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A Sample From Chapter 1: Introduction

Derivatives in Islamic Finance
by Sherif Ayoub
The twentieth century has certainly been an interesting period in human history in terms of opportunities and challenges in the economic and financial realms. The advent of globalisation and the continued formation of new structures of the international financial architecture (e.g., the rise and fall of the Bretton Woods system, and the Washington Consensus) along with the concomitant revolution in information technology (IT) have contributed to not only increasing the profit potential for businesses around the world, but also to augmenting the complexity and uncertainty that they have to contend with in the search for that profit.

The past century also saw the (re)introduction of Islamic finance as defined by the economic doctrine of the Shari’ah with its three pillars of the prohibition of Riba (usury), Gharar (excessive uncertainty) and Maysir (gambling). For Riba, the fundamental basis for its proscription can broadly be related to the elimination of the injustices linked to the financial slavery of individuals by opportunist money lenders who strive to benefit from the sanctity of the repayment of debt obligations in Islam without any of the commensurate risks that exist in the world of commerce. The prohibition of Gharar is focused on the increase of certainty within commercial transactions by reducing the
information asymmetry as well as the elimination of the malicious devouring of the property of others by dishonesty or deception or by taking advantage of informational ignorance. As for Maysir, the objective of Islamic jurisprudence in its prohibition is the promotion of a productive work ethic that increases welfare (both at the individual level and to society) as opposed to concentrating on the unearned gains of gambling with all its associated antisocial behaviour.

Notably, within its relatively short history, modern Islamic finance, which is built on the Islamic theory of Qiyas (analogical reasoning) that is centred on linking modern-day financial transactions to the commercial practices of the early Muslim community in the seventh century, has had the challenging task of attempting to provide a sustainable alternative to an advanced ‘conventional’ financial system that is by no means static in nature in that it continues to evolve to address, and arguably also to introduce, new issues into the global financial markets.

At the heart of the dynamism of conventional finance are theories built mainly on neoclassical economic foundations that, with the assistance of mathematical computing advances, have been significant in shaping the discourse in the domain of risk and return. Specifically, conventional finance has had the unique advantage of a fairly well-developed universe of processes as well as instruments that identify, measure and manage the various risk exposures facing investors (especially entities in the real sector).

In contrast, when one examines the theory and practice of risk management in Islamic finance, it can be discerned that the Islamic finance industry has been in the difficult position of endeavouring to reconcile the risk-management demands by business entities in the global Islamic community with the challenges posed by the seemingly rigid stances
taken by some of the Shari’ah scholars with respect to the contemporary risk-management framework. Accordingly, in the realm of the management of market risks (particularly interest/profit rate risk, currency risks and commodity risks), these restrictive stances have, in effect, resulted in the proscription in the usage of the majority of hedging instruments, which have derivative-like features, even if they are utilised with a legitimate commercial rationale.

The ensuing problem in undertaking appropriate market-risk management becomes endogenous to an Islamic finance industry that, in its modern form, has grown tremendously from its humble beginnings in the 1950s and 1960s with the mutual banking experiments in Pakistan, Egypt and Malaysia that were followed by institutionalised banking practices in the 1970s in Dubai, Saudi Arabia and Kuwait. More specifically, the Islamic finance industry had grown to an estimated size of US$ 1.1 trillion by the end of 2012 and in the Middle East and North Africa (MENA) region (including Turkey) the industry has recorded a compound annual growth rate (CAGR) of 20 per cent in the five years ending 2010 vis-à-vis 9 per cent by the leading conventional banks (E&Y 2011). This, it should be pointed out, comes mainly from countries that are endowed with large natural resources and are experiencing high population growth rates in addition to harbouring a desire of seeking to positively interact with an increasingly globalised setting of commercial and financial practices.

Effectively, the aforementioned growth, which can be observed to exist at multiple levels in the Islamic finance industry, inevitably transposes the nature of inherent market risks in Islamic finance from a sedentary role to a position of dominance in the elaboration and implementation of corporate strategies not only for the competitiveness of enterprises seeking to operate within the confines of the economic
doctrine of the *Shari'ah*, but also for their survival in the international marketplace. In fact, it has been widely acknowledged by many observers that the Islamic finance industry will not be able to sustainably continue on this growth trajectory, and may even regress, without a proper market-risk management framework that can effectively deal with the complex risks that exist in today’s globalised economy.

Subsequent to the foregoing background, it may be stated that the present book is formulated with the objective of advancing knowledge on the topic of derivative hedging instruments within the context of market-risk management in the Islamic finance industry. This objective, in turn, is to be achieved by two means: First, the book will inject economic-centred theories, along with a wider elaboration of the modus operandi of the financial markets, into the Islamic finance discourse on the subject matter. Second, the book will attempt to examine the rationale for the various stances (both in favour and against) on the permissibility of derivative hedging instruments in a manner that not only accounts for the numerous instruments currently existing in the financial markets, but also some of the proposed solutions in the Islamic finance space.

In essence, the aforementioned objective is envisaged to assist in the overcoming of what can arguably be described as an incomplete appreciation by some of the participants in the Islamic finance industry of the economic and financial principles that underlie what is inherently an economic subject matter. This, it will be shown, can be seen by the nature of the current commentary that regularly places paramount importance on the form of the contracts and instruments rather than on the religious substance (that has economic rationales) that regulates its existence.

Consequently, more often than not, the end result observed is a mixture of macro-level (e.g., eliminate all derivative
hedging instruments from society) and micro-level (e.g., Arabic-named byzantine transactions) recommendations with little insight as to how these recommendations relate to existing economic theories, introduce new theories that can better explain the economic behaviour of individuals or even how they are meant to be implemented in a dynamic and interconnected globalised setting along with the externalities (both positive and negative) that can result in the course of that implementation.

