should be "make finance only available to morally acceptable products/services" so that products that harm human beings and other creatures around us and/or products that hurt the environment of mother earth, the home of our grand children, naturally, physically, spiritually and/or socially, should not have accessibility to funds that are collected from the public at large under all/any schemes of deposits of the financial sector's institutions.

While the Reform Bill's creation of a consumer protection agency in finance is another good step in the right direction, what is needed more than consumer protection is stakeholders' protection through a morally-based government-guided market-intrinsic protection agency that should be assigned the task of monitoring and screening new financial products before they are adopted in the market. Such an agency can follow up on financial engineering and market practices where the outside regulator can only reach them with a lag at a later stage/time.

3.4 Operationalization of the new finance ideology in the short run

We need to eliminate all zero sum contracts so that speculation can be reduced. Contracts like index trading, CFD (Contract for the Difference), currency price betting, internet currency trading, and their likes, all such contracts should be withdrawn from the finance market and their licensing for trade be cancelled. They should be eliminated and taken out of the organized financial markets so that we do not assign resources for purely speculative transactions and we do not allow these speculative contracts to unrealistically affect the price movement. If someone insists of individual freedom of trading anything, these contracts then may be placed in casinos along with other gambling products that require special licensing and special areas of trade.

Commodity and currency futures should be gradually restricted. This should be done in the direction of bringing them to reality so that the ultimate goal would be that only non-speculative transactions can be undertaken. It is not difficult in the present world with its means of communication and open markets that we restrict trading commodities and currencies in organized regulated markets only to real units that deal with these commodities and currencies as real suppliers or real demanders. All the arguments about the role/benefits speculators provide in the market do not apply in our modern hyper I.T. systems because we have sufficient number of real economic units that achieve the benefits of this role. We can impose restrictions in the form of market registration whereby only these economic units that are related to a given commodity can trade it. The objective is to tame speculation and re-divert resources of all ‘Jumpers on prices’ to real investment rather than commodity and currency speculation.

Hedging through futures or options can still be available but only to those who have existing future asset or liability positions. There are plenty of them in the real market that will create real exchange relationships.

Certain forms of behaviour can also accommodate more regulations such as imposing restrictions on day trading, lengthening the process required for a trade before it can be reversed and de-listing the market makers and kicking them out of the organized financial markets.

Short sale should not be available as a way of speculation. This can be achieved by increasing the margin to a high limit that may reach 100%, dis-allowing lending of shares and depriving short sale from benefiting of any financial facilities including margins.

Speculation in commodity, currency and equity markets can further be reduced by drying out its financing sources. We should deprive those who distort our finance system from any leverage under whatever name this may be. What is the economic benefit that can be brought about by juggling names hundreds of times a day on titles of equities, commodities and currencies?

Debts securitisation should be restricted to interlinked institutions within same holding company in order to force a financial institution that accepts a debt to bear all the consequences of its debt itself alone or with its sister companies within the same holding company. This will increase due diligence and precaution exercised in debt creating.3

Finally, financial market accessibility should be reduced from 24 hours 7 days a week across the globe to an extent that is barely sufficient to provide needed liquidity in the market, an extent that sustains transacting real exchange and supports real production.

3.5 In the Long Run

In the long run, there are four golden pillars of reform.

The first Pillar of reform should be genuinizing organized markets. This can be achieved by revising regulations and trading requirements in the equity markets and stock exchanges with the aim of making speculation on shares difficult. Liquidity in the equity markets is an indispensable element that will not be sacrificed. But liquidity requirement is different from speculation. Speculation creates excess but only artificial liquidity. It raises prices undesirably and creates a false illusion of profits. We must not let go on speculation in equities. Sufficient liquidity in the equity market can be obtained by opening stock exchanges across borders while we regulate stock trading in such a way that eliminates speculative commitment of liquid funds.

Along with genuinizing the equity markets we will need also to genuinize futures and options whereby the many folds multiplication of transactions will not be permitted. The same should also equally apply to

[3] Interestingly in the current crisis retail finance companies maintained better status than wholesale finance providers because they were always able to throw the bug on the latter.

currency markets. All derivative trading should be eliminated so that derivatives can be issued but only exercised or let die, they should not be traded.

The second Pillar of reform in the finance sector is to strictly channel all finance activities through the venues of sale, lease and venture capital (sharing). This means the removal of loans from the finance sector and the de-legalization of interest.

When finance is provided strictly through lease, sale or venture capital contracts we would be creating a one to one correspondence between the financial sector and the real sector so that finance would be issued only to enhance real market production and exchange. By their very definition, such regulations would eliminate interbank debt-based transactions and remove all forms of debt securitization; both activities do not produce or create value. On the other hand, not only that finance will simply become a supportive activity of the real market but also there will be a huge reduction in the layers of financial assets that are built in the current system above a narrow layer of real market. This would remove, eliminate or at least drastically reduce the up-side-down pyramid phenomenon of financial capitalism and would bring the system back to a more stable wide-based real market. Once this second pillar is put in place, financial assets would become mere representation of real assets and cannot, by their very nature, overgrow the real side of the market. Furthermore, this methodology of defining finance and financial contracts would remove all parasitic uses of funds from the finance sector and throw back loans to the arena of personal relations instead of being economic/business transactions.

The Third pillar of the long run reform is to strengthen the stake-holders protection agency to become a real financial ombudsman by giving it the authority to protect the public interests in the process of financial engineering and requiring all new products to pass through this financial ombudsman.

In fact, an ombudsman is needed not only in the finance market but also in other markets so that we can reduce speculative transactions that waste resources and hurt consumers. In this direction the government of Singapore started measures to restrict speculation in the real estate market (as reported on news of Feb. 20/ 2010). A permanent financial market ombudsman is needed to check and control the potentially harmful untrue financial products that may destroy wealth and transform our economy into a virtual one.

The fourth Pillar of the long term reform should be the creation of stand-by finance provider(s) that can remove the harmful effects on the real productive units/corporations of repetitive mishandlings by financial conglomerates. Self destructive mismanagement of the wall-street financial giants must not be allowed to halt the functioning of companies and institutions that work, in the real market, on creating goods and services and on producing income and employment. Such stand-by financial institutions may count on the tax-payer money and would provide return-generating finance to companies in order to prevent the downfall of companies that depend on financing extended by big wall-street players. It would have been an amazing exercise to simulate the results on income and employment that could have been obtained had the seven hundred billion dollars finance package of the Bush administration been used to finance real market companies instead of spending them to save the financial firms.

4. Conclusion

As a conclusion we should look forward to a world that is clean of financial (and other kinds of) corruption and its affects that hurt and distort the very desire to produce. We should look for a post financial capitalism era in which the financial sector plays a production role based always on ownership contribution to the economy rather than provision of interest-based debts; an economy in which the government and the Ombudsman as stakeholders' protection agencies can work together to the benefit of all instead of allowing speculators an ability to divert recourses from real production into a culture of "snatching the other guy's money."

Challenges of Transforming Riba-based Government Debt in Pakistan to *Sharī´ah*-Compliant Instruments

Riaz Riazuddin*

Abstract

Substantial progress was made in Pakistan during the first decade of twenty first century towards the transformation of financial activities to *sharī´ah* compliance. This was based on earlier work of many scholars spread over several decades after the inception of Pakistan. The parallel approach adopted in the country has the potential to reach the ideal, if and only if, concerted efforts from key national institutions continue to move forward. Progress has been much slower in respect of Islamisation of government debt obligations, although the *sharī´ah*-complaint instruments have been used successfully by the private sector to mobilize resources through *musharaka* based TFCs. This paper identifies the causes for slower growth and the benefits of overcoming the challenges which are: eliminating the domestic debt held by the central bank; acquirement of *sharī´ah* compliant debt obligations by SBP to conduct monetary policy; challenges relating to the issuance of Government of Pakistan (GoP) *Ijara ṣukuk* - limited availability of non-encumbered government assets*;* creating appropriate non-interest-based benchmarks for linking *sharī´ah*-compliant returns and gradually transforming the mindset of investors towards broader acceptability of *sharī´ah*-compliant products through publicity campaigns. The paper suggests that an asset survey be undertaken by the government to identify and document the assets for enabling future *ṣukūk* issuances. Some other suggestions are also offered to speed up the process of transformation towards *sharī´ah* compliance

Key Words: GoP; Ijarah ṣukūk; Sharī´ah-compliant instruments; Definition of Riba, Central Bank Balance Sheet; Ibn Khaldun; Inflation targeting.

1. Introduction

Substantial initial progress was made in Pakistan during the first decade of twenty first century towards the transformation of financial activities to sharī´ah compliance. This was based on earlier work of many scholars

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spread over several decades after the inception of Pakistan1. Much earlier, Allama Muhammad Iqbal very clearly enunciated the need to transform the financial system to sharīʹah-compliance in his Persian Mathnawi "*Pas Cheh Bayed Kard Ay Aqwam-i-Sharq*' (What Should Then Be Done O Nations of the East?)[2]"

ایں بنوک، ایں فکرِ چالاکِ یہود　　نورِ حق از سینۂ آدم ربود
تا تہ و بالا نہ گردد ایں نظام　　دانش و تہذیب و دیں سودائے خام

These banks, the result of clever Jews' thinking,
have taken away God's light from the heart of man.
Unless this system is destroyed completely,
Knowledge, religion and culture are mere empty names.

Although the present situation is far from the above ideal, the parallel approach adopted in our country has the potential to reach this ideal, if and only if, concerted efforts from key national institutions continue to move forward. Since the adoption of a three-pronged strategy by the SBP and the establishment of the first full-fledged Islamic bank (Meezan Bank) in 2002, together with opening of stand-alone Islamic banking branches of conventional banks, steady progress has been witnessed in their evolution. The share of Islamic banking assets to total banking assets increased from 0.31% in December 2002 to 6.4% in September 2010. This gradual transformation was achieved by a remarkable performance of Islamic banks whose asset growth outpaced those of conventional banks by a wide margin during this period.

Progress was much slower in respect of Islamization of government debt obligations, although the *sharīʹah*-compliant instruments were used successfully by the private sector to mobilize resources through *musharaka* TFCs. The first rupee-denominated [3] *sharīʹah*-compliant

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[1] Aurangzeb Mehmood (2002) provides a review of these efforts starting from the inception of Pakistan. Efforts during 1988 to 2003 are detailed in Chapter 14 of History of the State Bank of Pakistan 1988-2003.

[2] Allama Iqbal wrote this *mathnawi* (long poem) in Farsi in 1933 after his visit to Afghanistan (along with Syed Suleman Nadvi) at the invitation of then Ruler of Afghanistan.

[3] In Pakistan, the first *sharīʹah* -compliant Euro-denominated *ṣukuk* was issued by the Government of Pakistan in 2005 to raise foreign exchange to finance current account deficit.

instrument was issued by the government in September 2008[4]. Since then, the share of GoP *ijara ṣukūk* has gone up from zero in June 2008 to 1.8% in November 2010 in government domestic debt. It seems that the transformation of government debt to *sharī´ah*-compliant instruments is much more challenging than the transformation of conventional banking instruments. Why is that so? Table 1 provides a glimpse of the enormity of transforming Pakistan's total debt and liabilities to *sharī´ah* compliance. This paper identifies those challenges only for the major part of total debt and liabilities due to Government Domestic Debt and also notes that there are great benefits embedded in overcoming each challenge from macroeconomic management point of view. Some modest suggestions are also offered to speed up the process of transformation towards *sharī´ah* compliance.

2. The First Challenge: Getting Rid of Government Domestic Debt held by the Central Ban

The stock of outstanding government domestic debt stood at Rs 5294.7 billion as on December 2010 as shown in Table 2. Outstanding amount held by SBP stood at Rs 1432.5 billion or 27.1% of total domestic debt. Accumulation of this debt comes about through a seemingly innocuous financial transaction between GoP and the State Bank of Pakistan. With a very simple book entry, SBP credits the Rupees required by the government and book a liability as well as an asset (called Market Related Treasury Bill) in SBP books of accounts. The simple nature of this transaction conceals one of the greatest financial evils invented by financial wizards. This evil is recognized well by the scholars and economists all over the world, yet continues to be still practiced by some governments, leading to creation of excessive or hyperinflation.

What is wrong with this simple transaction and why this should be banned altogether? The answer, coming from "common sense" is also very simple. The money or purchasing power created in this manner, and transferred to the government, comes out automatically, without any real productive business activity, taking place neither in present nor in future. This is a unique kind of loan, where the principal created also seems to be very similar to *riba*, not to mention the interest received by the SBP which definitely falls under the following definition of *riba*:

[4] The details of rupee-denominated GOP *Ijara ṣukuk* are provided in SBP, FSCD Circular No. 13 dated September 06, 2008. Annexure-"C" of this circular, which explains the structure and documentation, is also annexed with this paper for ease of reference.

> "*Riba*" means any stipulated payment over and above the principal lent in consideration of the time given for repayment, either on simple or compound basis, or any discount given on assignment of debt or any financial paper representing money".

Above definition is from the Report of Raja Zafar ul Haq Commission[5]. This Commission took a perplexingly lenient view of the government borrowing from SBP by stating that "Government's transactions with the SBP are of a book-keeping nature. It is proposed that Government would no longer pay interest on SBP holding of TBs; future borrowings will continue as before except that it would be on non-interest basis".

As pointed out earlier, the "principal" created through a book-keeping entry by SBP seems to be clearly a kind of *excess* over nothing and, therefore, seems to be a grave injustice and resembles *riba* in its essence. Some of the arguments that establish this similarity are as follows:

i) With this transaction, a rupee amount (Principal) is transferred by SBP to government. While this transfer is between only two parties (SBP and government), an injustice is created that affects every agent in the economy through increase in prices due to excessive printing of currency.

ii) According to Baeck (1991), "For Al-Maqrizi, price inflation caused by monetary manipulation was not just a monetary phenomenon. A sick currency was the product of a morally sick society."[6]

   Principal so transferred results in debasement of currency, but enhancement of SBP balance sheet. Extent of initial debasement is due to transfer of principal, which is augmented by further debasement when SBP realizes the accrued interest on this transaction. SBP (the lender) gets an advantage of "profit" through this transaction. Currency is debased even further when SBP transfers its "profits" to government and if it spends this on any activity other than retirement of existing debt.

iii) According to Islahi, "Most Islamic jurists hold the view that a loan involving any advantage or benefit to the lender comes within the meaning of *riba*."[7]

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[5] Report on elimination of *riba*, Commission for Islamisation of Economy, Government of Pakistan, August 1997.
[6] Baeck (1991), p. 111.
[7] Islahi (1988), p. 136.

iv) Principal so transferred creates a deception in the minds of many agents that government can use it for real beneficial activities like economic development and alleviation of poverty.

v) According to Islahi (1988), "Al-Ghazali also warned about the consequences of debasement of the monetary unit." He (Al-Ghazali) says: 'To put a bad money into currency is an injustice for the reason that the person who makes a transaction with that money is harmed.' He further writes: 'Circulation of one bad dirham is worse than theft of a hundred dirhams, as theft is one sin and it is finished once for all; while spending bad money is an act of evil which affects all those who use it.'[8]

vi) In reality, the principal so transferred has come about because of the decline in value of rupee held by each agent in the economy (either rich or poor). In other words this transfer has actually robbed many agents through creation of inflation tax (imposition of this tax does not require the approval of parliament!).

vii) Islahi (1988) quotes from Ibn Taimiyah that "All evils (such as injustice, exploitation, etc.), on account of which interest is forbidden, exist in these transactions, perhaps with a greater degree of fraud, cheating and troubles."[9]

viii) This transfer worsens the income distribution because the poor become poorer and the severity of poverty increases due to excessive inflation. While the rich are also negatively affected, but the extent is lower compared to those of poor.

ix) According to Islahi (1988), Ibn Taimiyah "… opposes debasement in the currency and over-production of money." He (Ibn Taimiyah) says: 'The authority should mint the coins (other than gold and silver) according to the just value of people's transaction, without any injustice to them.'[10]

So besides describing this challenge of getting rid of inflationary debt, I also ask a simple question to *sharī´ah* Scholars, "shouldn't this transaction between SBP and government be prohibited completely?"

The current outstanding level of this debt is so high that it is difficult to envisage its elimination in a short period of time. A proposed

[8] *Ibid*., p. 240.
[9] Islahi *op cit.* p. 135.
[10] *Ibid*., p. 141.

amendment in SBP Act, 1956 envisages limiting this outstanding debt to a maximum of 10% of government revenues of previous year. A five year period is envisaged in the amendment bill to allow the government and SBP to bring it down from over 68 percent in December 2010 to 10% in a period of 5 years after this amendment becomes effective. This bill has been discussed and cleared by the National Assembly and awaiting Senate’s approval for legislation.

This challenge will remain even after the legislation of enhancement in SBP powers. The government has to credibly commit and adhere to this law by lowering its deficit financing requirements. On the other hand, the SBP has to enforce this by not lending excess amounts. The real test for SBP will come after lapse of 5 year period allowed to government to reduce this debt significantly. Despite the enormity of this challenge, a significant portion of SBP debt can be reduced relatively easily, even from existing financial resources of the government of Pakistan. This assertion may seem surprising, but nevertheless true, as can be seen by looking at Table 3 which lists existing fiscal and financial resources of the government. The most surprising thing to note is the presence of surplus cash balances of government and public sector enterprises lying unutilized in several commercial banks (not with SBP). These balances together amounted to Rs 913 billion in December 2010, which means that 63.7 percent of SBP debt can be potentially retired by the use of existing resources. While this cannot be done with a stroke of pen at once, a practical approach would be to gradually withdraw these balances (say to the tune of Rs 20 billion per month), so that banking system is not suddenly affected with large withdrawals. If this advice is followed, stock of SBP debt can be reduced by Rs 480 billion in just two years. Furthermore, with the passage of time and government’s commitment to future reforms, a complete elimination of government domestic debt held by SBP is likely to become a reality within seven years of the pending legislation of SBP’s enhanced independence.

Great benefits are embedded in overcoming this challenge. Controlling inflation would become relatively easier, and there would be greater chances of SBP enforcement-induced behavior for fiscal prudence. This of course, is much easier said than done and it is precisely because of this reason, getting rid of SBP debt is the first and foremost challenge.

3. Second Challenge: Limiting the Excessive Expansion in Central Bank Balance Sheet and Conducting Monetary Policy

Before describing the second challenge, we have to first settle the question of what should be the primary objective of any central bank from the Islamic perspective. Wisdom of Ibn Khaldun seems to settle this question for good. According to Chapra (2010), “If one were to use modern terminology, one could say that Ibn Khaldun found a stable price level with a relatively low cost of living to be preferable, from the point of view of both growth and equity in comparison with bouts of inflation and deflation. The former hurts equity while the latter reduces incentive and efficiency. Low prices for necessities should not, however, be attained through the fixing of prices by the state; this destroys the incentive for production.” It clearly seems that Ibn Khaldun’s wisdom foresaw ‘inflation targeting’ many centuries ago, which was adopted by modern central banks just a couple of decades ago. Inflation targeting approach explicitly requires the primacy of ‘price stability’ as the main goal for a central bank, which Ibn Khaldun clearly advocated.

According to Mishkin (1999), those central banks that adopted this strategy, first brought down high or excessive inflation by controlling the quantity of money circulating in the system through control of central bank balance sheets. Wisdom of Al-Ghazali, Ibn Taimiyah and Al-Maqrizi foresaw this approach much earlier. They clearly saw inflation to be a monetary phenomenon i.e. debasement or over-production of money causes inflation and other injustices. Solution, therefore, is to remove the over-production of money (excess liquidity, or monetary overhang in modern terminology) from the system. This is what central banks open market operations intend to achieve. In simple words, if the government actions have created excess currency in circulation, it has to be drained back from the system to bring inflation down.

Overcoming the first challenge will, however, create a new challenge for the central bank. How will the central bank conduct its monetary policy when it does not hold any short-term government paper (T-bills)? The answer is that if the central bank is allowed to issue a *sharī´ah*-compliant instrument (against its assets) then it should not face any difficulties in mopping excess liquidity from the system whenever such a need arises. Also, if the central bank is allowed to subscribe to *sharī´ah*-compliant instruments issued by the government, it can use these to manage liquidity through their outright sales and outright purchases from the financial institutions. Parallel approach would, of course, require the continuity of these transactions with conventional banks until full transformation. Also, the *sharī´ah*-compliant instrument has to be tradable for these transactions to be permissible. This is possible if the instruments are based on *shirkah* and *ijara* basis.

Regarding the question of central bank subscription to *sharī´ah*-compliant instruments, two questions would be worth exploring by the scholars. First, which of its resources will the central bank use to make these investments? Second, should the central bank be allowed to make this investment through a simple book entry? If allowed, it would be like using nothing to become a subscriber. Should this be permissible? Again I would request the *sharī´ah* scholars and financial experts to explore this question. My suggestion would be to allow the central bank, if there are clear monetary policy needs to hold these instruments in the short-run, to the extent of deposits held by central bank (of financial institutions) due to cash reserve requirement (CRR). Also, a part of central bank profit can be earmarked for this kind of investment each year.

If a sufficient amount of subscriptions to *sharī´ah*-compliant instruments are already held by the central bank, then there would be no need for it to issue its own *sharī´ah*-compliant instruments. Excess liquidity can be drained by selling these instruments to financial institutions, and liquidity shortages can be addressed by purchasing these instruments held by the financial institutions in a similar manner, as is customarily done through open market operations. For this approach to be feasible, it will be necessary for the government to issue a *sharī´ah*-compliant tradable short-term instrument of a maturity not exceeding one year. *Ijara ṣukūk* structures clearly make it feasible. Once issued and subscribed by Islamic (and conventional banks), these can be purchased by the SBP in smaller sizes to gradually build an inventory specifically for the purpose of conducting open market operations. Till such time, it has to rely relatively more on the instrument of cash reserve requirement (CRR).