Thus, the coming chapters will seek to elaborate a multidimensional perspective of the subject matter in the most wide-ranging manner possible that includes an investigation into areas that have hitherto been relatively unexplored in the Islamic finance industry. The aspired outcome, it should be asserted here, is not so much the simple focus on espousing a position on the permissibility of derivative hedging instruments, as it is on seeking to increase the sustainability of the Islamic finance industry by way of ensuring that exposures to market risks are managed in the most effective and efficient manner possible.

With that in mind, the forthcoming discussion is divided into three broad parts comprising eight chapters. The first part contains the introduction and one chapter that can be thought of as the philosophical foundation of the book. Specifically, Chapter 2 delves into the conceptualisation of truth in Mua'amalat within Islamic thought, which is deemed to be pertinent in a discussion that relates to religious injunctions that were elaborated by Shari'ah scholars with a belief in the injunctions’ inherent legitimacy consequent of the perception of a superior proximity to the truth contained in the Islamic scripture (i.e., Quran and Ahadith).

The second part, in turn, includes three chapters that concentrate on the aspects in the discourse that are associated with the topics of market-risk management and
derivative instruments. In essence, the third chapter of the book commences the substantive discussion with a wide view on the identification and measurement of market risks as well as the strategies (and their rationales) that are used in dealing with them. The fourth chapter attempts to add depth to the discussion by probing the economic aspects of derivative instruments along with the undertaking of instrument-specific analysis, both of which are often overlooked in the descriptive-natured commentary on the subject matter in the Islamic finance literature. As for the fifth chapter, which is a key chapter in the book, it endeavours to examine, in detail, the discourse on derivatives in Islamic finance through the analysis of the juridical, academic and practitioner perspectives, including a scrutiny of the design of contemporary derivatives in the Islamic finance industry.

The third part of the book, for its part, seeks to add new facets to the consideration of market-risk management and derivatives that were, despite their relative neglect in the literature on the subject matter, deemed to be important to add further contextualisation to understanding. This includes the sixth chapter that centres on the unease of Shari‘ah scholars in condoning the permissibility of financial instruments that have monetary benchmarks, such as interest/profit rate and foreign exchange, as underlying variables. The unease, in turn, can be discerned to have resulted in a systemic avoidance of an effective debate on the recognition of these contracts (or even their ‘Islamic’ equivalents) on the financial statements of the entities that use them in the Islamic finance industry. The seventh chapter, as the final substantive chapter of the book that is followed by the conclusion chapter, concerns the constant perception of a static association between the prohibition of Maysir (gambling) and derivative instruments, which was a recurring theme in the existing discourse on derivative instruments in Islamic finance.
CHAPTER 2
INTEGRATED RISK MANAGEMENT FRAMEWORK

Not only do banks need to apply prudent risk management practices, but also an integrated risk management approach is essential to avoid crisis. In fact, risk management is a dynamic area, where its applications are re-visited in the aftermath of every crisis. Only recently, improvements to risk management practices and regulations have been suggested after the sub-prime crisis and amidst the European debt crisis. In any case, banks should and are asked to follow a comprehensive and integrated approach for managing risks. Islamic banks are not ruled out of this picture, especially when operating in a global financial system where, in some cases, Islamic banks follow conventional banking regulations. However, Islamic banks, being part of a relatively less-developed industry, face many challenges in implementing adequate risk management practices. Islamic banks may typically apply some conventional risk management practices, modify some applications to fit the specific nature of Islamic banks, or develop new approaches to manage the risks. While some challenges hold back Islamic banks from a comprehensive and integrated approach towards managing risks, the importance of such an approach should be recognised in view of recent financial crises. This chapter describes the risk management framework, elaborating on its applicability to Islamic banks, capturing the main steps
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of a risk management process. The chapter also explains the risk management challenges faced by Islamic banks and finally provides an integrated approach for managing risks in Islamic banks, which captures the risk management challenges faced by the industry.

2.1 Risk management framework

Banks are the backbone of any economy and thus governments tend to ensure the sustainability of banking business all over the world. One function of banks is to transform risks from individuals or deposit holders, who are risk averse, and employ the funds in risky projects. The intermediation role is enhanced by a bank’s ability to accumulate information and eliminate information asymmetry. During the past decades, banking business has become more active and has exceeded the traditional intermediary role, where banks engage in global investment activities, such as investing in the derivatives market and actively engaging in securitisation activities. Widening banking activities on the international level not only increases profits, but also exposes banks to a larger variety of risks. One clear example is systemic risk, caused by market disruptions, in which one bank failure leads to the collapse of the banking system.

As banking business revolves around risk, the importance of managing risks in banks has been emphasised for decades. Such an emphasis appears after every financial crisis when further risk management developments are introduced. One recent example is the suggested enhancements introduced to liquidity risk management through Basel III after the sub-prime financial crisis, which impose clear improvements to the quality and quantity of liquidity risk measures. Being the backbone of economies, banks seek to implement prudent policies and procedures and
apply an integrated process to adequately manage risks. In general banks follow the same risk management processes, which would vary only slightly from one bank to another.

The terms risk management process, system and framework are used interchangeably, where the definitions, although providing the same risk management function, vary in their degree of comprehension. Risk management is a process that starts by identifying risks, going through having consistent and understandable measures for each risk, then choosing among the risk mitigation strategies. Finally, the process should conclude by establishing appropriate procedures to monitor the results, which is a very important step in any risk management process as it allows for constructive analysis. Added to the described steps of managing risks, an integrated framework and a day-to-day risk communication throughout the different operating levels are the foundation for a best-practice risk management process. Moreover, an evaluation of the resulting risk profile should be conducted ex post and ex ante. In this sense, we can differentiate between the terms risk management framework and process. Risk management process refers to the steps underlying any risk management system, which are risk identification, assessment and mitigation. On the other hand, the term risk management framework implies a broader view of the risk management system in which both economic (ex post and ex ante) and regulatory analyses are engaged. The risk management process is applied for each phase of analysis, economic and regulatory, within the framework (Pyle 1997: 2; Crouhy et al. 2001).