While it may seem at present that SBP will be constrained severely by its inability to issue its own *sharī´ah*-compliant instrument in large sizes, this will actually be the greatest advantage in controlling its balance sheet.[11] For any central bank, a benefit embedded in the use of *sharī´ah*-

[11] Real assets of SBP, comprising of property and equipment amounted to Rs 17.9 billion as of end-June 2010. However, the valuation of property was done four years earlier; next valuation is due on end-June 2011. If gold reserves are also included in real assets, these amount to Rs 219.9 billion on end-June 2010, valued at market prices. It may be worthwhile for the central bank to slowly acquire real assets for the purpose of issuing

compliant instruments is the self limiting character of Islamic finance. There would be much lower chances of excessive expansion in central bank balance sheet that becomes a primary cause of high or hyperinflation. At the same time there would be no risk of unreasonably low expansion in the reserve money due to ample powers of the central bank to purchase *sharī´ah*-compliant instruments held by the financial institutions. The main challenge is to have an instrument that conforms to *sharī´ah* for both ownership and tradability in secondary market. Also, the size of these instruments held by the banks should be reasonably larger than the regulatory-induced (SLR) demand for them so that active trading can take place among the banks and SBP is able to build an inventory for conducting open market operations.

4. Third Challenge: Replacing Domestic Debt (held outside SBP) with *Sharī´ah*-Compliant Instruments

This is the area where initial progress has occurred rapidly within last 2-3 years after the launch of Rupee denominated Government of Pakistan *ijara ṣukūk* in September 2008. Although the share of *ijara ṣukūk* in total domestic debt is only 2.5% its share in permanent debt is 14.4% (December 2010). *Ijara ṣukūk* not only have the potential to meet the demands of Islamic banks to fulfill their SLR requirements, it is as attractive to commercial banks and also offers a profitable mode of investment for individuals. The main challenge for the government is to identify the assets, with full documentation and valuation, which can be based to structure the required *ijara ṣukūk*. Meeting this challenge would also result in a benefit of financial prudence because the amount of resources raised would be limited by the value of identified assets. There is also a danger here that if government is not firmly committed to transform the existing debt towards *sharī´ah*-compliance, it can use the new instruments to raise additional resources for deficit financing, instead of using these to replace existing *riba*-based instruments.

Hence, government has to be fully committed to gradually transform the debt, following a parallel approach, to *sharī´ah* compliant instruments. Transformation to the extent of value of identified assets would not be very difficult, but a part of the debt has to be retired to achieve full transformation. What is the size of real assets held by the government, both federal and provincial combined? Based on the work of Arby (2008)

Sharī´ah-compliant instruments against those assets to meet the monetary policy requirements.

on estimation of national income and investment, a ballpark estimate of the value of government real estate capital stock was Rs 2413 billion in FY10. Domestic debt excluding SBP held portion was Rs 3481 billion. This means that even after retiring the SBP debt, government assets may not prove sufficient to replace the existing domestic debt with *sharī´ah*-compliant instruments. Moreover, most of the existing domestic debt is held by the federal government while most of the assets are owned by provincial governments[12]. If the share of federal government is only 26.8%, it can issue *sharī´ah*-compliant debt instruments to the tune of Rs 647 billion only.

Above numbers are, of course, only meant for illustration of challenge of replacing existing debt to asset-based *sharī´ah*-compliant instruments. What is needed urgently is a survey of all government assets for the purpose of identification, documentation and valuation of each asset. While this may prove to be a tedious task for the government, it is necessary to undertake this to speed-up the progress of transformation towards Islamization of existing debt. This will also help the government to issue foreign exchange denominated *ṣukūk* in international markets in future as it did in 2005.

There are many benefits embedded in overcoming this challenge. If the government limits its borrowing to the extent of value of its assets, it will pave the way for the private sector to raise more resources to undertake productive economic activities that promote investment and growth. Combined value of assets of the private sector is usually much larger than those of the government. Private sector productive activities are usually constrained by the government debt raising unproductive activities and not by the dearth of real assets. Greater private sector productive activities will enable the government to raise more taxes. This is also realized in conventional interest-based system and to limit government fiscal excesses, fiscal responsibility and debt limitation are usually legislated in many countries. These laws seldom work because the limiting mechanism is *ad hoc* and based on the size of the GDP of the economy, and not the value of real assets of the government.[13] Self

[12] Past 46-year cumulative streams of federal and provincial investments show that the share of federal government in capital stock may be no more than 26.8% in FY10.

[13] Pakistan also has a "Fiscal Responsibility and Debt Limitation Act 2005", which required the revenue deficit to become nil by 30th June 2008 and the 'Total Public Debt' not to exceed 60 percent of GDP after 30th June 2013. Former requirement had already been breached and the likelihood of latter also looks difficult as Total Public Debt was 62.1 percent as on 30th June 2010.

limiting nature of the *sharī´ah*-compliant instruments is a joint blessing for both the public and private sectors.

5. Fourth Challenge: Establishing a Benchmark Rate of Return for *Sharī´ah* Compliant Instruments

This may not look like an immediate challenge, but imagine a situation in future when close to 50% of domestic debt has already been transformed through *ijara ṣukūk* or other *sharī´ah*-compliant instruments. Clinging to *riba*-based benchmark will then become problematic. Despite a necessity at this stage and favourable opinions of *sharī´ah* scholars on permissibility of this practice, considerable skepticism and cynicism exists even among educated individuals, which negatively distorts their perceptions about Islamic financial practices. This may limit the potential demand of this product among them, although regulatory-induced demand through SLR requirement of SBP and Islamic banks' demand for medium to long-term investments is unlikely to be diminished. Nevertheless, a considerable part of existing debt cannot be transformed into *sharī´ah*-compliance solely on the basis of institutional participation. So even if there is no immediate challenge, it would be fruitful to start thinking about how the benchmark is going to change when half of domestic debt becomes *sharī´ah*-compliant.

Usufruct derived from a real estate can be valued at the potential rent it can earn when rented out. Annual rate of rental would be the annual rent amount expressed as percent of the value of real estate. Just for illustration, if the value of a real estate is Rs 10 million and capable of earning a monthly rent of Rs 125,000, then the annual rental rate is 15%. One can establish a benchmark for office space by conducting surveys that estimate both the value of office space as well as rent. Surveys in major cities can be conducted to establish an "Office Price Index" and an "Office Rent Index". Annual rental rate can be easily derived from these indices. An extensive purposive survey can be done initially to establish these rentals, which can be updated every six month through smaller surveys. Extensive surveys can be done every five years to keep the benchmark current with structural changes taking place in the real estate sector. Sample size of these surveys could be kept very small; no more than a hundred or so. What is more important is the careful selection of properties and the quality of process which ensures soliciting market values of both real-estate and rents. Transparency of survey methodology and public availability of updated indices every six month would be of paramount importance.

Annual rental rates, estimated in this manner, will show some fluctuations, but these fluctuations are unlikely to be very large unless huge differentials emerge between growth rate of office property values and growth rate of market rent of office space. This is because annual rental value is a ratio of market value of rent to the value of property and its variation will depend on the difference between growth rate of numerator and the growth rate of denominator. For example, if annual rental value is R, property value is V then the annual rental rate $r = (R/V)$. Also, if the numerator is growing at an annual rate of increase of g, which is different from the growth rate of denominator h by a fraction of d then the new annual rental rate $r_1 = r + dR/[V(1+h)]$. As a specific example based on earlier illustration, assuming $r = 15\%$, $g = 15\%$ and $h = 10\%$ i.e., $d = 5\%$ then $r_1 = 15.68\%$. Purpose of this illustration is to show that the fluctuations will be based on what is happening in the real-estate sector of the economy, which is likely to affect the growth rates of rents and property values in a different manner, resulting into a new rate of rental, as it should be.

An alternative approach, based on surveys of small number of knowledgeable real-estate dealers, can also be considered. These dealers can be asked every six month (or every quarter) about their expert opinion on the values and rents of primary office space in major business centres. This survey may prove to be less difficult to implement compared to earlier suggestion. Moreover, instead of constructing office price and rent indices, median (or any other appropriate non-parametric central tendency measures) rental yield can be selected as the benchmark yield and tracked periodically.

Similar survey-based techniques may also be used to establish benchmarks for *musharaka*-based instruments by estimating profit rates in appropriate sectors of the economy. My main purpose of this discussion is that without any efforts and experimentation at this stage, it would become very difficult to change the existing practice of adopting riba-based benchmark for *sharī´ah*-compliant instruments. It is difficult to imagine that a benchmark, once established, will change by itself in future.

6. Fifth Challenge: Publicizing the Distinguishing Features of *Sharī´ah*-Compliant Instruments

A much broader challenge is to transform the mindset of educated Muslim elite in favour of the genuineness of Islamization efforts thereby convincing them that the instruments developed so far are indeed different from conventional interest-based products, besides conforming to the *sharī´ah*. A carefully launched publicity/education campaign to remove the cynical perceptions of a large number of Muslims in Pakistan will go a long way in converting the faith-based latent demand to an effective demand for Islamic financial products. A recent survey completed at the State Bank of Pakistan indicates that while the 95 percent respondents believe interest rate charged by commercial banks to be *haram*, only 44 percent effectively demand the use of Islamic financial products. A considerable size of the respondents perceived Islamic banking mainly as *qarḍ al-ḥasan*[14]. Awareness about other *sharī´ah*-compliant products was much lower. While the results are by no means alarming, but considerable efforts are needed to increase awareness about existing Islamic financial services already available in the market. There seems to be a considerable availability of products (supply), but the latent demand has to be induced (through publicity/education campaign) to become an effective demand.

In the case of government *ijara ṣukūk*, the demand-supply balance is currently different from the above scenario as the supply has recently started, which is primarily meeting a regulatory-induced (SLR) demand for these instruments. However, the government has recently allowed individuals to hold these as well, if not acquired through initial auctions. This means that Islamic banks can sell these in secondary market to individual investors. SBP instructions and guidelines to financial institutions have already been issued in this regard[15]. From the supply side, the government intends to issue *ijara ṣukūk* in substantial size each quarter.

Are individual investors aware about the existence of these instruments? Perhaps not, and unless these are publicized by the issuer (GoP), manager (SBP) and retailers (mainly Islamic banks), we may see a situation in future where these are primarily held by financial institutions, despite increased supply. This publicity need can be addressed by a participatory approach among the three stakeholders. Easy to understand brochures can be designed to persuade individual investors to increase their demand. Individuals' awareness about *ijara ṣukūk* will also increase by this approach. Moreover in brochures and advertisements, the distinguishing features of *ijara ṣukūk* (compared to a plain vanilla bond) should be overemphasized, without de-emphasizing the similarities.

[14] The Demand for Islamic Banking: A Case Study of Pakistan, an ongoing study at SBP nearing completion.
[15] State Bank of Pakistan, FSCD Circular No.13, September 06, 2008.

Cynical views of individuals (if any) due to the similarities with plain vanilla bond should only be addressed through greater emphasis on ownership aspect (in a real asset) of *ijara ṣukūk* and earning a *halal* rate of rental due to the beneficial (proportionate) ownership of the real asset. Documentation of owned assets for the period of *ijara* should be easily accessible to each individual investor. Due to the complex nature of documentation, easy to understand summaries should also be available to investors.

The need to expand the skilled human resources in the tenets and practices of Islamic finance can hardly be overemphasized. This resource need will rise very quickly with speeding of transformation process and will affect all stakeholders including the Government of Pakistan, State Bank of Pakistan and Islamic as well as conventional banks. Active intervention of the central bank would be desirable to chart out a strategy to fulfill this important need. It is proposed that the *Sharī´ah* Board of SBP takes up this and ancillary challenges to put Pakistan firmly on the gradual path towards full transformation.

7. Conclusion

Progress in Islamization of domestic government debt in Pakistan had been relatively slower than the progress in Islamic banking in the first decade of twenty-first century. The first and the foremost challenge is to eliminate the domestic debt held by the central bank. Second challenge is the acquirement of *sharī´ah* compliant instruments by SBP to conduct monetary policy. Third challenge, where a definite progress has been witnessed recently, relates to the issuance of Government of Pakistan *Ijara Sukuk* that have the potential to replace permanent (long term) portion of domestic debt. Replacement of domestic debt will be limited by the availability of government owned assets. It is proposed that an asset survey be undertaken by the government to identify and document these assets for enabling future issuances. Fourth challenge, though not an immediate one, is to actively experiment towards creating appropriate non-interest-based benchmarks for linking *sharī´ah*-compliant returns. The fifth and final challenge is to gradually transform the mindset of investors towards active acceptability of *sharī´ah*-compliant products through publicity campaigns.

شرع برخیزد ز اعماقِ حیات   روشن از نورش ظلام کائنات

گر جہاں داند حرامش را حرام   تا قیامت پختہ ماند ایں نظام

The sharī´ah grows out of life's bosom;

Its light illumines the darkness of the universe.

If the world were to accept its judgment

regarding what is forbidden,

This system would endure forever.

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Disclaimer: Author is solely responsible for any errors in this paper. Views and opinions expressed in this paper are author's own and should not be necessarily attributed to the institution for which he works.

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Annexure

Table 1
Pakistan's Debt and Liabilities Summary
(In Billion Rupees)

End Period	FY07	FY08	FY09	FY10	Dec-10
I. Government Domestic Debt	2,610	3,275	3,861	4,653	5,294.7
II. Government External Debt	2,151	2,762	3,452	3,667	3,838.0
III. Debt from IMF	85	91	419	690	748.8
IV. External Liabilities	49	88	104	96	94.3
V. Private Sector External Debt	78	128	198	218	226.8
VI. PSEs External Debt	73	82	87	83	70.6
VII. PSEs Domestic Debt	104	137	290	375	390.7
VIII. Commodity Operations Debt*	99	127	336	415	364.3
A. Total Debt and Liabilities (sum I to VII)	5,249	6,691	8,746	10,196	11,028.1
B. Total Public Debt (sum I to IV)	4,896	6,216	7,835	9,106	9,975.7
C. Total External Debt & Liabilities (sum VI to VIII)	2,436	3,152	4,259	4,754	4,978.4
D. Commodity Operation and PSEs Debt (Sum VI to VIII)	275	347	713	873	825.6
As a percentage GDP					
Total Debt and Liabilities	60.5	65.3	68.7	69.5	
Total Public Debt	56.4	60.7	61.5	62.1	
Total External Debt & Liabilities	28.1	30.8	33.4	32.4	
PSEs Debt & Liabilities	3.2	3.4	5.6	5.9	
Government Domestic Debt	**30**	**32**	**30**	**32**	

*This includes borrowings from banks by provincial governments and PSEs for commodity operations.

Notes:
1. Debt and Liabilities show end-period outstanding positions
2. For conversion into rupees from US dollars, weighted average customer exchange rates prepared by Domestic Markets & Monetary Management Department have been used for month end exchange rates.
3. Data pertain to end period.
4. Data for Nov-10 is provisional

Table 2
Government Domestic Debt (Major Instruments)
(In Billion Rupees)

End Period	FY07	FY08	FY09	FY10	Dec-10
I. Permanent Debt (1+2+3)	553	608	678	794	909.6
1. Ijara ṣukūk 3 years (shari'ah compliant)	0	0	28	42	131.3
2. Pakistan Investment Bonds (PIBs)	353	412	441	505	522.1
3. Prize Bonds	175	183	197	236	252.1
II. Floating Debts	1,108	1,637	1,904	2,399	2,859.2
1. Market Treasury Bills	656	537	796	1,227	1,426.8
2. Market Related Bills (MRTBS held by SBP)*	452	1,053	1,108	1,125	1,432.5
III. Unfounded Debt	940	1,020	1,271	1,456	1,524.3
1. Saving Schemes (other than Prize Bonds)	830	911	1,163	1,350	1,416.0
IV. Foreign Currency Certificates (held by residents)	10	9	8	3	16
Government Domestic Debt (I+II+III+IV)	2,601	3,275	3,861	4,653	5,294.7
Memorandum Item:					
Shar'iah Compliant Share in Government Domestic Debt (%)	0.0	0.0	0.7	0.9	2.5
Shar'iah Compliant Share in Permanent Domestic Debt (%)	0.0	0.0	4.1	5.3	14.4
Share of Permanent Debt in Domestic Debt (%)	21.2	18.6	17.6	17.1	17.2

Notes:
*Outright Sale of MRTBs is not included
Nov-10 data is provisional

Table 3
Fiscal & Financial Resources and Uses
(In Billion Rupees)

	FY07	FY08	FY09	FY10
Total Revenue	1,298.0	1,499.4	1,850.9	2,078.2
Total Expenditure	1,800.0	2,276.5	2,531.3	3,007.2
Fiscal Deficit	-377.5	-777.2	-680.4	-929.1
SBP Profit	108.7	164.8	204.2	186.7
Government Domestic Debt	2,610.4	3,274.7	3,860.7	4,652.7
Government Domestic Debt Held by SBP[1]	455.2	1,056.3	1,111.0	1,128.1
Government Cash Balances in Scheduled Banks[2]	366.4	403.2	455.8	552.9
PSEs Cash Balances in Scheduled Banks[3]	272.4	291.4	280.2	320.5
GDP (MP)	8,673.0	10,242.8	12,739.3	14,668.4
	% Change			
Total Revenue	20.6	15.5	23.4	12.3
Total Expenditure	28.4	26.5	11.2	18.8
Fiscal Deficit	16.0	105.9	-12.5	36.5
SBP Profit	59.5	51.6	23.9	-8.6
Government Domestic Debt	11.7	25.4	17.9	20.5
Government Domestic Debt Held by SBP	-11.0	132.0	5.2	1.5
Government Cash Balances in Scheduled Banks	28.0	10.1	13.0	21.3
PSEs Cash Balances in Scheduled Banks	6.4	7.0	-3.8	14.4
GDP(MP)	13.8	18.1	24.4	15.1
	% of GDP			
Total Revenue	15.0	14.6	14.5	14.2
Total Expenditure	20.8	22.2	19.9	20.5
Fiscal Deficit	-4.4	-7.6	-5.3	-6.3
SBP Profit	1.3	1.6	1.6	1.3
Government Domestic Debt	30.1	32.0	30.3	31.7
Government Domestic Debt Held by SBP	5.2	10.3	8.7	7.7

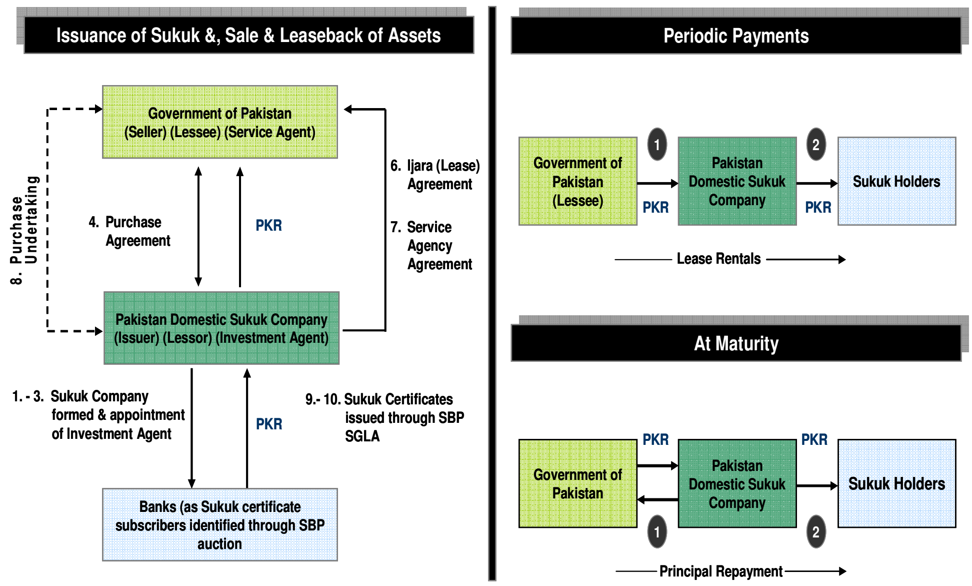
Government Cash Balances in Scheduled Banks	4.2	3.9	3.6	3.8
PSEs Cash Balances in Scheduled Banks	3.1	2.8	2.2	2.2
	% of Total Revenue			
Total Expenditure	138.7	151.8	136.8	144.7
Fiscal Deficit	-29.1	-51.8	-36.8	-44.7
SBP Profit	8.4	11.0	11.0	9.0
Government Domestic Debt	201.1	218.4	208.6	223.9
Government Domestic Debt Held by SBP	35.1	70.4	60.0	54.3
Government Cash Balances in Scheduled Banks	28.2	26.9	24.6	26.6
PSEs Cash Balances in Scheduled Banks	21.0	19.4	15.1	15.4
GDP (MP)	668.2	683.1	688.3	705.8

1. Includes Government Securities held by SBP plus Treasury Bills held by SBP only.
2. Government Deposits with Scheduled Banks which include Deposits of Federal & Provincial Governments and Local Bodies

3. Non-Financial Public Sector Enterprises

GoP *Ijara Sukuk*: Structure and Documentation Brief

I. Facility Structure Synopsis – Diagrammatic Illustration



II. Facility Structure Synopsis – Explanation:

1. A Special Purpose Company, wholly owned by the Ministry of Finance, Government of Pakistan, has been formed to act for and on behalf of Sukuk holders, namely, Pakistan Domestic Sukuk Company Limited (the “SPC”).
2. State Bank of Pakistan (“SBP”) will conduct an auction by which Sukuk Investors will be identified.
3. Pursuant to the Certificate Subscription Undertaking, Sukuk Investors will appoint the SPC as Investment Agent.
4. The SPC will enter into a Purchase Agreement with Government of Pakistan or National Highway Authority (“GOP”) for purchase of certain pre-identified tangible assets, such as a portion of the M3 Motorway for the first Sukuk issue (“Sukuk Assets”) at an agreed price (“Purchase Price”) equivalent to the Sukuk issue (“Sukuk”) amount.
5. Pursuant to a Declaration of Trust, the SPC (as Trustee) will declare its responsibilities towards the Sukukholders.
6. The SPC (as Lessor) will enter into an Ijara Agreement with GOP (as Lessee) wherein SPC will lease the Sukuk Assets for a fixed period, being 3 years in case of the first Sukuk issue. Lease Rentals will be paid on a semi-annual basis, i.e. a total of 6 lease rental periods for the first Sukuk issue.