There is no ‘single best way’ for implementing an effective risk management process or framework since banks are not all equal. Yet, a risk management framework can be flexibly designed and adapted to match different banks’ operations. In principle, adequate risk infrastructure
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should be established to support management policies. This adequate infrastructure requires qualified personnel, accurate data and integration of risk management operations with available technology. Accurate risk data should be ensured in order to allow for the use of the appropriate risk measurement methodologies that would best apply to each risk exposure. The emergence of models and risk management tools for quantifying and monitoring risks alleviates risk control decisions and enhances an efficient risk management process (Heffernan 2005).

There is no concise agreement about what constitutes an optimum risk management system; however, it is agreed that banks should follow an integrated risk management framework to achieve the desired practices of risk management. An integrated process allows management to monitor risk-return profiles at all operational levels and define corrective or enhancing actions. The description of the adequate framework, process or system varies from one bank to another, yet all descriptions are sketched around the importance of implementing a well-defined analysis and control process of risks, whether that is to be applied at the corporate level or the business unit level. An integrated risk management framework can be described as a system that applies the four main steps of the risk management process – risk identification, measurement, mitigation and review – through two phases of analysis, namely economic and regulatory analyses. The economic analysis is further subdivided into ex ante and ex post, as demonstrated in Figure 2.1 below.

A risk management process is often presented through four steps, as illustrated in Figure 2.1. The first two steps – identification and assessment – are referred to as the risk analysis step, which requires adequate analysis of risks faced by the bank. This is conducted through a thorough identification of risks followed by risk measurement/quantification.
The text refers to the phases of analysis in Economic Regulatory Analysis as Ex-ante and Ex-post. Under Ex-ante, the analysis involves:

- Identify all risk exposures, such as credit, market, and operational risks.
- Use quantitative and qualitative measurement tools to assess all risks.
- Apply the appropriate mitigation techniques based on the organisation's strategy.
- Ensure adequate reporting and monitoring activities for the risk management process.

Under Ex-post, the analysis involves:

- Determine whether the identified risk exposures were adequate and complete or not.
- Compare actual risk measures to targeted risks measures.
- Apply the appropriate mitigation techniques based on the organisation's strategy.
- Evaluate the performance analysis.

The regulatory analysis phase includes:

- Identify risky assets to enable the determination of the different risk weights.
- Determine the Capital Adequacy Ratio (CAR).
- Maintain the required regulatory capital.
- Ensure all the regulatory requirements have been met.

The risk management process includes:

- Risk identification
- Risk assessment
- Risk mitigation
- Risk review

A figure (Figure 2.1) illustrates the Risk management framework with these phases and processes.
Risk analysis is considered the backbone of the risk management process since it facilitates the decision-making process when determining the appropriate strategies to be used for mitigating the analysed risks. During the risk mitigation phase, senior management sets strategies to control the analysed risks according to their viewed importance. Finally, an efficient monitoring system is implemented in order to provide feedback and help in modifying future risk management procedures. This last step requires a critical review of the whole process after risks have been identified, assessed and suggested mitigation strategies have been put forward.

Added to that, a risk management process should be applied throughout different phases of analysis. The process is employed within the economic analysis phase, which includes ex ante and ex post phases of analysis, as well as the regulatory analysis. The economic analysis starts during the planning period (ex ante) and continues with the evaluation phase (ex post). The ex ante and ex post analyses enable managers to evaluate performance on a risk-return basis and compare actual performance with targets set by management. During the ex post analysis, previous results are assessed, while the potential future performance developments are analysed and accounted for during the ex ante analysis. The ex ante phase of analysis gives the opportunity to analyse risk-taking decisions, while the ex post perspective enables management to monitor risks. Taking these two perspectives when analysing risks is essential with all risk-management-related decisions in which analyses are to be conducted during risk events and afterwards. This paves the way for a better future decision-making process (Heffernan 2005). Furthermore, a bank’s management ensures compliance with regulatory and supervisory issues that aim at maintaining a sustainable economic environment within the regulatory analysis.
In conclusion, the four steps of the risk management process should be implemented during each phase of analysis (ex ante and ex post). After the risk exposures are adequately identified, the assessment suggested within the framework comprises both qualitative (such as policies) and quantitative (such as statistical measurement models) elements. It is recommended to use a quantification model, when applicable, that is able to consistently capture different banking risks and that can be easily adjusted based on the complexity of the business. In this regard, Value at Risk (VaR) and Risk Adjusted Return on Capital (RAROC) are commonly agreed upon risk measures that qualify for such a purpose and are increasingly being accepted as the widely practised methods by industry regulators and practitioners (Crouhy et al. 2001).

Modern risk models introduce a bank-wide risk management concept where risk management is fragmented across different risks and business lines. For example, market risk analysis is based on quantitative methods and models, credit risk analysis is fundamentally based on qualitative techniques, while Asset Liability Management (ALM) requires specific risk measurement tools to define the appropriate funding and investment policy on the overall business level of the bank. Yet, the foundations of risk measures are comprehensive and allow risks to fit into a common basic framework by applying common concepts such as VaR (Bessis 2002: 64–6). According to Beder (1995), the BIS and the International Swaps and Derivatives Association, among others, declared VaR a fundamental risk measure for the best-practice risk management approaches. However, the level of sophistication of a bank’s risk management programme should correspond to the overall level of risk and complexity of its business (BCBS 2009: 10).

The VaR model measures the economic capital (risk
capital) and is introduced by the Basel committee as a main component in risk management that provides a more flexible method to better assess and capture banking risks within the regulatory capital. However, the efficiency of economic capital as a risk measure is questionable since it does not always provide an early warning system for critical losses. That is especially clear in the case of financial innovations, where there is no appropriate historical data on which risk models rely – provided in the case of new risks. Another reason is because interdependencies among risk categories are not fully captured. The recent sub-prime crisis provides a clear example with the case of Structured Investment Vehicles (SIVs) that were treated as low-risk off-balance-sheet items shifting to high-risk on-balance-sheet items and drawing away liquidity lines. Accordingly, intense scenario analysis and stress testing are used to assess areas of similar potential problems; these are important risk measurement methods because they reflect the possible risk effects on different capital definitions, such as economic and regulatory capital (KPMG 2008). Likewise, Scholes (2000) suggests that despite having the VaR as an accepted dynamic measure for determining the regulatory capital of banks, regulators should also elucidate the importance of applying other methods that help to plan for crises, such as stress testing, because the VaR analysis per se fails to qualify a bank as capable of meeting its obligations in time of crises.

Similar to VaR, the Risk Adjusted Return on Capital is another important measure for managing risks. RAROC has a two-fold function: it is used to allocate capital according to risks and for institution-wide risk management schemes (Ahmed 2006). RAROC allows an expanding line of business to reach an efficient allocation of capital based on the accompanied risks, thus managing risks relative to returns.
Moreover, using advanced applications of RAROC allows the bank to expand the base of products with a larger set of information through calculating the return generated from a certain transaction as compared to the required risk capital. Added to that, risk capital, also referred to as economic capital, has become a central concept of modern risk management, which is required to protect against large unexpected losses. However, its calculation represents a challenge based on the understanding of the underlying risks, which emphasises that the more risk is understood, the better is our ability to calculate risk capital. RAROC has become essential for integrated risk management since it allocates capital based on the associated risk, and thus enables the bank to determine different risk-return profiles. Finally, the last step within the framework, risk review, ensures adequate risk reporting and monitors risk performance on the business-unit level and the corporate level.

Once the bank has identified the proper risk analysis techniques the appropriate risk mitigation methods should be identified. Sometimes it is suggested that an appropriate process for the management of risks achieves the objectives of risk mitigation without putting in specific mitigation strategies. This directly leads to the final step in an integrated risk management system, in which a bank should insure an efficient reporting and review system throughout the different departments. Banks usually maintain solid accounting and disclosure standards that are then audited to meet the prudent regulation. On one hand, such a solid regulated system of financial reporting should be designed to assist banks in evaluating performance. On the other hand, banks should maintain and train sufficient risk management experts who are able to identify and evaluate the different risks faced by the bank. It is suggested that the risk-management function operate independently of
the line-management units, where risk managers report directly to top management.

In general, in order to minimise losses banks should manage risks on the corporate level, business-unit level and transactional level (Marrison 2002: 7). At the business and transactional levels, risks are managed based on the type of risk and the amount of risk exposure. As for the corporate level, management tries to maximise the overall returns under a limited amount of risk by considering three core risk management decisions. First, is deciding on the desired bank’s credit rating/creditworthiness measured by quantitative and qualitative measures set by independent agencies such as Standard & Poor’s (S&P) and Moody’s. Credit ratings are basically determined by the capital the bank holds against the risks taken, where the higher the capital-to-risk ratio, the higher the rating received, enabling a bank to access funds at lower costs. Consequently, the capital-to-risk ratio should be in line with the creditworthiness the bank targets. This leads to the second core decision of calculating the amount of available capital to decide whether an increase of the bank’s capital is necessary. Such an increase could either be through issuing shares or retaining profits. Finally, a bank’s management is able to calculate the total risk capacity, which equals the probability of default multiplied by the available capital. Hence, the bank’s management decides on the amount of risk to be allocated to each business unit, such as corporate lending or trading. After allocating risk limits, the bank also determines a target required rate of return, referred to as the hurdle rate, in return for the given risk limits.

A successful application of the risk management framework can only be insured through developing an integrated reporting and monitoring system for the risk process. Reporting and monitoring of risks are ensured through the
last step of the risk management process – risk review – where reporting and monitoring activities should flow from top-down and bottom-up operational levels. During the \textit{ex ante} phase, the risk reporting and monitoring system is set and ensured throughout the different departments and levels of operations. Further, the designed reporting and monitoring systems are evaluated as part of the \textit{ex post} phase. Also, a bank should be aware of the reporting requirements set by the relevant regulatory and supervisory authorities.

To sum up, the proposed framework provides an integrated and comprehensive risk management system that is equally applicable to conventional and Islamic banks. The framework captures the main risk management process, provides an \textit{ex post} analysis to evaluate and modify the risk management process, and ensures that regulatory aspects are in line with the banks’ operations.

2.2 Risk management challenges in Islamic banks

Islamic banking activities, although not completely varying from conventional banking, result in a special banking model. Managing risks in the Islamic banking model is not by any means an easy task. In practice, Islamic banks are faced with some challenges that hinder adequate management of risks. These challenges can be summarised in five main points. The first challenge is the inappropriate identification of Islamic banking risks caused by the intermingling and unique mixture of risks that result from the various activities conducted by Islamic banks. Second, Islamic banks need more rigorous risk assessment techniques that capture the uniqueness of the Islamic financial structure. Third, the lack of liquid assets as well as the non-existence of a lender of last resort, along with the minimal use of
securitisation, increases liquidity risk among Islamic banks. Fourth, \textit{Shari'ah}-compliant mitigation strategies are yet to be developed and maintained within financial markets; hence, this requires an adequate deployment of financial engineering techniques. Finally, Islamic banks lack an integrated risk management framework that outlines the existing challenges. Figure 2.2 summarises the risk management challenges faced by Islamic banks.