Lease Rental means an amount equal to the product of (i) the Rental Rate for such rental period, (ii) the Margin, (iii) the number of days in such rental period divided by 365, and (iv) the face value of the Sukuk issue, plus the Supplementary Rental for such Rental Period.

Supplementary Rental means expenses incurred by the Service Agent in respect of maintenance,

Major Maintenance, Repair and Insurance responsibilities will be undertaken by the SPC (as beneficial owner of Sukuk Assets) but may be delegated to GOP as Service Agent under a Service Agency Agreement in consideration for a nominal fee.

At maturity or upon an Event of Default, GOP undertakes to purchase (pursuant to a Purchase Undertaking) the Sukuk Assets at the Exercise Price. The Purchase Undertaking (Wa'd) clearly states that the Exercise Price will be an amount equal to the initial cost of the Sukuk Assets plus any accrued amounts under the Ijara Agreement with respect to the Supplementary Rental.

Banks subscribe to their respective share of the Sukuk Issue through the Subsidiary General Ledger Account ("SGLA") mechanism

SPC (as Issuer) will issue Sukuk Certificates, the proceeds of which it will use to purchase of the Sukuk Assets. Each sukuk certificate will represent an undivided interest in the Sukuk Assets.

III. Key Documentation:

Documents	Signatories	Purpose
Purchase Agreement & Sale Deed	▪ GOP as Seller ▪ SPC as Purchaser	GOP sells Asset Pool to SPC
Ijara (Lease) Agreement	▪ SPC as Lessor ▪ GOP as Lessee	SPC leases Asset Pool to GOP
Service Agency Agreement	▪ SPC as Issuer & Lessor ▪ GOP as Service Agent	Service Agent to perform certain functions on behalf of SPC
Purchase Undertaking	▪ GOP	GOP undertakes to purchase the assets either upon an event of default or maturity
Declaration of Trust	▪ SPC as Issuer & Trustee ▪ SBP BSC as delegate	SPC declares trust on the assets, on behalf of the Sukuk holders and appoints SBP as the delegate
Agency Agreement	▪ SPC ▪ SBP BSC	SPC appoints SBP BSC as the Paying Agent, Registrar & Reference Agent
Certificate Issuance Undertaking	▪ GOP & SPC	SPC appointed as Agent to perform certain functions on behalf of Investors
Certificate Subscription Undertaking	▪ Investors	Investors agree to subscribe to the Sukuk certificates
Costs Undertaking	▪ GOP	GOP undertakes to pay fees & expenses, & provide indemnities associated with the Sukuk Issuance

Money Creation and Control from Islamic Perspective

Prof. Dr. Zubair Hasan*

Abstract

This paper deals with familiar facts in monetary economics from an unfamiliar angle. It argues that it is not factual to regard the legal tender money and bank credit as of different genus: they work in tandem to the same ends in an economy, conventional or Islamic. Also, it does not matter what serves as money – solid gold or flimsy paper – for keeping its value stable; only the blind would argue that staff is indispensable for walking. Money is just an instrument: it was never nor can ever be classified into Islamic and non-Islamic. What it does – good or bad – depends on how we use it. Money does not generate crises; its mismanagement does. It follows that the refuge the world is searching today from recurring financial crises does not lie in money substance: history testifies that national economies could not remain turmoil-free during the centuries of the yellow metal sway over the monetary scene. The paper concludes that it is the human factor that has been the source of good or evil for mankind including money matters. And the quality of human factor true religion can alone improve: morality without faith is rudderless.

Key words: Monetary policies; Gold standard, managed currency; Islamic banking; Central banks

1. Introduction

At the dawn of societal living economies were run by a system known as barter: A person exchanged whatever good or service he had with the goods or services others possessed. Barter required *double coincidence of wants* – B should not only have what A wanted but must also be in need of what A could offer in exchange. This was restrictive of transactions that could be made, consumed more time and curtailed specialization. The frustrations barter imposed on human ambitions led people to create money. We can define money by what it does i.e. by its *functions* or by identifying the *substance* which performed those functions. The temporal uniformity of the notion lies in the functional approach because what substance performed those functions over time and space is a welter of things approaching infinity. But herein lays the romance of money. From

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hides and skins via cowrie shells, salt, spices and precious metals to promise to pay working as money has been a fascinating journey of human ingenuity.

The functional approach to the definition of money sees its significance in serving as a medium of exchange, as a measure and a store of value and as a unit of account. In essence, these functions help tear apart the two sides of the barter coin – sale and purchase. You can sell what you have for money, keep that money with you and buy at will what you want and when. The eventual exchange involves real goods and services at both ends; money works merely as a go-between. If paper or plastic can perform the functions efficiently why use much more valuable things to serve as money? If roads could be built in the air will that not release land for growing more food? Money derives its significance from its *general acceptability* and that acceptability stems from its value remaining stable, not from the value of what it is made. We do not print cinema tickets on chocolate so that people could eat them in case they miss the movie.

Why are then suggestions today for a return to gold as the fulcrum for restructuring the international monetary system? [1] To me, psychology, haplessness, loss of direction and presumably some national interests are among the major factors. The search for an answer drags us back to the history of the money's evolution. This we do in the following Section 2. In section 3 we shall argue that it is not the systemic failure but the demise of human integrity that has pushed the world to the brinks of disaster. In Section 4 we summarize the argument and present a few policy prescriptions for consideration.

2. Evolution of Money

2.1 A social convention

Money was not invented: it evolved as a social convention and took various forms over time and space. This lent precedence to money substance over its functions in discussions on the subject. The importance of what works as money was reinforced as in the process of measuring the value (prices) of other goods and services money assumed a value for

[1] The suggestion that surprised many came from a person of no less stature than the World Bank governor Bob Zeollick (December 2010). Interestingly, it gave a boost to the clamor for a return to Gold Dinars and several articles on the subject made their appearance on the heels of Bob's statement including Karim (2010), KFH Research (2010) and Zein (2011)

itself that fluctuated inversely with variations in the general price levels over time and space. In that money was a different sort of measure compared to others that we use in our daily lives. Money made of or linked to something valuable in use, like gold or silver, made its value fluctuate inversely with those of other goods and services. The stability in the internal value of money thus requires the controlling of fluctuations in the domestic price level. Also, what worked as money in various countries is not mostly identical. This gave rise to the issues relating to the determination of the values of different moneys in terms of each other or foreign exchange rates for promoting inter-nation trade. The rising tide of international trade with the passage of time demanded something tangible that could help local monies enable their mutual convertibility. The need added to the significance of substance for the role money played in an economy.

Bronze and copper were the first to get converted into coins but gold and silver did not take much to replace them. Gold silver coins were made in Lydian – modern Turkey - as early as around 560 BC and could well be regarded the earliest forms of metallic coins. However, these coins were too soft to withstand the wear and tear in circulation or resist corrupt clippings resulting in their weight falling below the initial measure. Gold and silver had to be mixed with alloy to make coins adequately hard. This demanded standardization of the alloy proportion in the coins to ensure their authenticity and uniformity in terms of their precious metal content. The work was done by informal private agencies for most part of the 2500 years of sway the yellow metal had over the monetary matters across the world. Touchstones were used to verify the purity of coins in terms of their fineness. the convention continued even beyond the publication of Smith's *Wealth of Nations,*1776. Indeed, the author was much impressed by the spontaneous evolution of such benevolent social institutions as money, division of labor and capital accumulation that played such a vital role in promoting growth in the *wealth of nations.*[2] Note that gold standard in England was established by an Act of Parliament only in 1860 and in the USA much later in 1900.

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[2] See Gide & Rist (1953) for an excellent analysis of this influence under a sub-title: *The naturalism and optimism of Smith* pp. 85-109. One would not presumably come across such detailed and graphic description of the subject in other books on the History of Economic Thought.

2.2 State entry

In the private manufacture of coins, the standardization process required that gold was pre-alloyed and coins were weighted before they went into circulation. As long as people knew the manufacturer and had trust in him no touchstones were needed. At the time when Islam made its appearance on the scene, the gold coins in circulation were made in Rome and carried the stamping of pagan idols. The fact that the Prophet (Peace be upon him) allowed their remaining in circulation, testifies by implication that the faith did not divide money into Islamic and non-Islamic. However, to continue with the thread, the governments soon started stamping the coins with an emblem to strengthen the process of standardization. The emblem was a guarantee for the weight of the coin, its degree of purity and its value. The facility gave people the satisfaction of carrying value within their money, but it could not prevent the loss of precious metal in the circulation process and more than that through clipping of coins for recycling. Carrying money in pockets and over space involved both cost and risk. Governments of all shades soon discovered that coins derived their value essentially from the emblem; they often debased the coins to lower their precious metal content. To that extent coins became no better than notes printed on metal. This led Gresham to postulate during the Victorian era that bad (debased) money drives good (full-bodied) money out of circulation.[3] Finally, the side by side circulation of coins made of gold, silver and copper in many places, especially in Europe, led merchants to place premium on gold and distort the relative price of metals.

2.2.1 From metals to paper

To overcome the above mentioned difficulties of commodity money – the coins – banks began to issue paper receipts to depositors stating that the receipt was redeemable for the precious metals stored with them. Soon the receipts started circulating as money because everyone started taking them as good as gold. They were representative of the yellow metal. The suggestion for enforcing a 100% reserve requirement today, especially in

[3] Could that be the reason for the Qur'an to condemn the hoarding of gold and silver (9: 34-35)? Some claim gold and silver are Islamic money and their hoarding will reduce the quantity of money in circulation to the disadvantage of the economy; so the condemnation of hoarding these metals. I have a different interpretation. The reference in the two verses is explicitly to the stock of metals for which Zakat has not been paid. Even after Zakah has been paid it may not be desirable to retain money just for the sake of pleasure of seeing and touching it at will but it may not be punishable the way the verses state.

Islamic economics, derives its inspiration from the policy of that era. But much water has since turned in the ocean around the world.

It soon became apparent that to spend money and toil to dig the glittering metal out from the bowls of earth only to lock it back into the dark vaults of banks was an avoidable folly. To the relief of our pretty ladies, representative money proved just a small step to usher in the practice of banking based on fractional reserve. Banks were soon printing receipts above and beyond the amount of yellow metal deposited with them. It benefited traders and enriched the bankers. Paper notes had appeared in China as early as the year 806 AD and dominated the scene until the middle of fifteenth century. China stopped using paper notes in 1455 because their overproduction led to high inflation. But the fractional reserve system being an easy and effortless way for self-enrichment, the banks could not curb the temptation to over issue the notes. Intermittent bouts of inflation became rampant across the world. If the linkage of money to gold at its zenith could not stop the emergence of the malady; on what basis can the advocates for its revival can convince one that the resuscitation of gold can ensure it today? Inflation could not, as it cannot, sustain itself for long because it carries *within* its fold the weapons for its own demise. Sooner or later, it must turn its tail upward to nosedive. The slump that the burst of the bubble generates is found to be sticky and more damaging. We shall return to the issue in some detail later. Presently, we turn to the two interesting developments in monetary history that the non-sustainability of inflation triggered.

The first was the emergence of the state as a monopolist for the conversion of gold into coins and of coins into gold at the official mint. Initially, this service to people was rendered free of cost but later on a small fraction of gold (or silver) brought to the mint for coinage was used to be taken out to cover manufacturing costs. The deduction was known as the *seignorage* – the right of the king/lord over the possessions of the commoners. Thus, free coinage did not mean free of cost. It meant that people were free to bring for conversion into coins at the mint only the indicated precious metals – gold or silver.[4] The main reason for

[4] Coins were divided into two types: Standard and token. Standard coin was full-bodied money. Its face value and intrinsic value (the pure gold content at market price) were the same. It was the unit of account , unlimited legal tender and a standard for deferred payments. Minting was free only for standard coins. Token coins were multiples of standard coin and their face value was more than their intrinsic value. Token coins were legal tenders only up to a limit after which one could refuse to accept them in receiving

acquiring monopoly power in coin-making was its profit churning potential. The need to put a tab on money supply for curbing inflation and keep it commensurate with the overall needs of the economy was of smaller significance. Thus, money creation could not be left entirely to private discretion. And this brings us to the second major development.

The expanding international trade and the resultant complexity of foreign exchange issues added further to the growing governmental interest in the monetary affairs. Even as the authorities were attracted to money creation for a variety of reasons, especially the profit, it was sure to bring in, they did not consider it expedient to put their finger in the business directly; they chose to raise a facade – the Central Bank.

2.2.2 The rise of central banking

The process of government overtaking the creation of money proceeded on a slow pace. The first to come in were the regulations limiting the credit creation power of banks. They had to cope with some organizational restrictions including the continuation of the partners' liability as unlimited in banking far longer than in other businesses. But at the same time, the risks bankers took were sought to be reduced through severe penal provisions including in places even capital punishment for the defaulters.

The rise of democracy and the concern for human rights brought in some relief for the borrowers in the form of increased transparency in dealings and lowering of interest rates. Meanwhile, industrial revolution spread fast to other countries in Europe and their control of colonies had stabilized. International trade was rapidly expanding. The growth of wealth and prosperity of European nations became increasingly dependent on the colonies for obtaining industrial inputs and to sell finished products in their vast markets. Private banks still had the sway and there is an argument that their coalitions that had already started emerging in the face of liquidity shortages could presumably have efficiently functioned well also as 'the lenders of the last resort". The argument candidly implied that the ushering in the central banks was not needed. (Gorton and Hung, 2001)

But the governmental objectives for intervention as stated above were different. Bank failures during the second half of the 19th century created the opportunity for intervention and a large number of banks collapsing

payments or discharge of debts. Token coins were made of base metals like copper and did not enjoy the facility of free coinage.

like a house of card during the inter-war period only helped hasten the process. Thus, central banks came into existence as a response to the inability of banks themselves to cope with panics (Goodhart, 1985). The process took the semblance of a natural evolution as some private banks were asked to operate as government's bank (Gorton & Hung, 2001).[5] The authors provide some interesting information on the rising numbers of the central banks over time. This we reproduce in the following Table. Many of them were allowed to take up the 'Lender of the last resort' function much later.

Table 1: Growth of central banks over time

Year	1900	1950	1990
Number of central banks	20	59	161

3. Central banks and economic stability

The declared objective of establishing a central bank in a country was to have an institution devoted to keeping stable the value of its currency both internal and external. For performing the function, central banks were given some privileges: inter alia they were to serve as bankers to the government, granted the sole right for issuing currency notes, adopt measures to control the creation of credit by commercial banks and operate as the lender of the last resort. Central banks could not compete with ordinary commercial banks for business in the market. They had to guide and help the latter with a view to achieving stability in the value of money. Since coins of gold were already in circulation in many countries, central banks were to streamline the system for the issuance of currency with reference to the yellow metal. The rules for such streamlining were embodied in what came to be known as gold standard described below.

[5] Prior to the establishment of the Reserve Bank of India, the Imperial bank was entrusted to work for the government. Later it was converted into the State Bank of India and then nationalized. Even today in some matters it works as an agent of the RBI where the latter has no branches of its own. The State Bank of Pakistan is an off shoot of the same development.

3.1 The Gold standard

As explained earlier, paper money grew gradually out of gold coinage. The era of 100% reserve for note issue was very short. As a first step, a certain portion of (legal) money was allowed to consist of currency notes convertible into gold which could circulate along with coins. A one-on-one reserve of gold for paper currency was not needed to ensure convertibility as all people were rarely expected to seek conversion of their notes at the same time. Schemes of keeping gold reserves to cushion currency note issue varied among countries[6]. But the common element of them all was to have and maintain an overall relationship between the gold held in reserves and the volume of currency in the country. In other words, gold controlled the volume of money in circulation through keeping a minimum gold reserve, however defined. To invoke public confidence, monetary authorities had to keep the price of gold stable in the country. This was the essence of what was named in the literature as the *domestic* gold standard.

But gold standard as described above could not ensure price stability at home. For, gold standard does not stabilize price levels; it merely stabilizes the relation between the volume of gold and the volume of currency. Even if the price of gold remains unchanged, fluctuations in the *volume* of gold must make the *volume* of currency vary, forcing variations in the general level of prices. Thus, Instead of stabilizing, the domestic gold standard forced prices to fluctuate[7]; it failed to curb inflation or to prevent depression.

Domestic gold standard was part of the evolution of money - not the result of 'invention' - and its extension to external transactions was part of the same process. When gold coins constituted most of the money supply in two countries, there was little room for variations in their exchange rate. So long as the two currencies A and B were freely convertible into gold at a fixed price, their rate of exchange could not vary from their *mint parity* by more than the small margin from what were called as the *gold points*. Any demand for foreign currencies that could not be met in the foreign exchange market at a rate within say 0.5 percent on either side of the *mint par* was shunted out to the gold market. Thus, the demand for any currency in the foreign exchange market always equaled its supply. The

[6] For a brief discussion of these schemes, see Crowther (1948, pp. 281-300)

[7] A reduction in the volume of *currency* may cause a reduction in the quantity of money or it may not the two can, on occasions, run divergent courses. See Crowther (1948, p. 297 where he also mentions a few historical examples of such diversions with reasons).

gap was covered by the gold movement across the two countries. Figure 1 explains the automatic nature of the balancing mechanism.

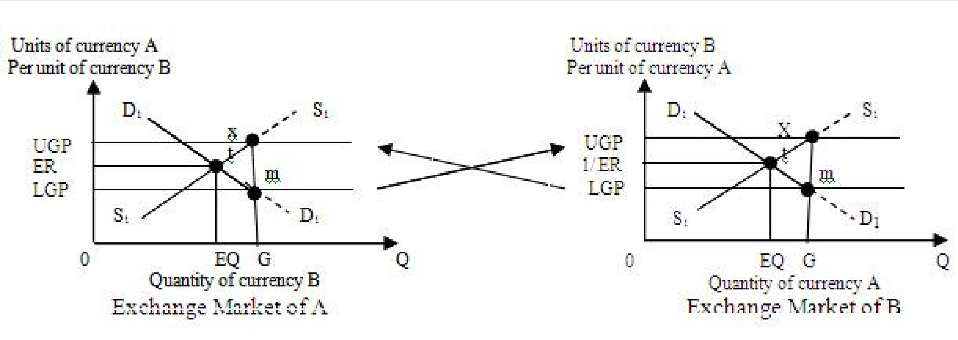

Figure 1: The Gold. Standard Mechanism

It is assumed that currency A contains 3.2727273 grains of gold 11/12 fine while currency B has 10 grains of gold 9/10 fine. The *mint par* (the domestic price of foreign currency (ER) of the two currencies will then be:

$$For\ \ country\ B:\ \frac{10\times\frac{9}{10}}{3.2727273\frac{11}{12}}=3\ units\,of\ \ A\ \ per\ unit$$

$$For\ country\ A:\ \mathrm{Re}ciprocal\ of\ \ 3\ i.e=0.333333\ of\ B\ \ per\ unit$$

Assume further that the cost of transporting gold worth 1 units of currency A between the two countries is 0.0005 units of that currency. Then, in the foreign exchange market of country A the exchange rate .3333 + 0.0005 = .3338 will be the upper gold point (UGP), and the lower gold point (LGP) will be (.3333 – 0.0005) = .3328.We now have the apparatus to explain how gold standard would operate between the two countries.

If the demand for currency B starts rising relative to its supply in country A – the balance of payments moves against A – the exchange rate in the market will start rising[8] but it cannot cross the UGP[9] as it will become cheaper for importers to buy gold in the market and export it to country B. D_1 will cease shifting up any more; excess of demand will move out from the currency market to that of gold, allowing only a tiny (tx) departure from ER. In contrast, if the balance of payments becomes increasingly favorable to country A, raising the supply of B currency relative to its demand in the exchange market, the ER will start falling: currency A will become dearer in country B. But the process cannot go on unabated. As soon as the rate crosses the upper gold point which would be the same as LGP in A -- again a small divergence (tm) from ER - the importers in country B will find it cheaper to ship gold to country A rather than buy currency in the exchange market. Under gold standard no country can stop either export of gold or its import. Gold standard works on the assumption that at gold points the supply of the metal is kept perfectly elastic. The assumption could become a reality only if countries or some international authority is willing to buy and sell at a fixed price.