The first challenge, represented by the inadequate identification of risks, is mainly driven by the bundling of risks and the transformation of credit and market risks throughout different phases of an Islamic contract. Moreover, the
unique structure of the Islamic banking model makes the identification process unconventional, and hence challenging. The mixture and structure of Islamic banks’ risks vary more than that of conventional banks. The structure of the balance sheet of the Islamic banking model provides various financing (e.g. murabaha or ijara) and profit-loss-sharing (PLS, e.g. musharaka or mudaraba) instruments on the asset side. Each instrument holds different sources of risks based on its contractual agreement, for example, the sources of operational risks in an ijara contract will differ from the operational risks inherent in a murabaha contract. To adequately manage risks, Islamic banks should embrace a detailed analysis of the underlying risks.

Sundararajan (2007: 40–64) acknowledges that recognising the specific bundling of risks in individual Islamic financial contracts and the associated correlations are a major challenge, because all contracts include a mix of credit and operational risks. For instance, in the case of a salam contract, the bank is exposed to counterparty risk upon the advance payment, market risk for delivering the commodity as specified in the contract and operational risk for holding the physical asset. Moreover, each contract undergoes more than one stage, each involving a different mixture of risks. It is better for Islamic banks to assess risks for each contract/instrument separately to facilitate the risk management process, because the implications of the importance of each risk vary based on the nature of the contract/instrument (Ariffin et al. 2009). However, the individual assessment should be integrated at the overall bank level in a way that considers correlation among various risks. Yet, Islamic banks attempt to manage risks individually, rather than in an integrated manner, ignoring the fact that these risks are mixed and probably correlated (Akkizidis and Khandelwal 2007). Accordingly, an essential step towards maintaining a
clear identification of risks is to un-bundle the mix of risks, elaborating on the sources of each risk arising as a result of each contractual agreement, and to determine their possible correlations. This can be done by understanding the main features upon which the contractual agreements are based, which are provided by the AAOIFI standards.

The assessment of risks represents the second challenge towards adequate risk management in Islamic banks. Currently, Islamic banks depend on qualitative methods to measure some risks, such as the use of credit scoring as a measure of credit risk. However, the use of quantitative risk measurement methods is essential to define the value of the identified risks and determine if further actions are required, such as applying a ‘stop loss’ scenario or minimising/increasing any of the financing activities. Such decisions are taken by the bank’s management after analysing the returns relative to the underlying risks. Accordingly, the risk-return analysis is critical at this stage. Islamic banks lack sufficient data to conduct such analysis and it is even challenged that Islamic banks require more rigorous measurement techniques to capture the integrated risk structure. Hence, it is important that Islamic banks start by identifying the risk measurement models suitable for each set of risks, and accordingly monitor and report the risks. Such a process would eventually lead to developments in the utilised risk measurement methods. Among the challenges facing risk assessment for Islamic banks is the difficulty in deciding on the appropriate assessment approach, either qualitative or quantitative, for each type of risk. This can be solved by having a clear understanding of the nature of each identified risk, which will provide the ability to identify the appropriate assessment tool to be utilised. Other challenges, such as developing an Islamic benchmark or the high cost of allocating advanced risk models, also remain a point of
argument among researchers. In any case, both quantitative and qualitative risk measures must be backed up by scenario analysis to strengthen the risk assessment. Scenario-based analysis, specifically stress testing, is critical to minimise the third risk-management challenge – liquidity management – which is caused by the lack of Shari‘ah-compliant instruments. Such analysis helps in determining the liquidity position of the bank under different market conditions and, accordingly, it enables the bank to set mitigation strategies and be prepared for other different scenarios.

Liquidity management requires keeping liquid assets for a bank to meet its short-term obligations on time. When illiquidity problems arise, banks turn to interbank or central bank lending. Conventional banks manage their liquidity requirements through money-market products and interbank activities to avoid having idle cash in the bank. However, Islamic banks, in principle, have limited access to Islamic money-market products and prohibit interbank activities that involve interest. Hence, Islamic banks hold higher levels of liquidity, which negatively affects their profitability measures (Brown et al. 2007). Managing liquidity in Islamic banks represents a significant challenge for two reasons. First, Islamic banks lack liquid Shari‘ah-compliant instruments, since Shari‘ah law restricts assets securitisation that takes the form of debt instruments except when it is traded at par value. This specifically curtails diversification and restricts the banks’ ability to manage maturity profiles of assets and liabilities. Second, it is difficult to access funds from existing capital markets as there is no interbank market for Islamic banks. Moreover, unlike conventional banks, the function of ‘the lender of last resort’ does not exist under Islamic banking operations because it is based on interest, which is prohibited (Archer and Abdel Karim 2007).
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In their early stages, Islamic banks were stuck with high liquidity levels due to high growth of deposits versus loans and investment opportunities. In turn, Islamic banks relied heavily on conventional banks for employing their liquidity, which has often meant a lower return to Islamic investors as a result of a second layer of intermediation. However, due to the increased integration with international markets, Islamic banks are becoming more efficient in managing their own investments and channelling sources of funds to users of funds. Nevertheless, Islamic banks still rely on conventional banks when seeking financial engineering expertise since the former lacks the in-house expertise to develop Shari’ah-compliant products (Iqbal and Molyneux 2005). Currently, each Islamic bank uses its own strategy to hold a sufficient liquid portion of investment accounts that acts as a cushion against liquidity runs (Ariffin et al. 2009). This may have a negative impact on the bank’s profitability if large amounts of idle cash are held from the invested amounts. In an attempt to solve this problem, the Bahraini monetary authorities have employed Shari’ah advisors to assist with auditing and developing short-term financial instruments, aiming to provide liquidity for Islamic financial markets and, hence, to solve one of the major challenges facing Islamic finance (Khan and Bhatti 2008).

Similar to the liquidity risk management challenge, risk mitigation is lagging behind for the Islamic finance industry. Islamic banks clearly lack sufficient and compatible Shari’ah-compliant mitigation strategies, which requires further research to design the appropriate Shari’ah-compliant techniques. Until more appropriate techniques are developed, an Islamic bank can select the most adequate techniques within those existing in the financial market. Finally, Islamic banks lack an integrated risk management framework that outlines the existing challenges. Despite
the importance of having a comprehensive and integrated system for managing risks in Islamic banks to sustain industry growth, two main obstacles hinder that approach. First, is the cost of integrating, compiling and analysing information from different business lines/units and, second, is the regulatory cost imposed on the banking business, for example capital and liquidity requirements set by regulators (Cumming and Hirtle 2001). The next sections introduce an integrated risk management system in which risks can be easily reported, compiled and analysed.

2.3 Integrated risk management in Islamic banks

Among the lessons learnt from conventional banks’ major risk events are that banks should maintain a full understanding of the business, ensure there are internal controls and monitoring systems within an integrated risk management process (Crouhy et al. 2001), as well as be aware of the complexity of the current financial markets that lead to the concentration of risks as a result of financial innovations and model risks (Das 2006). The conventional banking system has exhibited different crises ending with the sub-prime meltdown in 2008 and extending to the current European debt crisis. Believing that the Islamic banking industry is not immune to similar crises, experts in the industry should examine the causes of such events to learn their lessons. Ahmed (2009) suggests that the practices of Islamic finance could cause similar episodes within the Islamic financial sector, identifying three key factors of a crisis that could evolve in the Islamic financial sector: a deregulated environment, excessive risk taking and complex financial innovations. As such, a regulatory framework for Islamic financial institutions should be maintained in which excessive risk taking is strictly prevented and
regulated. Moreover, developing complex (innovative) Shari'ah-compliant financial instruments should be minimised and controlled, particularly since the risks of Islamic financial instruments are not yet easily comprehensible. Risks within the Islamic financial industry should be managed through an integrated framework to control such events.

To attain a reasonable assessment of the underlying risks, a holistic perspective of the financial system must be realised (Greuning and Iqbal 2008). For Islamic banks to achieve an effective management of the underlying risks, a complete analysis and adequate understanding of the risks, regulatory system, market/s, and financial and economic environment under which the bank operates must be obtained. Accordingly, a risk management framework should be developed to analyse and manage the underlying risks of Islamic banks in a comprehensive manner. Moreover, when identifying risks, analysing the financial and economic environment should not be ignored, as they have a great impact on the level and density of risks. As this book does not focus on a specific economic or financial environment, but rather addresses universal Islamic banks with varying operating models, specific economic analysis will be ruled out despite its importance.

One important element that must be considered when designing an integrated risk management system for Islamic banks is to account for the risk management challenges faced by banks in the industry. In other words, whatever the system proposed to manage risks it should eventually propose a solution for each of the previously mentioned challenges. Hence, designing a framework as presented in Figure 2.1 would be the guiding path for Islamic banks to manage risks in an integrated manner, solving the listed challenges facing Islamic banks. The framework implements the risk
INTEGRATED RISK MANAGEMENT FRAMEWORK

management process through the economic analysis phase (ex post and ex ante) and the regulatory analysis phase. Adequate analysis and mitigation of risks is essential to enable banks to evaluate their performance relevant to their risk profiles. Accordingly, the framework aims at evaluating the performance of the bank on a risk-return basis while comparing it with pre-identified targets.

Regarding the first challenge, in which risk identification is not a clear process in Islamic banks, risks should be identified through the three phases of analysis: ex post, ex ante and regulatory analysis. Throughout the economic analysis (ex post and ex ante), the sources of risks are identified on the basis of the contractual agreements as well as on the overall business model. Risks based on the contractual level are determined by reviewing the elements of each contract underlying each financing instrument as stipulated by the AAOIFI standards. The overall sources of risks are identified based on the Islamic bank operational model, which appears similar to the conventional classification of overall bank risks. This helps the banking firm to ensure that all underlying risks are clearly taken into consideration before proceeding to the quantification process. Furthermore, it should be ensured that all risks inherent in every financing activity, as well as those that appear solely on the balance sheet, such as displaced commercial risk and withdrawal risk, are also included within the identified risks.

Once the first challenge is accounted for, it would be easy to choose among the widely practised assessment methods, either qualitative or quantitative, to measure the degree and severity of the risks. As the main aim of the framework is to conduct a risk-return analysis, measures that specifically address these elements should be used, such as the RAROC. Moreover, if risks are well identified, monitored and reported through the framework, Islamic banks will have
the required data to move to the more sophisticated and advanced measurement methods. Nevertheless, building a suitable database would require a high level of cooperation among Islamic banks.

Having clearly analysed the risks, a bank will be able to decide on the efficiency of the selected mitigation tools, throughout the economic analysis. In addition, being able to identify the liquidity risk position of the bank, suitable liquidity management tools can then be easily decided upon by screening capital market opportunities. This approach of managing risks in an integrative manner, followed by the final step of reviewing the risk performance, will result in an improved process that leads to an effective management of risks. It ensures monitoring of the different activities through an effective reporting system and adequate flow of information within the bank (top-down and bottom-up flow of information). By following an integrated and comprehensive approach of managing risks, the fifth challenge of the lack of an integrated risk management system for Islamic banks would have been met.