Stability of exchange rates is desirable, rather necessary, in the present era of globalization for promoting free trade and liberalization, but on a *return to gold* only the naïve or the vested interests will insist. Let me explain very briefly the reasons as to why the return is neither desirable nor practicable. The issue of internal stability, I have already touched upon. Under the strict rules of the game, it is realistic to assume that the central bank of country A keeps gold in reserve just what is obligatory, say 40% of notes in circulation, to ensure their convertibility. Suppose now that there is an inflow of gold, ignoring reasons, worth $ 1 million. This moves into the reserves of the central bank. If it does not, as it cannot, build a buffer stock of gold, it must put additional notes worth $ 2.5 million in circulation. And if the banking system is to maintain a 10% reserve for credit creation the economy would become awash with a monetary expansion of $ 25 million. This multiple expansion of money supply may impose inflationary pressures on an otherwise stable economy. You may work out the deflationary potential of gold out flow of a similar magnitude. In fact, gold standard inherently carries a deflationary bias: a country losing gold must contract credit but the one receiving it is under no compulsion to expand credit.

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[8] For a real world illustration see Halm (1956, pp.176-177). He explains how the exchange rate between USD and Pound Sterling was settled when both countries were on gold standard during the inter-war period

[9] It may be noted, as shown in Figure 2, that the gold export point of one country becomes the gold import point of the other country and vice versa.

Gold standard can work smoothly if prices - wages in particular - were reasonably flexible, there were no structural rigidities in the economy, and public authorities were willing to surrender their discretion and independence to the automation requirements of gold standard mechanism. The suspension of gold standard under adverse circumstances in the past was the proof of the unwillingness of policy makers to accept such surrender.[10] This unwillingness has only become more obstinate with the passage of time. This obstinacy was one of the reasons why the original designers of the IMF scheme rejected a return to gold standard so as to impart a measure of flexibility in the arrangement; the amendments of 1978 buried the gold-link for good.

Until the beginning of the last century, the measure of money requirements was the amount of the work money had to do, largely as a medium of exchange. Given the velocity V of money circulation, the measure was in close harmony with the level of real output. Even as per this criterion, the quantity of money needed could initially be managed; but gold supplies soon fell short to meet the monetary needs of economic expansion and currency notes with partial metal backing soon appeared on the scene to supplement coins. Compare this situation with the current scenario.

During the second half of the last century the real output the world produced was more than what it could during its entire existence before 1950. Where is the gold to support money expansion to match the increase? The growing volume of financial transactions knows no bounds. More than a trillion US$ go round the world stock markets every twenty four hours in speculative trading. It is estimated that the volume of money involved in foreign exchange spot transaction alone is 70 times of the money value of world's real output. Supply of money tied to gold would fail to meet the money requirements of the modern age. One may be fond of day dreaming but return to gold is not even worth that dream. Today, financial transactions are an ocean wherein real transactions are just a tiny island. Return to gold (Dinar) is not possible (Hasan, 2008).

Since the last semblance of national currencies being linked together via gold disappeared forty years back, all countries have been running their economies entirely with fiat money; the money which is not backed by the reserve of any real commodity. Legal tender laws are the legs on

[10] For a detailed explanation of the monetary expansion and contraction processes under the gold standard and their repercussions, see Halm (1956, Chapter 12, section 4 pp. 189-192).

which it stands. To me it is true money. It is not the moon drawing its shine from the sun – the reserves. It is the sun itself.[11]

3.2 Creation of money

Undergraduate text books on money and banking invariably make a distinction between legal tender money as issued by the central bank of a country and credit or bank money that is generated by commercial banks through the granting of loans to borrowers. They also teach us that fiscal policy of a country falls in the government terrain while the monetary policy is autonomously designed and operated by its central bank. All such lessons must be taken with a grain of salt.

The early central banks were established when the mercantilist era was still on. They were brought into existence by powerful businessmen controlling politics for serving their own nefarious ends (DeLorenzo, 2008). Ownership structures and the role of central banks have since witnessed many changes over time and space but their basic functions have virtually remained unaltered (Goodhart, 2010)[12]. Three of their functions – (i) working as bankers to the government, (ii) being the sole issuer of currency notes and (iii) controlling of credit the commercial banks create – unfold the linkage between the fiscal and monetary policies of a country and the extent of a central bank's autonomy.

3.2.1 Fiscal policy- money supply interface

The function of the central bank to work as the banker to the government opens the window for the latter to interfere with the supply of currency or *base money* in the country. Even as the central banks have the sole right to issue currency notes, the right has not always been absolute. For example, in India, the one rupee note which is unlimited legal tender was issued by the government of India not by the RBI. The government could always

[11] It will be wrong to believe that we have fiat money for the first time now. In fact, even during the era of commodity money there were legal tender laws put in operation to strengthen the monetary systems. These laws legally relieved the debtors of their obligations if they offered to pay the debt using what government declared as money. In some cases refusal to accept this form of payment was illegal and could at times attract even death penalty. Ancient Rome and post-revolution France are cited as examples. (Cobb 2010. Why Cobb (p.12) calls it a major breakthrough in the history of money is not clear. In the past the existence of fiat money was an exception, today its non-existence is an exception.

[12] However, there is a strong case for scrutinizing the power structure in the central banks, especially the ones operating in the area of Islamic banking. This can bring to light forces influencing their workings.

exchange these notes for bigger denomination with the latter. The second source is that the government can always borrow currency from the RBI through the creation of treasury bills which the latter could sell in the money market. The conversion of government securities into legal tender money at the RBI was used by the British to unleash unprecedented inflationary pressures on the Indian economy to their own advantage.[13]

Table 2: Exchange rates: 1US$ value in German Mark

Jan. 1918	5.21	Mar. 1923	21,190.00
Jan. 1919	8.20	Apr. 1923	24,475.00
Jan. 1920	64.80	May 1923	47,670.00
Jan. 1921	64.91	June 1923	109,966.00
Jan. 1922	191.81	July 1923	353,412.00
April 1922	291.00	Aug. 1923	4,620,455.00
July 1922	493.22	Sept. 1923	98,860,000.00
Oct. 1922	3,180.96	Oct. 1923	25,260,000,000.00
Jan. 1923	17,972.00	Nov. 1923	2,193,600,000,000.00
Feb. 1923	27,918.00	Dec. 1923	4,200,000,000,000.00

Source: Schools History –The seeds of evil: The rise of Hitler

(ASK.Com// Downloaded on 10.01.2011)

[13] In short the story was as follows. When England returned to Gold Standard after the WW1 in the twenties, the Indian rupee was tied to it at a fixed rate to have the *prestige* of being on gold (exchange) standard via the Sterling. In 1931 England went off the Gold Standard but the Indian rupee remained hanging by the Sterling coat minus the prestige. The linkage enabled the British to finance their huge balance of payments deficits with the country during the WW2 period through making RBI issue Indian currency against the piling up sterling debt, paper just replacing paper. Real goods and services moving to War Theater and money supply expanding within led to high inflation in India. It is interesting to note that inflation rate in England at war averaged not more than 7% a year during 1940-1945. Domestic inflation was largely transferred to India (and other colonies).

Another example, an eye-opener, comes from the German economy during the 1920s. After their victory in the WW1 the allied powers imposed such heavy reparation on the vanquished that the payments devastated the economy of the country as never before in modern history. The annual national income plus the liquidation of the accumulated wealth of the Germans was not sufficient to maintain the payments schedule. On the one side of the road the central bank was printing notes day and night so that the government could purchase goods from the market for export to meet the dates. On the other side the Germans ran with basketfuls of currency to beat the spiraling inflation – in one year prices rose 10^13 times. Inflation ran parallel to the depreciation of the German Mark that in fact had caused it. Table 2 (given above) presents the depreciation drama.

Figure 2

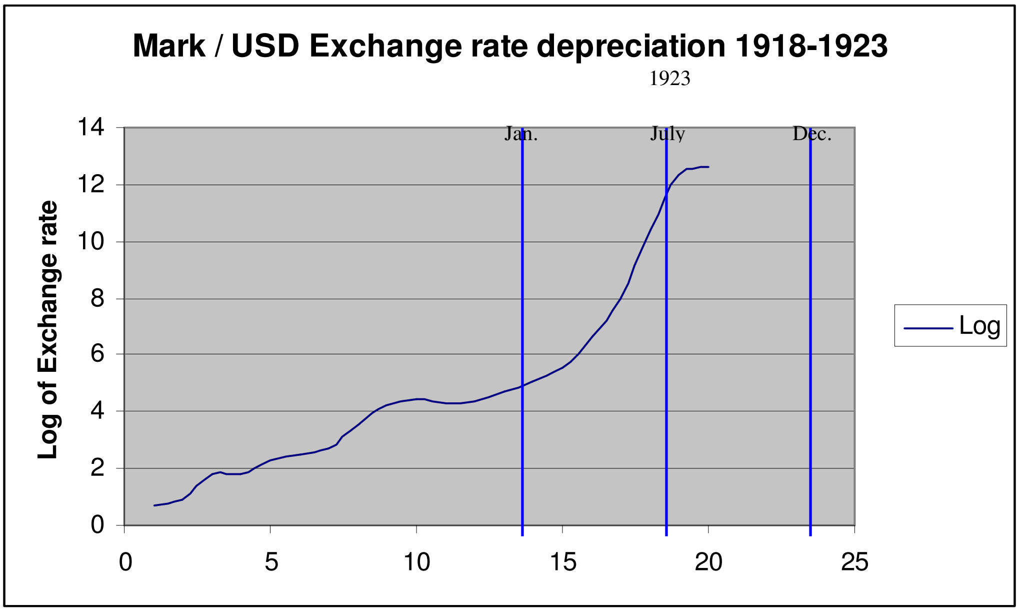

Figure 2 is constructed using Table 2 data on semi-logarithmic scale to keep its size manageable. We did not put the actual dates on X-axis to avoid congestion.

In Pakistan also the central bank of the country is at a loss to find ways of liquidating the huge debt the government owes to it as the consequence of deficit oriented fiscal policies of successive governments. The bank had to print notes unmatched with the corresponding expansion in real output. The result was continual depreciation of the currency in the foreign exchange markets and inflation at home.

It follows from the above discussion that the central bank cannot determine the monetary base exogenously. It erodes the capability of the central bank to discipline the banking system and tempts the banks to defy cautions in credit creation that brings their owners large effortless leverage gains. This requires us to understand the credit creation power of banks and its limits.

3.2.2 Money creation by banks

We have already made a distinction between (i) currency or legal tender money and (ii) the bank credit or bank money. The two together constitute the M_1 version of money supply. The relationship between them lies at the heart of credit creation process that commercial banks follow. The volume of (i) i.e. currency in an economy serves as the *base* for generating (ii) the credit money. Part of the base money (currency) always remains *inside* the central bank while the remaining part is held *outside* by the public[14]. People deposit a part of the *outside* money with them in commercial banks as demand or time deposits which together constitute the *cash* deposits of the bank. A portion of deposits, say 10%, the banks have to keep with them as statutory reserve to meet the daily withdrawal needs of the depositors; the remaining they can lend on interest or invest in the Islamic profit earning schemes. In conventional banks the sum loaned is credited to the account of the borrower. Thus, loans generate what we call *credit* deposits. These loans and deposits appear one for each other as contra entry in the bank balance sheets. The banks make no distinction between the two sorts of deposits – cash or credit – in their lending operations.

To illustrate, let us assume that the amount of currency or base money circulating in a country at a time point is I00T half of which people keep with them under the Keynesian liquidity preference motives; the remaining 50T they deposit with the commercial banks. Suppose the banks on an average retain F fraction of their cash deposits as reserve to meet the daily withdrawals while the central bank wants them to maintain with it a minimum fraction R of their deposit – cash plus credit. How much credit can a bank create with these constraints? The credit multiplier M provides the answer. It is calculated as under.

$$M = 1/F\,[1 - R]$$

[14] The classification of currency into outside and inside money is of recent origin and some economists have found it a useful explanatory tool in their discussion of the credit creation process of commercial banks.

Suppose a bank has 50M in cash deposits and has to keep F = 0.1 fraction of the sum every moment in its safe to meet the daily withdrawal demands. Furthermore, the central bank requires each commercial bank to maintain with it 5% of its deposits – cash plus credit - in the form of cash implying R = 0.05. The credit multiplier M will then be 9.5. The 50M cash deposit with the bank will enable it to have total deposits worth 50 x 9.5 = 475M. From that amount if we take out cash deposits, the remaining 425M will be the *credit* (loan) deposits the bank has generated. Note that an individual bank cannot create credit disproportionate to others because on balance it will soon find its cash flows reducing via inter-bank clearances. The cash string forces it to remain with the group. However, the created creation power of the banking system is on the whole tremendous. The interest received on this amount minus the part of it payable for cash deposit holders and other operating expenses will all belong to the bank. Banking is thus an exceedingly lucrative business. Collectively, banks may generate a huge inverted pyramid of credit.

Businesses too are tempted to support the process as the rates of interest are usually much lower than returns the borrowings provide. Producers are tempted to finance even long run projects from short-term borrowings because in good times repeated and easy renewals can convert them into long-term funding. Leverage gains tend to make businesses over adventurous. But continued pumping in of funds ultimately causes the credit balloon burst, economies roll down the hill and unemployment tends to become rampant. Should Islamic banks indulge in credit creation as do the commercial banks as a part of the process? I refrain from discussing this issue here because I have already discussed it threadbare in my earlier writings (Hasan, 2008 and 2010) However, put briefly my position is as follows.

3.2.3 Islamic banks: credit creation and the crisis

Commercial banks and their functions evolved over time in response to the changing and expanding needs of trade, industry and commerce. Eventually, they emerged for meeting the short-term needs of business. These needs have been of seasonal character and creation of base money was geared to the more enduring demand for money to serve as a medium of exchange and a store of value. Credit creation is meant to keep the growth of base money smooth over time. This development left untouched the financing modes in Muslim lands. Islamic finance emerged on the seen very late for a variety of reasons. Innocuously, it chose to follow in the footsteps of the same system that it rose to replace. To me, Islamic banks have little option in the mutter of credit creation: their methods and precautions could of course be different. The real problem in fact is on the control side: what would or could replace the bank rate as control weapon in the hands of the central bank. Even in the case of conventional banks, the policy has failed to deliver. Long run profit expectations tend to run much higher above the schedules of interest rates after the WW2. The rising leverage ratios and commissions have to be curbed. Perhaps, there exists a case for taxation of leverage gains with steep progression.

It seems a bit misguiding to claim that Islamic banks withstood the current crisis better than their mainstream counterparts. They are yet too small to catch the cold and have not nursed the linkages for infection. And yet many Islamic banks did come to grief. Kuwait has recently refused to bailout the defaulting banks in the country.

4. Concluding remarks

This paper had set out to discuss some familiar ideas in the area of money creation and control in modern societies from an Islamic angle but arrived at some unfamiliar conclusion. The main ones are as under:

i) Money evolved as a social convention. Its essence lies in what it does, not in what it is made of. Its significance follows from the fact that it tears apart the two sides of the barter coin into sale and purchase. Money has no religious content. It was never nor can ever be divided into Islamic and non-Islamic

ii) Gold standard was evolved by the erstwhile imperial powers to exploit colonies for obtaining raw material and other inputs for their growing industries and open their vast markets for selling their products. It sacrificed the internal stability at the cost of external stability. That often hurt the developing nations, Gold standard never ensured that none will lurch; it only ensured that all will lurch together. The world should never return to gold. Presently, the IMF rules bar the linking of any currency to gold. The *dinarists* are traveling on a blocked end road.

iii) The autonomy of central banks is illusory. Governments have always been the prime movers in the matter of money supply. Fiscal policies have frequently been the undoing of monetary policies initiated by central banks. Governors of central banks are after all appointed by the government; they have to watch the movement of the authoritative eyes. They tend to be late to miss the train and under kill to avoid the charge of over killing.

I believe that any system can possibly deliver if human element is virtuous. Human beings are the greatest source of instability in the world – political, economic and social. Presidents retire and only then the nation knows that they bankrupted the nation for self-enrichments. Corruption, conspiracy and injustice rule the world. Powerful armies have marched for non-existent reasons into flourishing countries and destroyed them completely and for that they got away by merely saying sorry. The entire nations as Greece have gone bankrupt because of the misdeeds of their rulers – democratic or despotic. Today, if banks are too big to fail, nations are much bigger. To me all reforms will fail to deliver unless human beings are reformed. Rational morality has failed; faith is the hope.

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Use of *Ḥiyal* in Islamic Finance and its *Sharī´ah* Legitimacy

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Abstract

Sharī´ah legitimacy of Islamic banking has been a subject of intense debate and discussion among the religious scholars. A group of *'ulama* hold the opinion that current Islamic banking practices are un-Islamic. Their major objection on Islamic banking and finance is that it heavily relies on *ḥiyal* i.e. stratagems and subterfuges to circumvent *sharī´ah* prohibitions on *riba*, which frustrate the higher objectives of the *sharī´ah*. The purpose of this paper is to examine whether Islamic financial products and banking transactions are in nature of stratagems that frustrate the purpose and spirit of law or they are only clever uses of law with a view to provide solutions to difficult problems without frustrating the purpose of Islamic law. The article is divided into two sections. Section-1 deals with classical approach towards treatment of legal devices. Section-II deals with the application of *ḥiyal* to modern Islamic finance. In this section, subversive *ḥiyal* such as *bai´ al-'inah*, *tawarruq*, commodity *murabaha* and sale and lease back *ṣukūk* have been discussed. In the analysis of the author, such legal devices oppose the higher objectives of *sharī´ah* relating to Islamic economics and finance. This section also deals with such legal devices which suggest a way out or outlet from difficult situation. An attempt has been made to determine whether a particular device simply overcomes rigidity and inconvenience or it circumvents *sharī´ah* prohibitions. The paper emphasizes the centrality of *maqāṣid al-sharī´ah* in *ijtihad* and *fatwa* in the field of Islamic finance. It suggests that in developing financial products, *maqāṣid al-sharī´ah* should be given prime consideration; otherwise Islamic finance will lose its real merit and substance.

Key Words: *Ḥiyal*, *Makhārij*, *Maqāṣid al-Sharī´ah*, *Tawarruq*, *Bai´ al-ʿīnah*, Shariah prohibitions, Islamic finance, *ṣukūk*.

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1. Introduction

Sharī´ah Legitimacy of Islamic banking has been a subject of intense debate and controversy among the religious scholars. A group of *´ulama* holds the opinion that current Islamic banking practices are not Islamic in real sense. A major objection raised is that Islamic banking heavily relies on *ḥiyal* i.e. certain stratagems and subterfuges to circumvent certain *sharī´ah* prohibitions especially those on *riba*. These scholars contend that *murabaha* and *ijarah* are merely *ḥiyal* not real Islamic alternatives to conventional banking. The background of this paper is that on 29th August, 2008, a *fatwa* was issued by the *´ulama* belonging to prominent religious seminaries of Pakistan in which they declared the present Islamic banking un-Islamic. Their main objection is that it is primary structured on *ḥiyal* that frustrate higher purposes of *sharī´ah*.[1] The products developed by the banks may conform to the letter of Islamic law, but frustrate the spirit and purpose of law. The purpose of this paper is to examine whether the Islamic financial products and banking transactions are in the nature of stratagems that frustrate the purpose and spirit of law or they are only clever answers to difficult problems, commonly known in Islamic jurisprudence as *makhārij* i.e. a way out without frustrating the spirit and purpose of law. It attempts to determine whether a particular legal device simply overcomes the inconvenience and rigidity in law or it frustrates the purpose and spirit of *sharī´ah*. The paper will also investigate whether the classical jurists acknowledge *ḥiyal* as a tool of *fatwa* and legal reasoning. In this regard, different approaches in the treatment of *ḥiyal* in classical Islamic law will be studied.

The paper will deal with the issue of *ḥiyal* and its current relevance to Islamic banking in two sections. In Section-1, concept and treatment of *ḥiyal* in classical Islamic law will be discussed. Section-II will deal with the applications of *ḥiyal* in modern Islamic finance.

2. Concept of *Ḥiyal* in Islamic Law

2.1 *Ḥiyal:* Meaning and Forms

Ḥīlah literally means an artifice, device and stratagem. Technically it may be described as the use of legal means for extra-legal ends that could not, whether themselves are legal or illegal, be achieved directly with the means provided by the *sharī´ah*. It enables persons who would otherwise have had no choice but to act against the provisions of sacred law, to

[1] See, Murawwajah Islami Bankari, pp.229-232; Takmilah al-Radd al-Fiqhi, p.45.

arrive at the desired result while actually conforming to the letter of the law. Thus, *ḥiyal* (legal artifices) constitute legal means by which one can arrive at judicial outcome otherwise prohibited by the law.[2]

Ḥīlah in Islamic jurisprudence is used in two meanings. Firstly as tricky solutions to difficult problems without frustrating the purpose of law; they are clever uses of law to achieve legitimate ends. They are employed to overcome inconvenience in law. Such *ḥiyal* are considered to be lawful. The Hanafi and Hanbli jurists prefer to call them *makhārij* i.e. outlets rather than *ḥilas.*[3] Secondly, as device and subterfuge to circumvent certain *sharī´ah* prohibitions or to evade certain obligations. Such *ḥiyal* are declared unlawful by the *fuqaha*.

An example of a clever use of law is indirect exchange of superior dates with inferior dates, suggested in the hadith of Companion Bilāl (RA).[4] The requirement of Islamic law in the exchange of dates with dates is that dates on both sides should be equal. Now if a person wants to exchange it's inferior quality dates with superior quality, it has to ignore quality difference and exchange it on the basis of equality in weight on both sides. Any difference in the quantity will make the transaction, a transaction of *riba al-faḍl.* The solution to this problem is to sell inferior quality in market and buy from the proceeds of sale required superior quality. In this way the parties can overcome a difficulty without jeopardizing the letter of Islamic law. [This, however, is not a *ḥilah* in real sense; it is the act legalized by the Holy prophet (pbuh), the lawgiver, himself].

Unlawful is used either to circumvent a prohibition or to evade obligation. An example of *ḥīlah* intended to circumvent *sharī´ah* prohibition on *riba* is *bai´ al-´inah. Bai´ al-´inah* is to sell a property on credit for a certain price and then to buy it back at a price less than the sale price on prompt payment basis, both the transaction take place simultaneously in the same session of contract.[5] For example, A sells a commodity to B for Rs. 100/- on a one-year's credit. A, then buys the commodity back for Rs 80/- from B on immediate payment. In the above

[2] Encyclopedia of Islam, vol.3, p.510.

[3] Sarakhsi, *Kitāb al-Mabsūṭ*, vol.30, p.209; Ibn al-Qayyim', *I'lām al-Muwaqq'īn* ,' Zafar Ahmad Usmani, *'Ila al-Sunan*, vol.18, p.423.

[4] See, Bukhari, *Ṣaḥīh*, Kitāb al-Wakālah, Bab al-Wakālah fi al-Ṣarf, Hadith No.2303; Muslim, *Ṣaḥīh*, Kitāb al-Musāqat.

[5] Qurtubī, *al-Jāmi' li aḥkām al-Qur'ān,* Cairo 1353/1935, vol.3, pp.359-360;

case, A is a creditor and B is a debtor, A has advanced loan of Rs. 80/- under the cover of sale transaction in which he earns a surplus of 20 rupees. Another form of *bai´ al-´inah* is to sell commodity on cash and then buy it back at a higher price to be paid at some specified time in future. In this case, the prospective debtor sells an object for cash to the prospective creditor. The debtor immediately repurchases the object for a higher amount payable at a future date. Thus transaction amounts to a loan with certain increase.

The majority of Muslim Jurists consider this transaction invalid because the intended objective of the transaction opposes the objective laid down by the lawgiver.[6] This form of transaction, in their view, is nothing more than a legal device aimed at circumventing the obstacle posed by the prohibition of *riba.* It is a fictitious deal in usurious loan transaction that ensures a predetermined profit without actually dealing in goods or sharing any risk.

The example of *ḥilah* intended to evade some *sharī´ah* obligation is gift of zakatable amount before completion of one year in order to avoid *zakāh*. Similar to this is a situation where a person combines scattered animals to reduce the amount to be paid on account of *zakāh.* For example, a person owns forty sheep and his two sons also have forty sheep each. They combine them together as single property to give one sheep instead of three sheep on account of *zakāh.* Conversely, a person has forty sheep. He sells two sheep so that he is exempted from obligation.[7]

The last category of unlawful *ḥiyal* is reflected in a famous *sharī´ah* Maxim: *"Every legal artifice whereby nullification of a right or affirmation of a wrong is devised is unlawful".*[8] It suggests that a legal artifice which serves as means to violate some established principle of Islamic law and also defeats the intention of the law is unlawful. Conversely any legal artifice that does not contravene an established legal principle is valid and may be permissible in Islamic law.

A *ḥilah* affected on a debt transaction is generally treated as unlawful *ḥilah* because it intends to give some extra benefit to the creditor. Buy-Back agreement, sale with right of redemption belong to this category. A

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[6] Badawi, *Nazriyyah al-Riba al-Muharram*, Cairo al-Majlis al-A'la li Re'ayat al-Funun, 1940, p.203

[7] Bukhari, *al-Sahīh*, Kitab al-Zakah, Hadith No.1382

[8] Walid Ibn Rashid al-Sa'dan, *Talqīḥ al-Afhām al-'Illiyyah bi Sharh al-Qawa'id al-Fiqhiyyah*, p. 116.

famous maxim states: *ḥilah affected on debt is a ḥilah for riba*.[9] Some examples of *ḥiyal* on debt transaction are: to mortgage a house with the creditor and allow him to stay in it, or to sell an object to the prospective debtor for an exaggerated price and then immediately lend him some money or to buy from him certain commodity at a lower price or to lease him some asset at a rental higher than its prevailing market rate.

Ibn Qudamah (d.620 H) alludes to the above stated categories in his celebrated work *al-Mughnī.* He writes:

> Unlawful *ḥilah* means to do an act which is apparently permissible with the intention to achieve some unlawful purpose such as to do a prohibited thing or avoid some obligation or nullify a right. The permissible *ḥilah,* on the other hand, is sought to overcome difficulty and inconvenience (in law), with the purpose to abstain from an unlawful act or thing.[10]

2.2 Treatment of *Ḥiyal* in Islamic Law Schools

Juristic schools vigorously differ on the legitimacy of *ḥiyal*. Their views falling across spectrum: The Hanafis and Shafi's take the most lenient position. They declare them valid. Even the apparently subversive artifices are valid in these schools although immoral. *Bai´ al-´inah* (buy-back agreement) for instance is lawful in Shafi'ī School. Their argument is that it is the external form of contract and not the underlying intention that determines the validity of a contract or otherwise.[11] The Hanafi jurists allow *nikāḥ taḥlīl*, intervening marriage to facilitate remarriage between divorced couple after thrice repudiation (irrevocable divorce of major degree). They also allow *bai´ bil wafā* i.e. sale with right of redemption under need. Hanbali jurists have taken a balanced position on the issue. They allow only those legal devices that provide a way out from a difficult situation and consequently overcome inconvenience in law.[12] Maliki jurists condemn *ḥiyal* and declare them invalid. They even block ways that may lead to an evil. They call it *sadd al- dhara'i*'. In the following lines, we will discuss the approaches of schools for the treatment of *ḥiyal* in some detail.

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[9] See, Sidqi Burno, *Mowsū'ah al-Qawā'id al-Fiqhiyyah*, Mu'ssasah al-Risalah, vol.1, p.201

[10] Ibn-Qudamah, *al-Mughnī* vol.6, p.116.

[11] Shafi'I, *al-Umm* Kitab Ibtal al-Istihsan, vol.7, pp.279-279; Nawawi, *Rowdah al-Ṭālibīn*, vol.3, p.261

[12] Ibn al-Qayyim, *I'lām al-Muwaqq'īn*, vol.3, p.148.

2.2.1 Hanafi Approach in *Ḥiyal*

As noted earlier, the Hanafi jurists have taken a liberal and flexible position on *ḥiyal.* In the classical Hanafi books many instances of legal devices are observable where the boundaries between lawful *ḥiyal* and unlawful *ḥiyal* appear to have blurred. Fatawa Hindiyyah (compendium of Hanafi legal opinions) offers many legal devices whereby a lender can charge certain increase on his amount from the borrower. In one case Ibn ‘Abidin, author of Radd al-Muhtār, suggests that if creditor wants to give extension in time to his debtor against some increase in amount, he may buy some commodity against the amount of debt from the debtor and then sell the same commodity to him on credit at a higher price. For example he wants to increase the amount of loan from 10 dirham to 13 dirham, for extension in time of repayment; he can do it by buying commodity for 10 dirham (which is the amount of loan) from debtor, and sell it on credit for 13 dirhams. Ibn ‘Abidin claims that in this way he has been saved from indulging in *riba*.[13] We notice here that the solution suggested by Ibn Abidin, clearly violates the purpose of law. It is a subterfuge to circumvent prohibition of *riba*.

Hanafi jurists have also allowed *bai´ bil wafa* (sale with right of redemption) which carries the attribute of *riba*. This is a transaction in which a person in need of money sells a commodity to a lender on the condition that whenever the seller wishes, the lender (the buyer) would return the purchased commodity to him upon surrender of the price.[14] The reason for its designation as *wafa* is the promise to abide by the condition of returning the subject matter to the seller if he too surrenders the price to the buyer. Like *bai´ al-´inah*, this too is legal device for *riba*. The purchaser in this case is a creditor who benefits from the object held in his custody as pledge till the debtor pays him back his amount and retrieves his object. Islamic injunctions on pledge clearly provide that the creditor is not entitled to make profit out of the pledged property. Any profit drawn from it is interest. The Muslim jurists generally treat *bai´ bil wafa* as mortgage.

In another form, the borrower who owns certain property, sells that property to the lender, leases it back, pays rent on it (equaling interest),

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[13] See *Fatāwā , Tanqīḥ al-Ḥāmidiyyah*, vol.2, p.245

[14] Ibn ‘Abidin, *Radd al-Muhtar,* vol.4, p.341

and then invokes a right to repurchase the property for the original sale price.[15]

2.2.2 Maliki Approach in Treatment of *Ḥiyal*

Maliki jurists take the most strict position on ḥiyal. They condemn ḥiyal and declare them invalid. Shatibi writes:

> The prominent meaning of *ḥilah* is to do an act which is apparently permissible with the purpose to nullify and violate some *sharī´ah* rule. Thus the ultimate purpose of act is to offend established principles of *sharī´ah*. For instance when a person makes gift of *zakāh* soon before the completion of year, he in fact does this, to evade the obligation. This goes without saying that to make gift in itself is a permissible act and abstention from *zakāh* is prohibited act. Now when he combines a permissible thing, with prohibited thing, he in fact intends to escape *zakāh*. Otherwise, making gift in itself is permissible but if it aims at avoiding *zakāh* then it is unlawful.[16]

To establish unlawfulness of *ḥiyal*, Shatibi argues that *sharī´ah* was revealed for the purpose of regulating benefits which are universally applicable. He further argues that the *aḥkām* of *sharī´ah* are not the ends *per se*. They are meant to realize certain objectives. These objectives are in fact the interests that the *sharī´ah* seeks to achieve by these *aḥkām*. Now when a person performs certain act that defeats that interest, he in fact violates the will of the law-giver.[17]

Maliki jurists are so strict on unlawfulness of *ḥiyal* that they do not acknowledge even the lawful means which most probably lead to an evil. Maliki jurists call it *sadd al- dhara'i*'which is permanent principle of legal reasoning in Maliki School. Imam Shatibi has described *sadd al-dhara'i*'as use of a thing which has a benefit (*maslahah*) as a means to realize some unlawful end or to get to an evil (*mafsdah*).[18] Another Maliki jurist, Qarafi defines it in the following words:

> *Sadd al-dhara'i*'is to annihilate the matter of means of corruption in order to eliminate it. If an act which is itself free from corruption

[15] *Al-Fātawā al-Hindiyyah*, 3:209
[16] Shatibi, *al-Muwāfaqāt*, vol.4, p.201
[17] *Ibid*, vol.2, p.385
[18] Al-*Muwāfaqāt,* vol.4, p.199

(*mafsadah*) is used as means to corruption, Imam Malik prohibited that act in many cases.[19]

Thus *sadd al-dhara'i*'refers to an act which has a benefit but most probably leads to an evil which is equal to the benefit. The concept of *sadd al-dhara'i*', observes Kamali, is founded in the idea of preventing an evil before it actually materialize. It is therefore, not necessary that the result should actually happen. It is rather the objective expectation that a means is likely to lead to an evil result which render the means in question unlawful even without realization of the expected results.[20]

The relationship between means (*dhara'i*') and *ḥilah* is that both lead to an evil. But the means i.e. *dhara'i*'are not always associated with illegal motive. *Sadd al-dhara'i*'basically contemplates preventing an evil before its occurrence. The question of intention to procure a particular result cannot be a reliable basis for assessing the means that leads to that result. The question of intention of perpetrator is not relevant to the adjective determination of the value of means. A *ḥilah,* on the other hand, is always exercised with intention and with the purpose to circumvent some *sharī´ah* prohibition. In *bai´ bil wafā,* as we have observed earlier, the goods sold are in nature of mortgaged property. The transaction of sale authorizes the purchaser to benefit from the purchased goods which should not be permissible in the case of direct mortgage. Thus, the sale with right of redemption (*bai´ bil wafā)* was adopted as a tricky device to circumvent the prohibition of benefiting from mortgaged property held as security with the creditor. Now since the *ḥilah* violates the spirit of Islamic law, it should be condemned and discouraged. Similarly, a *dhari'ah* should also be discouraged as long as it leads to unlawful end.

2.2.3 Hanbli Approach

Hanbli Jurists make distinction between the *ḥilah* to overcome inconvenience in law and the other to circumvent *sharī´ah* prohibitions. They call the former *makhārij,* and consider them valid.[21] Ibn al-Qayyim a renowned Hanbli jurist has devoted full chapter to discussion on *ḥiyal.* Ibn al-Qayyim, like his contemporary Maliki jurist Shatibi emphasizes the role of intentions in juridical acts. He writes:

[19] Qarafi, *al-Furūq*, vol.2, p.32
[20] Kamali, Principles of Islamic Jurisprudence, p.394
[21] Ibn al-Qayyim, *I'lām* op.cit, vol.3, p.148; Ibn Qudamah, *al-Mughn ī*, vol.6, p.116

Intention is the essence of every juridical act. The act follows the intention. If the intention is valid, the act will be valid and if the intention is unlawful, the act would be unlawful. Thus if a person enters a sale transaction which he intends to be a means for *riba* transaction, the sale transaction would be treated as *riba*. The outward form of contract does not make it a sale transaction.[22]

Ibn Qayyim regards *ḥiyal* inconsistent with the spirit of *sharī´ah*. He compares *ḥilah* with *sadd al-dhara'i*'(plugging means towards unlawful ends) and concludes that doctrine of *ḥiyal* is in sharp contrast to the principle of *sadd al-dhara'i*' in that the lawgiver through *sadd al-dhara'i*' intends to block the means towards unlawful ends whereas *ḥilah* opens means towards unlawful ends.[23]

To prove the undesirability of *ḥiyal*, Ibn al-Qayyim cites the *hadith* in which Holy Prophet (pbuh) cursed the Jews for circumventing the prohibition of fat of animals. The *hadith* reads: "May Allah (SWT) curse the Jews, when Allah (SWT) declared the fact of such animals unlawful, they melted it and enjoyed the price they received". The fat of animal was prohibited for Jews. So they melted it and changed its form. They thought that prohibition did not apply to that new form. Thus, they continued benefiting from fat. Another form of benefit they devised was to sell it and enjoy the price. Ibn al-Qayyim after quoting this *hadith* writes: "Khattabi said: This *hadith* provides a proof that a *ḥilah* is invalid when it leads to commission of prohibited act. The mere change of word form and title does not change the *ḥukm* and effect, if there is no change in substance".[24]

Thus in the opinion of Ibn al-Qayyim intention and purpose of law is the touchstone to determine the validity / invalidity of a juridical act. Ibn al-Qayyim has given a number of solutions in his book to difficult problems which serve as precautionary measures which a prudent person should take before entering a transaction. Ibn al-Qayyim's solutions are more close to *makhārij* than to stratagems and subterfuges. Following statement of Ibn al-Qayyim will explain the point.

> If a person asked another person: Buy this commodity from this person at this price and I will buy it from you and will give you certain profit on it." The person thought that if he bought, the

[22] *I'lam al-Muwaqqi'īn*, vol.4, p.217, Egypt, 1388.H/1968 A.D.
[23] *Ibid*.
[24] *I'lām,* op.cit, vol.3, p.138

orderer might change his mind and refuse to buy it. In that situation he would not be able to return it to seller. The *ḥilah* in such situation is that he should buy it with *khayār al-sharṭ* (stipulated right of cancellation) for three days or more, and then present the goods to the orderer for sale. If he buys it at a stated price, the transaction will be enforced, but if he refuses he can return goods to original supplier by invoking his stipulated right of revocation i.e. *khayār al-sharṭ*.[25]

The case under discussion is that of "*murabaha* to purchase orderer". Imam Ibn Qayyim instructs that in case the buyer apprehends that orderer will decline to buy promised goods, he should, as a precautionary measure, stipulate in the purchase contract his right to return. As such, this solution is more in nature of a precautionary device than a stratagem or unlawful *ḥilah*. It can also be described as a risk-management device. Thus the *ḥiyal* in Hanbli School are generally used in the sense of *makhārij*.

3. Use of *Ḥiyal* in Islamic Banks

In Islamic finance, *ḥiyal* have been in practice since its inception. In Pakistan, in 1984 the State Bank introduced twelve modes of financing. Many of them represented stratagems and subversive *ḥiyal*. But gradually the size of such *ḥiyal* was decreased. Now most of the *ḥiyal* in practice are in the nature of *makhārij*. They are wise answers to difficult problems rather than unlawful *ḥiyal*. They are cleaver uses of law to achieve legitimate ends. There are, however, some devices which certainly fall under the category of unlawful devices as they defeat the higher purposes of Islamic economics and finance. These legal devices have badly affected the originality and authenticity of Islamic banking. Here we will deal with such *ḥiyal* in Islamic finance. It is pertinent to note that the opponents of Islamic banking generally regard all the legal devices practiced in Islamic banks as unlawful *ḥiyal* while the proponents identify them as *makhārij*, rather than subversive *ḥiyal*.

3.1 Unlawful *Ḥiyal* in Islamic Finance

The legal devices discussed under this title are the *ḥiyal* that frustrate the purpose of law and circumvent *sharī´ah* prohibition on *riba*. The list of such legal devices, *inter alia* includes *bai´ al-´inah*, *tawarruq* and

[25] *Ibid*., vol.4, p.24

Commodity Murabaha transactions. Sale and lease back ṣukūk also partially fall in this category as they have the properties of *bai´ bil wafā* which has been declared invalid by the International Fiqh Academy.

3.1.1 *Bai´ al-´inah*

Bai´ al-´inah i.e. buy-back agreement is one of the transactions that defeat the purpose of Islamic law. In Pakistan, buy-back was one of the twelve modes of financing suggested by the State Bank of Pakistan in 1980s. In 1992 the Federal Shariat Court and Shariat Appellate Bench of Supreme Court in 1999 held buy-back void. Since then it is no longer practiced in Pakistan. Auditing and Accounting Organization for Islamic Financial Institutions has ruled for its invalidity. The Islamic banks in Malaysia still rely on buy-back agreement as mode of finance. The bank, for instance, sells piece of land to the customer on credit and then buys it back for cash at a lower price. The difference in price is the bank's profit which is determined in advance. The reason for its practice in Malaysia appears to be is that the Shaf´ie jurists hold such contract valid. The unlawfulness of purpose in their opinion does not affect validity of contract as long as illegal intention is not explicitly mentioned in the contract.

3.1.2 *Tawarruq*

Tawarruq is a transaction whereby a person who is in need of money, buys a commodity on credit from a certain person and then, sells it in the market on cash at a price less than the one at which he purchased from its owner. It is called *tawarruq* because the purpose of this transaction is to obtain *wariq* (silver) i.e. money or finance by a needy person. For example, A is in need of Rs. 20000. He approaches B with the request to sell him certain commodity on credit. B sells him a computer worth Rs.20000 for Rs.30000 on credit to meets his immediate need of money. A sells it in the market on cash for Rs.20000/- and gets money. He is indebted to B for Rs.30000/-.

The classical Muslim jurists have divergent views about its legal status. A considerable number of Muslim jurists hold it invalid. In their opinion the motivating cause of the transaction is to get loan against certain increase. It is a subterfuge and a legal device to obtain money against a certain increase. Besides, it is an exchange of money for money with addition from one side.

Maliki Schools holds *tawarruq* invalid. The authoritative Maliki text *Mukhtasar Khalil* explains Maliki position on *tawarruq*. The author writes:

> "If a person asks the other: Lend me eighty and I will return to you one hundred". The other person says: It is not lawful but I will sell you a commodity worth eighty for one hundred. This is disapproved in Maliki School.[26]

Hanafi School has two divergent positions on *tawarruq*. Zayla'i (d.743) identifies *tawarruq* as *bai´ al-´inah* and disallows it. He says:

> The form in which *bai´ al-´inah* is practiced is that a needy person approaches a merchant and requests him to lend him some money. The merchant wants to earn from it but at the same time he does not want to be indulged in *riba*. So he sells to him a cloth worth ten for fifteen on credit so that the needy person could sell it for ten (which is the real value of cloth) on cash and meet his need. This is unlawful and reprehensible.[27]

Ibn Humam (d.861), another Hanafi jurist, did not consider it preferable, although allowed it.[28]

Shafi jurists emphasise that external form of contracts should be according to the requirement of Islamic Law. They are not concerned with the underlying intention.[29] From this it can be concluded that they acknowledge the validity of *tawarruq*.

Hanbli scholars hold *tawarruq* valid. Al-Mardawi, a renowned Hanbli jurist writes:

> "If a person needs cash, and for that purpose he buys a commodity whose value is hundred for hundred and fifty, it is lawful". This is the ruling of Imam Ahmad.[30]

Hanbli jurists regard it permissible. However, Imam Ibn Taymiyyah and Imam Ibn al-Qayyim do not agree with the acknowledged viewpoint of their school. They equate *tawarruq* with *bai´ al-´inah* (buy-back agreement).[31] Those who approve of *tawarruq* rely on the texts that permit sale such as the verse: Allah (SWT) has permitted *bai´* and forbidden *riba*

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[26] Mohammad Abdullah al-Khirashi, *Sharh al-Khirashī*, vol.5, p.106; Dardir, *al-Sharh al-Kabīr*, Baruit: Dar Sadir, n.d. vol.3, p.89.

[27] Zayla'ī, *Tabyīn al-Ḥaqā'iq*, vol.4, p.163

[28] Ibn Humām, *Sharḥ Fatḥ al-Qadīr*, vol.7, p.212 & 148, Beirut, n.d. (See also, Ibn 'Abidin, *Radd al-Muhtār*, vol.5, pp.325-326

[29] See,al- Nawawī, *Rawdah al-Ṭalibīn* 3/201, vol.3, p.416, Beirut 1405 A.H.