Furthermore, the regulatory analysis is designed to ensure that a bank complies with the proposed regulatory framework of Islamic banks, both at the local and international levels. During this phase, risk analysis should result in identifying risk weights as stipulated by the underlying regulations, which specify the required regulatory capital that should be met by the bank. The importance of designing a regulatory framework is also recognised by Sundararajan and Errico (2002) as one important factor to be considered by effective risk management within Islamic banking systems. However, regulatory issues vary according to the system in which a bank operates. The IFSB (2005) guidelines represent the sole available risk management regulatory guidelines for Islamic financial institutions. It
is worth noting that some governments have undertaken projects aimed at adapting Basel II to Islamic banks, such as the Kuwaiti government.\footnote{1} Yet, after the sub-prime crisis and the amendments imposed to Basel II, governments and supervisory authorities that aim at regulating Islamic banks should be aware of the implications of the Basel III accord upon their undertaken projects.

The remaining chapters elaborate on each of the steps in the risk management process and provide an application of the presented risk management framework to Islamic banks by the end of the book. However, it should be clarified that for an adequate application of the framework, the following points have to be noted. First, the framework must be within the main tenets of Shari’ah. This implies that ‘Shari’ah screening’ should be embedded within the economic analysis phase throughout the whole process of risk management (i.e. analysis and mitigation). Shari’ah screening should be conducted by Shari’ah scholars, who will exclude any prohibited activities and any instruments that contradict the Shari’ah principles. Laldin and Mokhtar (2009) suggest that Shari’ah screening should be applied at two stages: before engaging in an investment and while deciding on how to manage the risk exposures. Hence, Shari’ah scholars ought to be involved in the process of risk management. Accordingly, it is recommended that Shari’ah screening is conducted through the involvement of two Shari’ah supervisory boards – external and internal – where the internal Shari’ah board is responsible for supervising existing and new financial products to ensure Shari’ah compliance and the external board supervises the approvals provided by the internal Shari’ah board (Ghoul 2008b). Currently, the process of Shari’ah screening varies among Islamic banks as there is a lack of a globally recognised screening framework and a lack of independent Shari’ah scholars/experts. Ghoul
(2008b) presents the screening process of Dubai Islamic Bank (DIB) as an example of an Islamic bank that applies the two stages of Shari’ah screening. They employ internal Shari’ah experts within the development phase of financial products and the developed products are then audited by an external Shari’ah committee.

Second, full disclosure of information to all stakeholders should be ensured by the bank, as transparency needs to be enhanced in financial reporting. Such disclosures are even more essential in an Islamic bank relative to its conventional counterpart, since deposit holders in an Islamic bank have higher incentives to monitor the bank’s performance as their returns are highly dependent on the performance. Similarly, Sundararajan (2004) explains that disclosure of risk information, in addition to risk measurement, are key issues in implementing and enhancing a risk management strategy. Examples of essential information to be disclosed are the bank’s operating strategy, profit distribution strategy and treatment of the Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR). It is worth noting that among an examined sample of the world’s largest Islamic banks, Al-Baraka bank was the only Islamic bank that disclosed both PER and IRR, but with no reference to a specific profit distribution strategy.

The third important factor upon which the framework should be based is following unified accounting and reporting systems, as well as uniform Shari’ah standards. The AAOIFI proposes a uniform set of accounting and Shari’ah standards, which should be followed by Islamic banks. This will minimise operational risk by decreasing system and Shari’ah risks. According to Nedal (AAOIFI 2008a: vii), Secretary General of the AAOIFI, these standards have been implemented by Islamic banks operating in a number of countries, such as Bahrain, Sudan, Malaysia, Qatar, Saudi
Arabia, Dubai, Syria, Lebanon and Singapore. By following the AAOIFI accounting standards, disclosure of IRR and PER becomes a basic concept that should be implemented by Islamic banks. Such measures are considered corner stones in covering overall bank risks, as discussed later within the mitigation strategies.

As financial intermediaries, Islamic banks hold similar risks to their conventional counterparts. Yet, to have a clear understanding of Islamic banks’ risk map, risks should be classified on different levels. Applying the first step of the risk management process, the next chapter elaborates on the identification process and classification of the various risks in Islamic banks.

Note
1. Based on an interview conducted with Abdulkabir Elbatanoni (2010), Senior Consultant of Islamic Banking, currently with the Ahli United Bank, Kuwait.
Product Development in Islamic Banks
by Habib Ahmed

A Sample From Chapter 1: Introduction
In an interview conducted for this book, a senior official of an Islamic bank in Malaysia disclosed the following: ‘Almost 70 percent of our customers are non-Muslims. In fact, we find it difficult to sell products to Muslims clients as they ask many questions about the authenticity of Islamic products’. This statement reveals the paradox facing Islamic banking practice today. On the one hand non-Muslims, who can use conventional financial services, are choosing Islamic financial products in large numbers. They do so, not due to religious reasons, but because they find the terms and conditions of the financing attractive. For Muslim clients, however, terms and conditions are not the only factors determining their business with Islamic financial institutions. For them, dealing with Islamic banks is a matter of faith. As such, compliance of banking practices with principles and rules of Shari’ah becomes vital for them.

The predicament contemporary Islamic finance practice faces is at two levels: the first is foundational and the second legal. At the foundational level, Islamic finance is considered to be a part of an Islamic economic system which has an inherent social orientation. The overall goal of this system is to realise the objectives of Islamic law (maqasid al-Shari’ah) which should manifest in the economy as enabling growth, justice and equity. This implies that other than fulfilling the
PRODUCT DEVELOPMENT IN ISLAMIC BANKS

legal requirements, an Islamic financial system should also cater to the social needs of a society. Other than Islamic economists and scholars, many other stakeholders of the industry expect the Islamic financial sector to play this social role. This is evident from a survey of 1,500 stakeholders conducted by Dusuki (2008) in Malaysia, who finds that the bulk of the local communities, customers and depositors identify alleviating poverty, contributing to social welfare and promoting sustainable development projects among the key goals of Islamic banking.