[30] Al-Mardawi, *Kitab al-Insāf*, vol.4, p.337, Beirut. n.d.

[31] *'I'lām al-Muwaqq'in*, op.cit, vol.5, p.86; Ibn Taymiyyah, *Al-Fatawa al-Kubra*, vol.19, p.302

(al-Baqarah 2: 275). They, however, lay down certain conditions for its validity. These are:

i) There is a real need for transaction. The person undertaking *tawarruq* needs money and he is unable to get loan from any source. However, if he can get loan, then he is not allowed to enter *tawarruq.*

ii) The contract in its form should not be similar to a *riba* contract. This occurs where the seller expressly mentions that he is selling a commodity worth one thousand (which is the real price) for twelve hundred, because this amounts to exchange of money for money with excess. It is, however, lawful if he apprises the prospective debtor of its real price and his profit margin.

iii) The debtor (buyer of commodity) should not sell it before taking its possession.

iv) The commodity should not be sold to the same creditor (seller in this case) at a less price.

The Fiqh Academy of Muslim World League in its 15th session had also allowed *tawarruq* with certain conditions. It, however, reviewed its *fatwa* in its 17th session and declared current *tawarruq* practices by the Islamic banks invalid.[32]

The procedure of *tawarruq* transaction in the Islamic banks is as follows:

The bank arranges a commodity for its customer from international market and then sells it to him on credit. The bank also agrees with the customer that it will sell it in the market as its agent. This can be illustrated by the following examples:

A, a customer approaches B, a bank with a request to lend him Rs.10000. B purchases an item for Rs.10000 from C, a dealer on cash, and sells it to A, for Rs.12000 on a credit of one year. B, then in its capacity as the agent of A, sells it to C for Rs.10000 on cash, and hands over Rs.10000 to A, the customer.

It is worth-mentioning that Hong Kong Shanghai Banking Company (HSBC) and many other banks use *tawarruq* as mode of personal financing. The working of *tawarruq* in HSBC is that it buys metals from international brokers and then sells them on to customers at a pre-agreed

[32] *Qarārāt al-Majma‘ al-Fiqhī li Rabitah al-‘Alam al-Islāmī*, 1410/1998.

price that is payable over an agreed term. The customer appoints the bank its agent to sell the metals to a third party in the market. The proceeds are credited to creditor's account.

It is evident from the above mentioned practices of *tawarruq* in the banks that it is only a legal device (*ḥilah)* to circumvent the obstacle posed by the prohibition of *riba* by making it a sale transaction while in fact it is an interest-bearing loan transaction. It is a credit vehicle and technique to provide cash / liquidity against an increase over and above the amount of finance. Even the possession of commodity is not taken by the prospective debtor. The commodity also does not move into his risk and liability. Main objections raised on *tawarruq* practice are as follows:

i) This is a trick to get cash now for more cash paid later.

ii) There are effectively only two parties i.e. no real, unconnected third party.

iii) There is a concealed buy-back.

iv) The metal, subject matter of *tawarruq,* does not move at all in relation to *tawarruq* sales; this renders the metal virtually wholly irrelevant since it serves simply as a prop to enable these deals to be transacted.

v) *Tawarruq* does not involve any kind of risk that is associated with normal and genuine commodity trading activities.[33]

3.1.3 Commodity *Murabaha*

Similar to *tawarruq* is commodity *murabaha* which is practiced by some Islamic banks in various parts of the world also including Pakistan. It is a treasury product used mainly as a tool of liquidity management. The commodity *murabaha* is practiced in Pakistan in the following manner:

i) Upon the requirement of liquidity, Bank 'ABC' approaches the Islamic Bank (IB) for the requirement of funds. After the required approvals the IB and Bank 'ABC' enter into a Master Murabaha Facility Agreement (MMFA) to execute commodity *murabaha* transactions from time to time.

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[33] See, Salman H. Khan, Organized *Tawarruq* in Practice: A *Sharī´ah* Non-Compliant and unjustified Transaction, New Horizon, Oct-Dec. 2010; see also Sami Ibn Ibrahim Swaylim, *Qadhāyā fi al-Iqtisād wa al-Tamwil al-Islamī*, Dar Kunuz, Ishbalia, Riyadh. Pp.313-435

ii) After signing the MMFA Bank ABC submits an Order Form to IB for the total amount required; upon receiving the Order Form, IB purchases the commodity from the commodity broker/seller through telephonic recorded lines on spot basis at the prevailing market rate. The commodity (ies) could be a mix of different items such as pulses, fertilizer, rice etc.

iii) At the time of such Sale, IB appoints an IB Representative (*Muqaddam* or IB staff) for proper physical identification of the commodity and taking its possession at the broker's/sellers warehouse.

iv) Upon taking possession by IB Representative, the commodity broker/seller acting in its capacity as a Seller (or Undisclosed Agent) furnishes Delivery Order and a Sale Invoice/Sale Warrant entitling IB to hold the title of the commodities.

v) After taking possession, IB has the right to ask for physical delivery, if necessary (the broker may charge additional transportation charges, if the goods are transported for delivery, which are not considered part of the selling price as the sale takes place on 'as is where is' basis).

vi) IB credits the purchase price against this purchase in a checking account of the broker being maintained with the IB.

vii) Before selling the commodity to Bank 'ABC' on *murabaha* basis the IB Treasury Office takes telephonic confirmation (on recorded lines) from IB Representative whether he has taken possession of the commodity (ies) by signing the possession letter.

viii) Upon affirmative confirmation, IB Treasury Office sells the same commodity through recorded telephonic lines to Bank 'ABC' at cost plus profit on deferred payment basis for 'x' number of days).

ix) A separate authorized representatives of Bank 'ABC' (*Muqaddam* or Staff member) also takes the physical possession of the goods from IB Representative at the commodity broker's/seller's warehouse.

x) After receipt of the title and possession of the commodities, Bank 'ABC' is free to hold or sell the commodities to any other 3rd party in the ready market.

xi) Bank 'ABC' pays IB for the commodity purchased on the maturity date, i.e. after completion of 'x' number of days.

As mentioned above, commodity *murabaha* is a treasury product. Through it, the liquidity need of a financial institution, generally a conventional bank is met. Thus, the excess funds of Islamic banks are used by conventional banks. According to a survey, more than 70 billion rupees of Islamic banks are placed with conventional banks through commodity *murabaha*. Since it has been devised to meet liquidity need of a financial institution, it is obvious that no party is interested in commodity. The commodity does not come into the possession or risk and liability of bank that buys it. It is only a *ḥilah* to get a certain fixed increase on the amount lent generally to the conventional financial institutions.

3.1.4 Sale and Lease-back *Ṣukūk*

Sukūk have been defined by the Accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) in its *sharī´ah* Standard No.17 as: "Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of value of *ṣukūk*, the closing of subscription and the employment of funds received for the purpose for which the *ṣukūk* were issued".[34] The standard gives examples of fourteen different types of investment *ṣukūk* such as *ijarah ṣukūk, salam ṣukūk, mudarabah ṣukūk, musharakah ṣukūk* etc. Out of these*, ijarah ṣukūk* are the most popular Islamic investment certificates which are rapidly gaining ground in the capital market.

There are three parties to the structure of *ijarah ṣukūk*: the originator (beneficiary) of *ijarah ṣukūk*; the Special Purpose Vehicle (SPV) the issuer of *ṣukūk* and the investors (*ṣukūk* holders). The beneficiary creates SPV as an independent legal entity that acts as trustee for investors. The originator/beneficiary sells specific asset to SPV. *Sukūk* are issued by the SPV against that asset. The proceeds of sale and passed on to the originator. It leases back the asset and pays rentals to investors through SPV. It also gives undertaking to buy it back on expiry of lease. Pursuant to this unilateral undertaking, it buys the asset at its face value.

In Pakistan, WAPDA and Motorway *ṣukūk* are two important sovereign *ṣukūk* which were based on sale and lease back structure. WAPDA needed finance to enhance power generation capacity at Mangla.

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[34] Article 2, *Sharī'ah* Standard no.17, Investment *ṣukūk*, Sharī´ah Standards for Islamic Financial Institutions, 1429 A.H/2008 A.D., p.307

So it issued *ṣukūk* worth 7000 million rupees against ten turbines installed at Mangla. For this purpose, WAPDA First Sukuk Company was created to act as SPV. The asset i.e. turbines were leased back to WAPDA for a period of seven years. WAPDA gave an undertaking that it would buy them back at the end of lease period at face value.

The above structuring of sovereign *ijarah ṣukūk* has been contested by many *sharī´ah* scholars. In the analysis of these scholars the most controversial and objectionable feature of this type of *ṣukūk* is the buy-back arrangement in it in explicit or implicit form.[35] As we mentioned above, the SPV in case of sovereign *ijarah ṣukūk* is created by the Government which is the initiator, of and beneficiary from *ṣukūk*. The Government gives undertaking to buy it at face value. This is in the nature of put option to SPV. SPV, being a subsidiary of Government, is under obligation to exercise this option in favour of Government, the beneficiary.[36] So it is almost certain that assets are reverted back to the Government on maturity. This is also similar to *bai´ bil wafa* i.e. sale with right of redemption another controversial transaction of classical Islamic jurisprudence. In *bai´ bil wafa*, a person, who is in need of money sells an object on the condition that after certain period he will buy it back from the buyer at face value i.e. at the price of first sale. International Islamic Fiqh Academy has declared this transaction invalid. The reason of its invalidity is that it puts restriction on proprietary right of owner as he is not allowed to dispose it off through sale or gift; rather it binds him to sell it back to the first seller, at face value. This transaction is more close to lending than selling. The seller in the first transaction is borrower and buyer lender. The property remains with the lender as mortgage from which he benefits. This is established fact that any benefit drawn from mortgaged property is *riba*. After the expiry of loan period, the first debtor, pays price and gets his asset back. The second sale in above structure is in fact return of loan amount to the lender.

Besides the above buy back and *bai´ bil wafa* features in above *ijarah ṣukūk*, there are also some other controversial features in the arrangement. Some of such features are as follows:

i) In most of the cases, the ownership of the sold asset remains with the originator. It is not clear in what way the certificate holders own the asset.

[35] Salman Syed Ali, Islamic Capital Market Products, Developments and Challenges, Occasional paper No.9, pp.52,53
[36] *Ibid*.

ii) Major maintenance of the leased asset is undertaken by the lessee (originator/beneficiary) which means that the risk related to ownership has not been transferred to the owners.

iii) On dissolution event (even in case of destruction) the lessee is bound to purchase leased property. This means that the risk is borne by the lessee.

iv) Almost all *ṣukūk* guarantee the return of principal to the *ṣukūk* holders at maturity in exactly the same way as conventional bond. This is accomplished by binding promise from either the issuer or the manager to repurchase the asset represented by the *ṣukūk* at the price at which these were originally purchased by the investors.

Maulana M. Taqi Usmani, a renowned and leading *sharī´ah* scholar of Islamic finance has expressed his dissatisfaction over a number of *ijarah ṣukūk*. His main concern has been that these *ṣukūk* violate the *maqaṣid al-sharī´ah* i.e. higher objectives of Islamic Law and Islamic Finance. In a working paper presented before the *sharī´ah* Board of AAOIFI, Maulana Usmani describes current *ijarah ṣukūk*, inimical to the objectives of the *sharī´ah*. He observes:

> "If we consider the matter from the perspectives of the higher objectives of Islamic Law or the objectives of Islamic economics, then *ṣukūk* in which are to be found nearby all of the characteristics of conventional bonds are inimical in every way to these purposes and objectives. The whole objective for which *riba* was prohibited is the equitable distribution among partners of revenues from commercial and industrial enterprise. The mechanisms used in *ṣukūk* today, however, strike at the foundations of these objectives and render the *ṣukūk* exactly the same as conventional bonds in terms of their economic results".[37]

In order to make *ṣukūk* transaction *sharī´ah* compliant, it is necessary that these issues be addressed, otherwise it will remain a replication of the conventional bonds. In the present form, many sovereign *ṣukūk* are mere stratagems to circumvent *riba*.

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[37] *Ṣukūk and Their Contemporary Applications*, p.13

3.2 *Ḥiyal* as *Makhārij* in Islamic Finance

As opposed to subversive *ḥiyal,* there are certain legal devices which do not frustrate the purpose and spirit of law. They are clever uses of law to achieve legitimate ends. Legal devices in Islamic banks predominantly belong to this category. Following examples can be cited to prove this proposition.

Case No.1

Penalty for Default in in Islamic Banks

In conventional Banking where interest-based loans are advanced to the customers, the amount of loan keeps on increasing according to the period of default. On the other hand, in *murabaha* and *ijarah* financing; the two major financing products in Islamic banks, once the price is fixed, it cannot be increased. However, this restriction is sometimes exploited by dishonest customer who deliberately avoid to pay the price at its due date, because he knows that he will not have to pay any additional amount on account of default or late payment.

In order to resolve this issue, some contemporary scholars have suggested that the dishonest customers who default deliberately should be made liable to pay compensation / penal charges to the financial institution for the loss it may have suffered on account of such default.

It is argued in favor of charging compensation that the Holy Prophet (pbuh) has condemned the person who delays the payment of his dues without a valid cause. In well-known hadith he has said:

> "The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace".[38]

This Hadith allows corporal punishment for the delinquent debtor as well as blacklisting the delinquent debtor and exposing him in the public. This ruling, however, does not apply to the case of genuine default. The financial institution therefore, should verify the causes of default. If it is established that the default of the customer is due to poverty, no penalty or compensation should be charged or claimed from him, rather he should be given respite until he is able to pay[39]. The Holy Qur'an says: "And if he

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[38] Ibn Ḥajar al-'Asqalani, *Fatḥ al-Bārī, Sharḥ Ṣaḥīḥ al-Bukhārī*, p. 134-135, Hadith No. 2400.

[39] Muhammad Taqi Usmāni, op.cit. p. 133.

(the debtor) is short of funds, then he must be given respite until he is well off" (2:280).

Some contemporary scholars have suggested that some fine i.e. a certain quantity of money should be imposed on the defaulter. Such a fine can be proportional to the sum of money involved. It can also be related to the actual period of delay. But this proposal has not been accepted by the majority of Muslim jurists because it makes the fine similar to *riba*. The International Fiqh Academy of OIC has also rejected the proposal. In its judgment in 1990, it held: "If the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to its principal liability, whether it is made a precondition in the contract or it is claimed without a previous agreement, because it is *riba*, hence prohibited in *sharī´ah"*. In another resolution adopted in 2000, it reaffirmed the above, but added: "It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contract is usury in the strict sense". It also lays down that the loss that may be compensated includes actual financial loss incurred by the partner, any other material loss and the certainly obtainable gain that he misses as a result of his partner's default or delay. It does not include moral loss. These resolutions provide some relief only to those affected by delays in fulfillment of *salam/istisna* obligations. The amounts owed in installment sales and *murabaha* sales having become debts remain outside their purview.

The latest response to the challenge came from the Accounting and Auditing organization of Islamic Financial Institutions (AAOIFI), Bahrain. This response makes a penalty for default automatic. AAOIFI has suggested a self-imposed penalty on the customer. The *sharī´ah* standards of AAOIFI, which represent a successful attempt by the contemporary Muslim scholars at harmonization and standardization of *sharī´ah* views on Islamic banking, have suggested that: 'the contract of *murabaha* should consist of an undertaking from the customer to pay an amount of money or a percentage of the debt, to be donated to charitable causes in the event of a delay on his part in paying installments on their due date. The *sharī´ah* supervisory board of the Financial Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Financial Institution itself.'[40]

[40] Shariah Standard No. 8, Murabaha to the Purchase Ordered, Article 5/6, p. 126.

This rule is based on a ruling given by some Maliki jurists who say that if a debtor is asked to pay an additional amount in case of default, it is not allowed by *sharī´ah*, because it amounts to charging interest. However, in order to assure the creditor of prompt payment, the debtor may undertake to give some amount in charity in case of default.[41]

The State Bank of Pakistan also favours this solution. In its guidelines relating to *murabaha*, it says:

> It can be stipulated while entering into the agreement that in case of late payment or default by the client, he shall be liable to pay penalty calculated at a certain percentage per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purpose. The bank can also approach competent courts for award of solatium which shall be determined by the courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost.[42]

From this discussion, it can be concluded that AAOIFI's ruling on penalty for default is an effective mechanism to deter the delinquent debtors from intentional and deliberate default that causes harm to the financial institutions. Thus, compulsory charity suggested by AAOIFI serves as a way-out (*makhraj*) for the problem of delinquent debtor.

Case No.2

In conventional banks, hedging against fluctuation in value of currency is affected through forward and future currency contracts in which both the counter-values are deferred to a future date, while the requirement of Islamic law is that both the counter values should be exchanged in the same session of contract.

In Islamic banks, hedging against future devaluation of currencies is affected through unilateral promise to buy/sell given by the client i.e. importer or exporter. This is done in the following manner:

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[41] This is the opinion of Mohammad ibn Ibrahim ibn Dinar. See, Hattib al-Maliki, *Taḥrīr al-Kalām fī Masā'il al-Iltizām,*

[42] State Bank of Pakistan, 2004: http://www.sbp.org.pk/press/essentials/Essentials%20of%20Islamic.htm

i) A customer (exporter/importer formally requests the bank for a forward promise to buy/sell foreign currency to hedge against foreign currency rate fluctuation in future.

ii) The bank issues to the customer "promise to sell/purchase" as the case may be as per approved format. This promise to sell/purchase records the promise between bank and customer to sell/buy foreign currency at a future date.

iii) The customer signs and returns the "promise to sell/purchase" to the bank.

iv) The actual transaction takes place on maturity date and both counter values are exchanged.

The hedging can also be done through the execution of back to back interest free loans using different currencies without receiving or giving any extra benefit provided these two loans are not contractually connected to each other.

4. Conclusion

In the preceding pages we have analysed approaches of *fuqaha* in the treatment of *ḥiyal.* We have noted that Maliki and even Hanbli jurists regard them invalid. Hanbli *fiqh* allows only those legal devices which provide solutions for difficult problems. The legal devices suggested by Hanbli jurists are in fact precautionary measures and risk management devices. Shafi'īs acknowledge permissibility of *ḥiyal* though they consider them immoral. Hanafi jurists, especially the later jurists (*mutakhkhirun*) are liberal and flexible on the issue of *ḥiyal.* The later Hanafi jurist have used *ḥiyal* as mode of legal reasoning and issued many fatwas on the basis of *ḥiyal.*

In the present Islamic finance, many legal devices are used in order to overcome inconvenience and rigidity of law. Through the device of *makhārij*, practical and viable solutions have been provided by the *sharī´ah* scholars involved in Islamic finance. There are, however, certain legal devices which have adversely affected the originality and authenticity of Islamic banking. *Tawarruq* and commodity *murabaha* belong to this category. It appears that the emphasis of Islamic finance experts in these products has been on the external form of contract and Islamicity of contract rather than its spirit and substance. In our opinion, the islamicity of objective and purpose of transaction is equally important as its external form. The Islamic finance experts should fully utilize the potential of *sadd al-dhara'i'*'and *maqaṣid-al-sharī´ah* in deriving rulings and taking decisions in Islamic Banking and Finance.

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Islamic Banking: Theory, Practice and Evaluation

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1. Introduction

Banks are among the most important financial institutions in a modern economy. They perform certain vital functions for society. One of these is their role of financial intermediation: channelling funds from savers to entrepreneurs. Conventional commercial banks provide financial intermediation services on the basis of interest (charged and paid) on both the assets and the liabilities sides. Since interest is prohibited in Islam, Islamic banks have developed several alternative modes through which savings are mobilized and passed on to entrepreneurs. None of these involves interest. They take the form of either risk-and-reward sharing or trading in commodities/assets. Islamic banks also provide other services generally provided by conventional institutions, such as payment services, transfer of funds, insurance, fund management etc., through contracts which are compatible with Islamic rules. Islamic banking has gained wide acceptance and has succeeded in making inroads into the financial markets around the globe.

Islamic banking does not only fulfill the religious requirement for Muslims, but also broadens the choice-set available to other clients by offering both sales-based finance as well as products based on the sharing of risks and returns. The mix of fixed and variable return modes offered by Islamic banks can exert a healthy effect on the efficiency and stability of the financial system. Islamic banking is expected to contribute to greater allocative efficiency[1], financial stability,[2] growth[3] and social justice[4]. In a

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[1] See for example Zarqa (1982)

[2] See Al-Jarhi in K. Ahmed (1980); Zarqa (1983)

[3] See Al-Jarhi in Iqbal and Ahmad (2005)

world beset with financial crises, these strengths inherent in Islamic banking should offer a new ray of hope for achieving the cherished goal of systemic growth with stability.

The experience of the last 30 years has shown that Islamic banking is a viable, dependable and well-supervised activity. It is just another way of performing the financial intermediation function. Islamic banks are subject to the same regulatory standards and fall under the purview of the same supervisory authorities as conventional banks. In addition they have to comply with the Islamic rules which imply that their overall legal and supervisory environment is more stringent. In brief, Islamic banking adds a healthy dimension to the international financial system.

2. Why Islamic Banking is Needed?

In any economy, there is a need to transfer funds from savers to investors because people who save are frequently not the same people who have the ability to exploit the profitable investment opportunities. This function is performed through the process of financial intermediation in the financial markets. Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the needs of surplus and deficit units with respect to size, duration, liquidity and risk profiles. The process involves the creation of a variety of financial assets and liabilities with different characteristics to cater for different needs of savers and the ultimate users of funds. Financial intermediaries are also in a better position to collect information about investment opportunities, which is crucial for efficient allocation of society's resources.

The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. However, conventional banks perform their borrowing and lending activities and most other functions on the basis of fixed interest. In an Islamic economy, both giving and taking of interest is prohibited. As a matter of fact, interest is prohibited by most religions, including Christianity and Judaism[5]. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This requirement provides the rationale of Islamic banking.

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[4] See Chapra (1985)

[5] For evidence see Mills and Presley (1999) pp.101-113 and Chapra (1985) pp. 221-222. Also see article on 'Usury' in the Encyclopaedia of Religion and Ethics, edited by James Hastings (New York: Chalres Scribner's Sons, n.d.) vol.12, pp.548-58.

3. How Does an Islamic Bank Work?

Even though Islamic banks emerged in response to the market needs of Muslim clients, they are not religious institutions *per se*. Like other banks, they are profit seeking business institutions. While it is the preferred way of banking for one fifth of humanity, it offers a wider choice of financial products to all.

An Islamic bank is a deposit-taking institution whose functions include all currently known banking activities. On the liabilities side, it mobilizes funds on the basis of *mudaraba* (profit-sharing) or *wakalah* (as an agent charging a fixed fee for managing funds). On the assets side, it makes finance available on a profit-and-loss sharing basis or through the purchase of goods (on cash) and their sale (on credit) or other trading, leasing and manufacturing activities. It plays the role of an investment manager for the owners of deposits, except a part of demand deposits which are treated as interest-free loans from the clients to the bank and are guaranteed to be repaid in full. Such deposits neither share in risk nor reward. Equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations.[6] In this sense, Islamic banks are similar to universal banks operating in several European countries. An Islamic bank shares its net earnings with its depositors (other than current accounts / demand depositors) in a way that depends on the size and time-to-maturity of the deposits.

4. Potential Benefits of Islamic Banking[7]

Several potential benefits can arise from operations of Islamic banking model. These include:

i) The range of contracts available to savers and entrepreneurs is widened. The menu ranges from low risk trade-linked products to high risk-sharing contracts.

ii) The financial system is enriched by the establishment of financial institutions with different *modus operandi*. This diversity enhances the stability of the financial system because the behavioural characteristics of different types of banks are likely to vary.

iii) Competition among alternative banking models is expected to increase the efficiency of the financial system.

[6] The most important financial products that can be used by an Islamic bank are given in Annexure 1.

[7] Iqbal (2005)

iv) The financial needs of Muslims can be met in accordance with their faith. Since the public's acceptance of the services provided by the industry play a vital role in creating stable and efficient markets, plurality and inclusiveness are important for the development of financial markets.

v) The allocation of financial resources on the basis of profit-and-loss sharing (PLS) gives maximum weight to the profitability of investment as compared with credit worthiness in the conventional system. Such allocation of resources is expected to be more efficient than that on the basis of interest.

vi) As a result of PLS contracts, the liabilities side of the balance sheet tends to become symmetrical with the assets side. This helps making Islamic banks less vulnerable to external shocks and insolvency.

vii) The liability to share bank losses by investment depositors motivates them to be more vigilant about the operations of their banks and to demand greater transparency and more effective audit. Banks are also under pressure to evaluate their clients' projects more carefully and to monitor the risks more effectively.

viii) Since in the case of both profit-sharing and sale-based contracts, banks assets are created in response to investment opportunities in the real sector of the economy, and all financing is linked to commodities or assets, the real factors related to the production of goods and services (rather than speculative manoeuvres) become the prime determinants of the rates of return.

ix) Debt creation in Islamic finance is generally not possible without the backing of goods and services. Monetary expansion would thus tend to take place in step with the growth of the real economy. This is expected to control inflationary pressures. Destabilizing speculation would also be significantly curtailed as would the erratic and mass movement of short-term funds.

x) Like 'Ethical Funds', Islamic banks do not provide finance to projects considered socially undesirable. That introduces greater social responsibility.

5. Islamic Banking in Practice[8]

When commercial banking emerged after the industrial revolution, Muslim masses refrained to a very significant extent from dealing with commercial banks. However, growing needs of traders, industrialists and other entrepreneurs in rapidly monetizing economies were pressing. The Muslim economists and banks took up the challenge of developing alternative models of financial intermediation. Valuable theoretical work was done in early 19th century. At that time most of the Muslim world was under colonial rule. When Muslim countries gained their independence after the World War II, practical experiments in interest-free financing started at a modest scale and gradually expanded in scope.

While credit societies and cooperatives working on interest-free basis, existed in several Muslim countries even during the colonial period, the semblance of banking institutions started emerging in early 1960s. A pioneering experiment of putting the Islamic principles governing financial dealings into practice was conducted in Mit-Ghamr, Egypt, from 1963-1967. Deriving inspiration from the idea of German saving banks, the Mit-Ghamr initiative mobilized small savings from the rural sector largely through savings accounts. No interest was paid to the account holders. However, as an incentive they were eligible for small short-term interest-free loans for productive purposes. They were allowed to withdraw their deposits on demand. In addition, investment accounts on the basis of profit sharing were also introduced. The funds so mobilized were invested on the basis of profit-sharing with entrepreneurs.

The first interest-free institution with "bank" in its name, Nasser Social Bank, was also established in Egypt in 1971. This was the first time that a government in a Muslim country showed an interest in incorporating an interest-free institution. Even though the objectives of the Nasser Social Bank were mainly social, such as providing interest-free loans to the poor and needy; scholarships to students; and micro-credits to small projects on profit-sharing basis; the involvement of a public authority in interest-free banking sent important signals to Muslim businessmen having surplus funds. A group of such businessmen took the initiative of establishing the Dubai Islamic Bank in 1975 in Dubai, United Arab Emirates (UAE). This was the first Islamic Bank established on private initiative. However, the official support was crucial with the governments of UAE and Kuwait contributing respectively 20% and 10% of the capital.

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[8] For a more detailed coverage of Islamic banking in practice, see Iqbal and Molyneux (2005).

The most important development in the history of Islamic banking took place with the establishment of the Islamic Development Bank (IDB) in 1975. The IDB was established as an international financial institution in pursuance of the declaration of intent issued by a conference of finance ministers of Islamic countries held in Jeddah, Saudi Arabia in December 1973. The declaration was signed by the representatives of twenty-three member countries of the Organization of the Islamic Conference (OIC). The second conference of finance ministers, held in Jeddah, in August 1974, adopted the Articles of Agreement establishing the Islamic Development Bank. The inaugural meeting of the Board of Governors of the IDB took place in Riyadh, Saudi Arabia, in July 1975 and the Bank started functioning on 20 October 1975.

The period between 1975 and 1990 was the most important period in the history of development of Islamic financial industry. During this period, it matured into a viable alternative model of financial intermediation. It won respect and credibility in terms of both theoretical developments and practical experiences. On the one hand, several financial products compatible with Islamic principles were developed and on the other hand, Islamic banks showed good results in practice while using these products. The period was not only marked by establishment of a large number of Islamic financial institutions in the private corporate sector under different socio economic milieu, but also witnessed the expression of intent from three countries, namely, Pakistan, Iran and Sudan, to gradually eliminate interest from their entire economies and substituting it with a complete banking systems based on Islamic principles. Several practical steps were also taken in these countries towards achieving that objective. Even more important was the fact that several important multinational banks started offering Islamic financial products. These included Hong Kong and Shanghai Banking Corporation (HSBC), Chase Manhattan, Grindlays and Citibank to name only a few. That was a clear recognition of the viability of the new model and its acceptance by international players. The International Monetary Fund and the World Bank also recognized the importance of Islamic financial products as means of financial intermediation and produced papers to that effect[9].

[9] See for example, Haque and Mirakhor (1986), Iqbal and Mirakhor (1987) and Karsten (1982).

Broadly speaking two different approaches were followed by Islamic countries for the expansion of Islamic banking, viz., state-sponsored growth and development of Islamic banking in a competitive framework.

6. Country Experiences With Islamic Banking

6.1 Pakistan

The process of economy wide Islamisation of the banking system in Pakistan was initiated soon after a declaration by the then President of Pakistan in February 1979 that the Government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of three specialized financial institutions, House Building Finance Corporation, National Investment Trust and the mutual funds of the Investment Corporation of Pakistan.

For the conversion of the operations of commercial banks to a non-interest basis a gradual approach was adopted. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on profit/loss sharing (PLS) basis in all the domestic branches of the five nationalized commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest bearing deposits or PLS deposits, continued to operate till the end of June 1985. As from 1st July 1985, no banking company was allowed to accept any interest bearing deposits except foreign currency deposits which continued to earn interest. As from that date, all deposits accepted by banking companies shared in the profit and loss of the bank except deposits in current account on which no interest or profit was given and whose capital sum was guaranteed. The central bank of the country issued instructions specifying twelve modes of financing in which funds mobilized by the banks could be employed. However, in practice, banks relied almost entirely on *murabaha* (mark-up) and buy-back arrangements.

A beginning in the direction of introducing the *mudaraba* technique of financing was made in June, 1980 when a law was promulgated under which companies, banks and other financial institutions could register themselves as *mudaraba* companies and mobilize funds through the issuance of *mudaraba* certificates. Funds obtained through a *mudaraba* contract could only be used in such businesses which were permitted under the *sharīʹah*, and needed prior clearance from a Religious Board established by the government specifically for the purpose.

Though a number of steps were taken for the elimination of interest from the financial sector in Pakistan, the process of Islamisation was slow and selective. Nothing was done to eliminate interest from government transactions. Another disappointing feature of the situation was the lack of any notable progress in the transition to profit/loss sharing on the assets side of the banking system. Furthermore, no institutional mechanism was created for a continuous scrutiny of the operating procedures of banks and other financial institutions from the *sharī´ah* point of view. Individual scholars who examined these operating procedures pointed out several areas where the actual banking practices showed deviation from *sharī´ah*. In December 1991, the Federal Shariat Court, in one of its judgments, held that the system of mark-up financing as being practiced by banks was not in conformity with the injunctions of Islam. It also took exception to a number of other practices prevailing in the banking sector. The court instructed the government to repeal/correct all un-Islamic provisions and practices. The government filed an appeal against this decision in the Supreme Court, the apex judicial body. After a long delay, the Supreme Court took up hearing of this and some other similar appeals in 1998. It gave its judgment in 1999 in which it rejected the government appeal and endorsed most of the sections of the Federal Shariat Court judgment. The court gave the government a time frame ending June 2001 to correct objectionable practices identified by the Federal Shariat Court and the Supreme court itself while hearing the case. Later, on an appeal from the Government, the Court extended this deadline by one year. In compliance with that judgment, the government set up a Commission to devise a strategy for implementing the requirements of the judgment. The Commission submitted its report to the Government, but in the meanwhile one bank affected by the Supreme Court decision, filed a review petition. In 2002, the Court reversed its earlier decision and referred the case back to the Federal Shariat Court for a fresh hearing which has not started until now (2006). In the meanwhile, the Government has decided to follow a model of a mixed system whereby conventional and Islamic banking can function side by side. Until the end of 2005, the Central Bank had given banking licences to three Islamic banks. In addition, all commercial banks are entitled to open Islamic windows permission for which is granted on case-by-case basis. In April 2004, the Sharī´ah Board of the Central Bank approved the essentials of Islamic modes of financing to ensure compliance with minimum *sharī´ah* standards by banks conducting Islamic banking in Pakistan. In addition, model agreements for various Islamic modes of financing were developed and announced with the dual objective of facilitating the existing Islamic banking sector and the potential market players to use Islamic banking products and to create general awareness about Islamic banking products.

6.2 Iran

A new banking law, the "Law for Usury-Free Banking Operations", was enacted in Iran in August 1983 to replace interest based banking by interest free banking. The law required the banks to convert their deposits to an interest-free basis within one year, and their other operations within three years, from the date of the passage of the law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibilities of the central bank under the new system and the mechanics of central bank's control over the banking system.

The law allows the banks to accept three types of deposits, viz., *qarḍ al-ḥasan* deposits, general term investment deposits and project-specific investment deposits. On the asset side, the law provides thirteen different modes of contract, through which finance can be provided. Yasseri (2002) gives operational details of some of these modes. He points out that Iranian banks' most popular contract is instalment sales, followed by *musharaka* (civil), *musharaka* (equity), *mudaraba*, *salaf* (*salam*), *qarḍ al-ḥasan*, direct investment, *jualah* and hire purchase.

One important feature of Islamic banking in Iran is that banks are obliged to earmark a portion of their resources for grant of *qarḍ al-ḥasan* to help achieve the socio-economic objectives set out in the constitution of the country. In addition to banks, a number of charity organizations have also been established under government patronage to grant *qarḍ al-ḥasan*. Besides *qarḍ al-ḥasan*, banks are authorized to extend financial assistance for productive ventures on a profit/loss sharing basis in accordance with the principles of *mudaraba* and *musharaka*. Banks are allowed to provide part of the capital of a new joint stock company and also to purchase shares of existing joint stock companies. Banks are authorized to provide working capital financing to productive units by purchasing raw materials, spare parts and other items on their request for sale to them on the basis of deferred payment in instalments. Purchase of machinery and equipment for sale to their clients on a deferred payment basis is also allowed.

Studies on the progress made in the implementation of the new system show that banks have, in general, adapted well to the new procedures. Problems have been encountered, however, in moving away from traditional short-term trade financing operations and toward profit-sharing medium and long-term financing operations. It was expected that with the passage of time banks would increase their involvement in *mudaraba* and *musharaka* financing but this expectation has not been fulfilled. No attempt has been made so far to Islamisize international banking and financial operations. In addition, the government continues to borrow from the banks on the basis of a fixed rate of return.[10] It has also been pointed out that some banking practices in Iran are at variance with the practice of Islamic banking in other countries.[11] A number of studies refer to conscious efforts made in recent years to reorient the activities of banks in Iran to achieve Islamic socio-economic objectives.[12] The banking system has been used as an instrument of restructuring the economy, away from services and consumption toward production. Bank financing to the services sector has been drastically curtailed. Banks have reduced financing for the production of luxury goods and commodities with large import content, while financial assistance for the production of necessities and intermediate goods has been appreciably increased. Financing facilities for the agricultural sector have been considerably expanded. The banking system has also been used as an instrument of income redistribution through the provision of *qarḍ al-ḥasan* loans to low income groups, financing the building of low cost houses, and provision of financing for small scale agro business and industrial cooperatives often without stringent collateral requirements.

6.3 Sudan

The process of the economy-wide Islamisation of the banking system in Sudan has not been smooth and steady. The first attempt to Islamise the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest-based dealings with immediate effect and to negotiate the conversion of their then existing interest-bearing deposits and advances into Islamically acceptable forms. Foreign transactions were allowed to be continued on the basis of interest temporarily. It is reported that this sudden change forced the banks to

[10] In one of the studies it is stated: "In the case of the Islamic Republic of Iran, it has been decreed that financial transactions between and among the elements of the public sector, including Bank Markazi and commercial banks that are wholly nationalised, can take place on the basis of a fixed rate of return; such a fixed rate is not viewed as interest. Therefore, the Government can borrow from the nationalised banking system without violating the injunction of the Law." See, Iqbal, Zubair and Abbas Mirakhor (1987), p.24.

[11] A case in point is the treatment of investment deposits. In Iran, the law allows the nominal value of such deposits to be guaranteed while such a guarantee is not considered compatible with Islamic teachings in other countries.

[12] See Mirakhor, Abbas in Chibli Mallat (1988), p.55.

adopt the nearest Islamic alternative available that is *murabaha* which soon constituted 90 percent of their financial operations. It is also reported that the banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the Central bank of the country. Policy makers in the Central bank were also discontented with the procedure of transforming the banking system. They considered it as a mere political decision imposed by the government without being preceded by adequate detailed studies."[13] This experiment with economy-wide Islamisation of the banking system came to an end in 1985 with the change in government. The Government revived the process in May 1990 by reactivating an existing Islamic banking law. It issued a more comprehensive law in 1992 which envisioned an economy-wide Islamisation of the financial system including the government sector. Reports indicate that the effort is much more earnest and much better organized this time. Now all banks are using Islamic modes of finance. An important development worth mentioning is the attempt being made to eliminate interest from the government sector also. Other countries have found this a hard nut to crack. The government of Sudan has launched two Funds based on the principle of *musharaka* to mobilize resources for the public sector. The first is, the Government *Musharaka* Certificate (GMC). It is an instrument that enables the government to raise funds through issuance of securities that promise the investor a negotiable return linked to developments in government revenue in return for their investment in the provision of general government services. The other is Central Bank *Musharaka* Certificate (CMC). This is an equity-based instrument that is issued against the government (or Central bank) ownership in commercial banks. Under CMC, the Central bank becomes a partner with the investors in profits of the underlying assets. The distribution of profit between the Central bank and the investors is negotiable and the Certificate can be sold on the secondary market to another bank or the Central bank. While GMC is still operating, CMC has been temporarily discontinued.

6.4 Bahrain

The Kingdom of Bahrain was amongst the first to recognize the importance of the concept of Islamic banking and finance and as a consequence has been both supportive of the development of the industry in general and welcoming to the new institutions in particular. Consequently, Bahrain has gathered a concentration of specialist Islamic institutions on its shores. The first Islamic bank in Bahrain was established

[13] Osman Ahmed in Rodney Wilson ,ed., (1990), p.77.

in 1979, when Bahrain Islamic Bank was licensed. Since then, the sector has grown considerably. Now Bahrain has the largest number of Islamic financial institutions not only in the Gulf but anywhere in the world. The Kingdom is playing host to 26 Islamic banks and financial institutions, five industry-support organizations, six Islamic insurance companies and 34 Islamic mutual funds. A comprehensive prudential set of regulations for Islamic banks was introduced in early 2000 by the Bahrain Monetary Agency (BMA). This is referred to as the Prudential Information and Regulations for Islamic Banks (PIRI) framework. The framework covers areas such as capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management.

Within such an environment, the Islamic financial industry in Bahrain will be able to enjoy sustainable growth based upon strong investor and customer confidence, attractive product design and expanding markets. Much is already in place. The Bahrain Monetary Agency's statutory responsibility as the sole regulator for the financial sector and the sector's adherence to the PIRI framework ensures that Islamic institutions will continue to operate according to standards comparable to those of the conventional financial sector.

Product innovation continues apace. The *ijarah* and *salam ṣukūk* are now firmly established and the BMA is fully committed to a rolling program of further issues as an integral part of the development of Bahrain as an international Islamic *ṣukūk* market. These initiatives have been matched on their part by the private sector.

6.5 Malaysia

The Islamic financial system that has developed in Malaysia over the last two decades is emerging as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market.

The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) that came into effect on 7 April 1983. The IBA provides Bank Negara Malaysia (BNM) with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment

Certificates (GIC), which are government securities issued based on *sharī´ah* principles. As the GIC are regarded as liquid assets, the Islamic banks can invest in the GIC to meet the prescribed liquidity requirements as well as to invest their surplus funds.

The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB) which commenced operations on 1 July 1983. BIMB proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992. On 1st October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB accordingly. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia.

Recognizing that like any banking system, an Islamic banking system requires three vital elements to qualify as a viable system i.e. a large number of players; a broad variety of instruments; and an Islamic money market, BNM has adopted a step-by-step approach to achieve the above objectives. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as Skim Perbankan Tanpa Faedah (Interest-free Banking Scheme) or SPTF in short. More than 20 banks are now offering Islamic banking services. In addition, there are more than 50 Islamic investment funds. The Malaysian Financial Sector Master Plan launched in 2001 is the blueprint for the development of the financial sector over a 10-year period in Malaysia. The plan places importance on the development of Islamic banking and the *takaful* sector as an important component in the financial system.

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. To fulfil this requirement, the Islamic Financial Services Board (IFSB) was established in 2002. The IFSB is an international body hosted by Malaysia. It has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions.

7. Islamic Banks Working in Competitive Environments

There are around 115 Islamic banks (as per data of 2002) working in the private sector, excluding those in Iran and Sudan, which have declared their intention to convert their entire banking sector to Islamic banking.[14] These institutions are spread in a number of countries and continents. The geographical distribution of these Islamic banks is given in Table 1.

Table 1: Islamic Banks by Regions (2002)

Region	**Number of Institutions**	**%**
South and South East Asia	25	22
G.C.C.	56	50
Other M.E.	23	20
Africa	5	4
Rest of the World	5	4
TOTAL	**115**	**100**

Source: Islamic Banking Information System (IBIS), under construction at the Islamic Research and Training Institute, Jeddah.

[14] There are 17 Islamic banks in Iran and 29 in Sudan. Thus the total number of Islamic banks in the world is 161. This number does not include Islamic windows in conventional banks.

These figures show that the largest number of Islamic banks is in the Gulf Cooperation Council (GCC) countries followed by Asian countries and then by other Middle-Eastern countries. Arab World is the cradle of Islamic banking as 70 percent of Islamic banks are located there.

Saudi Arabia is the largest market for Islamic finance in terms of size. The largest Islamic bank in the world, Al Rajhi Banking and Investment Corporation, is based in Saudi Arabia. The bank had $ 20.8 billion in assets at the end of 2004. In addition, almost all other banks operating in Saudi Arabia are offering Islamic products besides their conventional operations. Saudi Arabia is also home to the largest concentration of Islamic funds. The most important Islamic banking institution, the Islamic Development Bank (IDB), is also headquartered in Saudi Arabia.

The Islamic Development Bank is a Multilateral Development Bank serving the Muslim countries. Its present membership stands at 57 countries. Its purpose is to foster economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of the *sharī´ah*. In order to meet the growing and diverse needs of its member countries, the Bank has established a number of institutions and funds with distinct administrative arrangements and operational rules. These entities and funds, affiliated with the Bank, enable the IDB to mobilize supplementary financial resources in line with the *sharī´ah* principles and to focus on those functions and activities, which cannot be covered under its normal financing arrangements. With these affiliated entities and funds, the Bank has evolved over time into a group called the IDB Group.

8. Evaluation of Performance and Efficiency of Islamic Banking

Several empirical studies are now available which have examined the performance and efficiency of Islamic banks. Earlier studies, due to data limitation relied more on descriptive statistics. As more data became available, several studies using more rigorous statistical techniques were conducted. One of the earlier studies, (Iqbal: 2001) employed growth rates and ratio analysis for 1990-98 period in a comparative framework using a sample of 12 Islamic banks and 12 conventional banks from 10 countries. The sample was drawn from countries where Islamic banking was most active. The study arrived at the following results:

i) Islamic banking industry showed higher rates of growth in terms of key variables as compared to conventional banks.

ii) Evaluation of the performance of Islamic banks through a number of key ratios yielded fairly satisfactory results. In general, Islamic banks were found to be well capitalized and profitable. They also seemed to be making an effective use of the resources at their disposal.

iii) When compared with conventional banks, Islamic banks as a group out-performed the former in almost all areas. However considerable variations were found among Islamic banks in terms of their growth and performance indicators.

For the purposes of this research, we have updated until 2002 the results of that study with a small change in sample. The reason for that change is that one Islamic bank and one conventional bank out of the twelve banks used in the earlier study[15] merged with other financial institutions and hence their time series was not comparable. Therefore, these two banks and their counterparts from the other Group were removed from the sample. The updated results are given in Tables 2 and 3.

Table 2: Comparative Annual Growth Rates (%)

	Total Equity		**Total Deposits**		**Total Investments**		**Total Assets**	
	Islamic Banks	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**
1990-94[16]	7.9	6.4	9.3	3.1	11.3	-0.8	9.3	4.8
1994-98	12.9	4.0	5.8	5.7	7.3	7.7	7.1	5.4
1998-02	7.3	2.7	13.0	5.7	11.2	7.3	11.7	5.5

[15] In 2000 the Faysal Islamic Bank of Bahrain merged with Islamic Investment Company of the Gulf. Therefore, Faysal Islamic Bank of Bahrain and its counterpart conventional bank, National Bank of Bahrain were excluded from the sample. Similarly, in 2001 one of the conventional banks included in the earlier study's sample, The Pacific Bank Berhad, was acquired by The Malayan Banking Berhad. Therefore, The Pacific Bank and its counterpart Islamic bank, Bank Islam Malaysia Berhad were also excluded from the sample.

[16] Reproduced from Iqbal 2001. Details on sample can also be seen there.

Table 3: Comparative Ratios (%)

Ratios[17]	1990-94[18]		1994-98		1998-02	
	Islamic Banks	Conven-tional Banks	Islamic Banks	Conven-tional Banks	Islamic Banks	Conven-tional Banks
Capital Asset Ratio	9.3	9.0	11.8	8.9	12.2	8.7
Liquidity Ratio	20.2	27.7	14.6	38.7	14.2	32.02
Deployment Ratio	92.2	75.8	96.6	63.9	97.2	69.2
Cost/ Income Ratio	55.9	NA	50.9	60.8	56.1	66.4
ROA	1.9	NA	2.3	1.4	2.2	1.4
ROE	19.9	NA	19.2	8.9	18.0	8.7

It can be seen that despite a slight variation in the sample and change of period of analysis the results arrived at in Iqbal 2001 still hold, which gives us the confidence that those results are quite robust.

In a similar study, Bashir (2001) assessed the performance of Islamic banks in some Middle Eastern countries and found it to be well beyond acceptable levels.

Samad (1999) compared the performance of one Malaysian Islamic bank to seven conventional banks over the period 1984-1997. The Islamic bank was found to perform better than conventional banks in terms of liquidity and risk measurement (less risky). Although this study is based only upon one Islamic bank in Malaysia, the study is significant because it gives the efficiency of an Islamic bank outside the Middle Eastern region. A similar study by Sarker (1999) used Bangladesh as a case study. He argued that Islamic products have different risk characteristics, yet Islamic banks can survive even within a conventional banking architecture. Overall, the general finding from this kind of studies is that Islamic banks

[17] For definition of these ratios, see Iqbal (2001), pp. 10-15.
[18] Reproduced from Iqbal 2001.

are at least as efficient as their conventional competitors and in most cases out-performed them.

In recent years, studies employing more rigorous statistical techniques have reached similar results[19]. Al-Shammari (2003) used the translog stochastic cost and alternative profit frontier approaches to estimate bank efficiency in GCC countries and compared Islamic bank efficiency with other types of banks. Cost efficiency estimates for banks in the countries under study averaged 88%. These estimates improved over time from 84% in 1995 to 91% in 1999. This suggests that the same level of output could be produced with approximately 88% of current inputs if banks under study were operating at the most efficient level[20]. He then repeated the aforementioned analysis and estimated alternative profit efficiency for the same sample. For different bank types the profit efficiency scores ranged from 64% for investment banks to 73% for the Islamic banks. He concluded that in the GCC countries, Islamic banks are the most cost and profit efficient while investment banks are the least efficient.

The finding that Islamic banks are most cost and profit efficient than conventional banks is a finding confirmed in a similar study by Al-Jarrah and Molyneux (2003). They also use the stochastic frontier approach, with the Fourier-flexible functional form, and estimate banks cost and profit efficiency estimates for banks operating in Bahrain, Jordan, Egypt and Saudi Arabia. The study showed that the average cost efficiency for commercial banks was 94%, for investment banks it was 93% whereas for Islamic banks, it was 98%. They also estimated both standard and alternative profit efficiency for their sample of banks and the results are around 66% and 58% respectively over the period 1992-2000. It should be noted that these levels of efficiency are similar to that found in US studies which is about half of the industry's potential profits, according to Berger and Humphrey (1997).

Abdul Majid *et al.* (2003) used the stochastic cost frontier approach to estimate the cost efficiency of Malaysian banks over the period 1993 to 2000. Their data set included 34 banks (24 local and 10 foreign) from a total of 55 commercial banks in operation during the period of study. They used translog cost function to arrive at inefficiency measures. Their results show that Islamic banks did marginally better than conventional banks in

[19] For a good discussion of these techniques along with some results, see Molyneux and Iqbal (2005), pp174-254.

[20] This level of technical inefficiency is similar to the range of 10-15% found in the survey of 130 studies undertaken by Berger and Humphrey (1997).

terms of efficiency although both produce at a cost that is respectively 30.2% and 28% higher than necessary. The slight edge achieved by the Islamic banks over conventional banks is not however statistically significant. However, it can be safely concluded that Islamic banks are at least as efficient as their conventional counterparts despite a more restrictive business environment. It is also interesting to note that foreign banks are generally more efficient than local banks. Further test suggests that the difference is statistically significant at the 5% level.

El-Gamal and Inanoglu (2002) used the stochastic cost frontier approach to estimate the cost efficiency of Turkish banks over the period 1990 to 2000. The study compared the cost efficiencies of 49 conventional banks with four Islamic special finance houses (SFHs). The Islamic firms comprised around 3% of the Turkish banking market. Overall, the authors found these firms to be the most efficient and this was explained by their emphasis on Islamic asset-based financing which led to lower non-performing loan ratios. It should also be noted that the SFHs achieved high levels of efficiency despite being subject to branching restrictions and other self-imposed constraints such as the inability to hold government bonds. El-Gamal and Inanoglu (2004) substantially extend their earlier study by providing an alternative method for evaluating bank efficiency scores. Again they examine the cost efficiency of Turkish banks throughout the 1990s. They distinguish between groups of banks that have different production technologies. They find that the Islamic financial firms have the same production technology as conventional (mainly domestic) banks, and using standard stochastic cost frontier estimates they show that the Islamic firms are among the most efficient. In addition, they use a new labour efficiency measure – and again Turkish Islamic special finance houses are found to be among the most efficient.

Yudistira (2004) used a linear programming technique, Data Envelopment Analysis (DEA) to examine the efficiency of Islamic banks using a sample of 18 of the most important Islamic banks. The overall efficiency results from the study suggested that the inefficiency across 18 banks is small at just over 10 percent, which is quite low compared to many studies that estimated similar statistics for conventional banks[21].

9. Conclusions

Islamic banking, like any other banking system, must be viewed as an evolving system. Serious research work of the past fifty years has

[21] See, for example Goddard et al (2001).

established that Islamic banking is a viable and efficient way of financial intermediation. Islamic scholars and practical bankers have developed a number of financial instruments which can be used by Islamic banks in performing various banking functions in a modern economy. Islamic banking practice which started in early 1970s on a modest scale has shown tremendous progress during the last 30 years. A number of Islamic banks and other Islamic financial institutions have been established under heterogeneous, social and economic milieu. Recently, many conventional banks, including some major multinational Western banks, have also started using Islamic banking techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving. To design various parameters of such a system and establish supporting institutions are the biggest challenges facing the scholars and practitioners of Islamic finance in the new millennium.

While Islamic banking fulfils the religious requirements for Muslims, it also broadens the choice-set available to others by offering both sales-finance, low-risk products (i.e. buying and selling) as well as products based on sharing risks and returns. In addition to providing more choices to clients, this mix of fixed and variable return modes has a number of healthy effects for the efficiency and stability of the system. Islamic banking should not be seen as a religious movement. It is simply another way of performing the financial intermediation function and experience has shown it to be an attractive one.

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Annexure

Some Islamic Financial Products[22]

I. *Musharaka* (Partnership)

Musharaka literally means sharing. In the Islamic finance literature, it refers to an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss has to be shared in strict proportion of capital contributions. The basic rules governing the *musharaka* contract include:

i) Profit of the enterprise can be distributed in any proportion by mutual consent. However, it is not permissible to fix a lump sum profit for anyone.

ii) In case of loss, it has to be shared strictly in proportion to the capital contributions.

iii) As a general rule, all partners contribute both capital and management. However, it is possible for any partner to be exempted from contributing labour/management. In that case, the share of profit of the sleeping partner has to be in strict proportion of his capital contribution.

iv) The liability of all the partners is unlimited.

As a mode of finance, an Islamic bank can advance money to a client using the contract of *musharaka*. Normally the bank will use the option of being a sleeping partner. The contract can be more widely used by Islamic funds whereby the unit holders can assume the role of sleeping partners. The contact can also be used in securitized assets.

II. *Mudaraba* (Passive Partnership)

Mudaraba is a special type of partnership. This is a contract between two parties[23]: a capital owner (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in

[22] Revised and updated from Jarhi and Iqbal (2001).

[23] There could be more than two parties. The contract is explained using a two-party example only for simplicity.

accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner; the loss to the manager being the opportunity cost of his own labour, which failed to generate any income. Except in the case of a violation of the agreement or default, the investment manager does not guarantee either the capital extended to him or any profit generation. Some other important features of the *mudaraba* contract include:

i) While the provider of capital can impose certain mutually agreed conditions on the manager, he has no right to interfere in the day-to-day work of the manager.

ii) *Mudaraba* is one of the fiduciary contracts (*uqud al-amanah*). *Mudarib* is expected to act with utmost honesty, otherwise he is considered to have committed a grave sin (in addition to worldly penalties). This has important implications for the moral hazard problem.

iii) The liability of the *rabb al-mal* is limited to the extent of his contribution to the capital.

iv) The *mudarib* is not allowed to commit the *mudaraba* business for any sum greater than the capital contributed by the *rabb al-mal*.

v) All normal expenses relate to *mudaraba* business, but not the personal expenses of the *mudarib,* can be charged to the *mudaraba* account[24].

vi) The contract of *mudaraba* can be terminated at any time by either of the two parties on giving a reasonable notice. This condition may create serious problems in the context of modern commercial enterprises. However, the parties can agree on any conditions in the contract that will regulate the termination so as not to cause any damage to the enterprise.

vii) No profit distribution can take place (except as an ad hoc arrangement, and subject to final settlement), unless all liabilities have been settled and the equity of the *rabb al-mal* restored.

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-mal* and the bank as the *mudarib*. *Mudaraba* deposits can be either general, which enter into a common

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[24] However, in case of travelling outside the place of business, the *mudarib* is entitled to travel and living expenses during the trip.

pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the *rabb-al-mal* and the businessman as the *mudarib* (manager). However, the manager is often allowed to mix the *mudaraba* capital with his own funds. In this case, profit may be distributed in accordance with any ratio agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.

III. Diminishing Partnership

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

IV. *Bai´ al- Murabaha* (Sales Contract at a Profit Mark-up)

In the classical *fiqh* literature, there is a sales contract called *bai´ mu'ajjal* which refers to sale of goods or property against deferred payment (either in lump sum or instalments). *Bai´ mu'ajjal* needs not have any reference to the profit margin that the supplier may earn. Its essential element that distinguishes it from cash sales is that the payment is deferred. Strictly speaking, the deferred payment can be higher than, equal to or lower than the cash price.

There is another sale contract known as *bai´ al- murabaha*, which refers to a sale in which the seller declares his actual cost and the parties agree on adding a specific profit margin. Basically, this is a two party buying and selling contract. No financial intermediation is involved. The Islamic banks have created a mode of finance by combining the concepts of *bai´ mu'ajjal* and *bai´ al- murabaha.* They use this contract as a mode of finance in the following manner.

The client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called mark-up in favour of the bank. Thus, the transaction involves an order accompanied by a promise to purchase and two sale contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a mark-up. The deferred price may be paid as a lump sum or in instalments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the bank.

The basic rules governing the *murabaha* contract include:

i) The subject of sale must exist at the time of sale.

ii) The subject of sale must be in the ownership of the seller at the time of sale.

iii) The subject of sale must be in the physical or constructive possession of the seller.

iv) The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

v) As in any sales contract, the price must be specified, and once specified, it cannot be increased in case of default.

vi) The time of delivery must be specified.

vii) The payments schedule must be specified.

V. *Ijarah* (Leasing)

In the simple lease contract the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains is sold to the lessee at a predetermined price. This is called an operating lease, as opposed to a financial lease. The operating lease has a number of features that distinguish it from other forms of leasing. Firstly, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and responsibilities of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Secondly, the lease is not for the entire useful life of the leased asset but rather for a specified short-term period (for a month, a quarter, or a year) unless renewed by mutual consent of both the parties.

VI. A Lease Ending in the Purchase of the Leased Asset

Since the entire risk is borne by the lessor in the operating lease, there is a danger of misuse of the leased asset by the lessee. The financial lease helps take care of this problem by making the lease period long enough (usually the entire useful life of the leased asset), to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase the asset from the lessor at its market value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and in case of default on the part of the lessee the lessor can take possession of the equipment without court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer[25]. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the *sharī´ah* allows the sale of physical assets, it does not allow the sale of monetary debts except at their nominal value.

Some of the jurists have expressed doubts about the permissibility of financial leases. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. However, there are jurists who consider financial leases to be permissible if certain conditions are satisfied. Firstly, the lessor must bear the risks of leasing by being the real owner of the leased asset. The lessor cannot lease what he does not own and possess, and should be responsible for all the risks and responsibilities related to ownership. Therefore, a leasing contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying and taking possession and gets a reward without bearing any risk. Secondly, lease payments cannot start until the lessee has actually received possession of the leased asset and can continue only as long as it remains usable by him. Thirdly, all manufacturing defects and later damages which are beyond the control of the lessee, should be the lessor's responsibility[26]. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset.

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[25] The new buyer has to agree to continue the lease on the conditions previously agreed unless the lessee willingly agrees to new conditions.

[26] Some of these can be insured against, but this has to be done by the lessor at his own cost.

VII. *Salam*

Salam is a sales contract in which the price is paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a *salam* contract. It is usually applied only to fungible commodities. Some basic rules governing the *salam* sale are given below:

i) The price should be paid in full at the time of the contract.

ii) Goods whose quality or quantity cannot be determined by specification cannot be sold through the contract of *salam*. An example is precious stones.

iii) Goods can be sold only by specifying the attributes. They cannot be particularized to a given farm, factory or area.

iv) The exact date and place of delivery must also be specified.

Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an instalments sale contract. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a *salam* or instalments sale basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description, etc., as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *sharī´ah* point of view, the second contract must be independent, i.e., not linked to the delivery in the first contract. Should the second contract consist of an instalments sale, its date should be subsequent to the date on which the bank would receive the commodity.

VIII. *Al-Istisna* (Contract of Manufacture) and *Al-Istisna Al-Tamwili* (Financing by Way of *Istisna*)

Istisna is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. Any party can cancel the contract after giving a notice to the other before the manufacturing work starts. However, after the manufacturing work has started, the contract cannot be cancelled unilaterally.

Istisna is similar to *salam* in the sense that both are exceptions to some general conditions of sale which prohibit selling of something which is not owned and is not in the possession of the seller at the time of sale. However, there are some differences between the two which are summarized below:

i) The subject of *istisna* is always a thing which needs manufacturing, while *salam* can also be effected on things that do not involve manufacturing.

ii) In the case of *salam* full payment of price is necessary whereas in case of *istisna* the payment can be delayed.

iii) The time of delivery in case of *salam* must be specified at the time of the contract. In the case of *istisna* this is not necessary.

Istisna Al-Tamwili, which is used by Islamic banks, consists of two separate *istisna* contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed instalments and the bank undertakes to deliver the requested manufactured commodity at an agreed time. The second *istisna* contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in instalments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istisna* contract. The original purchaser (i.e., the bank's client) may be authorized to receive the manufactured commodity directly from the manufacturer.

IX. *Jualah*

It is a contract to perform a given task against a prescribed fee (in a given period). The services of real estate agents are a good example. For example, someone places his house for sale with a real estate agent, say within three months. If the real estate agent is able to sell it, he gets an agreed compensation (usually a percentage of the sale price). If he fails to sell it, he gets nothing and loses his effort and publicity costs. Banks can use this contract for providing some services against a fixed fee.

X. *Wakalah*

Wakalah is a contract whereby somebody (principal) hires someone else to act on his behalf i.e. as his agent for a specific task. The agent is entitled to receive a predetermined fee irrespective of whether he is able to accomplish the assigned task to the satisfaction of the principal or not as long as he acts in a trustworthy manner. He would be liable to penalties only if it can be proved that he violated the terms of the trust or acted dishonestly.

In the case of a financial *wakalah* contract, clients give funds to the bank/company that serves as their investment manager. The bank/company charges a predetermined fee for its managerial services. Entire profit or loss is passed back to the fund providers after deducting such a fee.

This contract is used by some Islamic banks to manage funds on an off-balance sheet basis. The contract is more widely used by Islamic mutual funds and finance companies.

XI. *Takaful*

Takaful is an alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.

A Takaful company has the following features:

i) The company is not the one who assumes risks nor the one taking any profit. Rather, it is the participants, the policy holders, who mutually cover each other.

ii) All contributions (premiums) are accumulated into a fund. This fund is invested using Islamic modes of investment and the net profit resulting from these investments is credited back to the fund.

iii) All claims are paid from this fund. The policy holders, as a group, are the owners of any net profit that remains after paying all the claims. They are also collectively responsible if the claims exceed the balance in the fund.

iv) The company acts as a Trustee on behalf of the participants to manage the operations of the *Takaful* business. The relationship between the company and the policy holders is governed by the terms of *mudaraba* contract. Therefore, should there be a surplus from the operation; the company (*mudarib*) will share the surplus with the participants (*rabb-al-mal*) according to a pre-agreed profit-sharing ratio.

XII. *Sukūk*

Sukūk are instruments for pooled securitizations. These are secondary instruments based on returns from real assets or their usufruct. *Sukūk* are meant to mobilize resources from the market based on the strength of one's balance sheet, credentials, track record, good will and prospects of the proposed project. These are basically, certificates of ownership which may or may not be negotiable in secondary markets. In recent years, Islamic financial engineers have developed a number of such instruments. These include, *ijarah ṣukūk*, *muqarradah bond/ṣukūk*, *mudaraba ṣukūk*, *salam ṣukūk* etc.

Islamic scholars offer the following general guidelines for issuing of securitized Islamic financial instruments:

i) Instruments should represent share in equity, real assets, usufruct, money or debt or a combination of some or all of these;
  a) instruments representing real physical assets and usufructs are negotiable at market price,
  b) instruments representing money are subject to the rules of *sarf* (money exchange) in their negotiability,
  c) instruments representing a combination of different categories are subject to the rules relating to the dominant category.

ii) The issuance of securitized Islamic financial instruments based on *mudaraba* or *musharaka* is subject to the following conditions:
  a) the principal and expected return on investment cannot be guaranteed
  b) if the financial instruments were issued for specific purposes or projects, the prospectus should include full disclosure of the nature of the activities, contractual relationships and obligations between the parties involved and the ratio of profit sharing,
  c) the issuers of financial instruments should keep separate accounts for each project and must declare its profit and loss accounts at the date mentioned in the prospectus and balance sheets.

iii) Holders of Islamic financial instruments are the owners of whatever rights these instruments represent and bearers of all related risks, and

iv) An instrument the object of which is debt should not be allowed to earn any return and that its negotiability must be in accordance with the *sharī´ah* rules.