From the legal perspective, the contention is that the Shari'ah requirements are being diluted. The crux of the condemnation is focused on the products offered by the Islamic financial sector, which increasingly appear to be mimicking those of conventional finance. In doing so, the legalistic forms of contracts are fulfilled but the substance and spirit are not. For example, in a recent study Dusuki and Mokhtar (2010) find that only 11 out of a total of 560 sukuk (Islamic bond) issues (or around 2 per cent of the total) qualify to be asset-backed as these fulfil the legal Shari’ah requirements of an actual sale of the underlying asset to the investors. The remaining 98 per cent of the sukuk replicates conventional unsecured bonds with the sale of the underlying asset not being actual, from both accounting and legal perspectives.

The failure of Islamic finance to fulfil the legal requirements has generated criticism from both detractors and proponents of the industry. At the extreme end of the spectrum, the Islamic financial industry has been denounced as a ‘deception’ and ‘charade’ (Saleem 2006a,b). Seniawski (2001) and Holden (2007) identify the current practice in the Islamic financial industry as ‘legal hypocrisy’ and Hamoudi (2007) calls it ‘semantic fantasy’ and ‘jurisprudential schizophrenia’. ElGamal (2007a, 2008) claims that Islamic financial institutions are ‘rent-seeking Shari’a arbitrageurs’ using
‘ruses to circumvent prohibitions’ of Islamic law at the product level. More recently, some Shari’ah scholars have joined the Islamic economists in pointing out problems with the legalistic approaches of approving Islamic financial transactions. Usmani (2007) points out the majority of the sukuk issues in the market replicate conventional bonds and are not in line with the spirit of Islamic law. Similarly, DeLorenzo (2007) is critical of total return swap and declares it to be unacceptable even though the form is Shari’ah compatible.

The dilution of Islamic financial practices both at the foundational and legal levels has disillusioned many proponents of the industry. Disappointment with the current practice of Islamic banking in their failure to fulfil the Shari’ah requirements (social and legal) is summed up by a comment by Dr Muhammed Obaidullah, a well-wisher and founder of the world’s largest internet-based discussion group on Islamic banking and finance. Reacting to a news item about the Indian High Court’s decision to halt Islamic banking plans in the country, he reacted in the following way:

It is indeed a blessing in disguise for India’s 150 million Muslims, a large majority of whom are poor and whose financial needs are certainly not going to be taken care of by the large banks practicing the ‘spurious’ variety of Islamic banking and investments. The so-called mainstream Islamic banking and finance is a sham, targeted at high net-worth individuals and corporations, against true Islamic ideals and spirits, a poor attempt to disguise conventional products in Islamic garb. (Obaidullah 2010)

To understand the context of the criticisms of the practice of Islamic finance, there is a need to reflect on the origins of
the industry. Islamic finance was conceptualised under a broader movement of revitalisation of Islamic values, identity and institutions. After a long period of colonial rule, many Muslim countries gained independence in the twentieth century. Muslim scholars and communities in the newly independent nations aspired to revert to institutions and organisations reflecting Islamic values and principles. On the economic front this led to, among others, the study of issues under the banner of Islamic economics. From an urge to seek solutions to economic problems in the light of the injunctions of Islam, economists asserted that the value system of Islam would provide a better concept of economic development and a pragmatic approach to achieve it, not only for Muslims but humanity at large. The scholars envisaged the discipline to realise maqasid al-Shari'ah. In its broadest perspective, the maqasid would include growth and justice (Siddiqi 2004).

One of the first manifestations of Islamic economics was the initiation of Islamic finance. The first experiments of Islamic finance began in the countryside of Mit Ghamar in Lower Egypt in 1963. Under the leadership of Ahmed al-Najjar, savings/investment houses operated in small towns in Northern Egypt, providing financing on a profit-loss sharing basis to small entrepreneurs and poor farmers. In the same year, the Pilgrims’ Management and Fund Board (Tabung Haji) was established in Malaysia to help people save money to go for hajj (pilgrimage). The funds were used to invest in industrial and agricultural projects.

After the formation of the Organization of Islamic Conference (OIC) in 1973, the Islamic Development Bank was established in 1975 in Jeddah, Saudi Arabia. The multilateral development bank was formed with an objective of fostering economic development and social progress of member countries in accordance with the principles of
Shari'ah. In the same year, the first Islamic commercial bank, Dubai Islamic Bank, was established in the United Arab Emirates (UAE) by a pious businessman named Saeed Ahmed Lootah. Initially, both banks did not have Shari’ah scholars or boards to guide their operations and operated according to their understandings of interest-free banking (Kahf 2004b).

As Islamic banking expanded, professionals from conventional banks and Shari’ah scholars got involved in its operations. While the former group managed the day-to-day activities of the banks, the latter group provided legitimacy to the operations. The role of Shari’ah scholars was to study individual transactions and approve their compatibility with Shari’ah principles. Initially, Islamic banks attempted to experiment with profit-loss sharing modes of financing. As bankers were not trained to manage the risks of equity-based instruments, they preferred to use debt-like sale-based modes of financing as these matched their background and skills. As Islamic finance grew, however, the main focus of the industry became providing ‘Shari’ah-compliant structures for conventional products’ (Dar 2007). In doing so, the practice of Islamic banking and finance gradually moved closer to conventional banking products and practices over the years. Chapra (1985) and Siddiqi (1983) apprehend that using debt-based instruments not only represents the status quo but also may not conform to the true spirit of Islamic commercial law as they negate the basic principle of risk sharing.

The debate surrounding the practice of Islamic finance has led to the distinction between Shari’ah-compliant and Shari’ah-based Islamic products. Whereas some scholars insist that Shari’ah-compliant and Shari’ah-based products imply the same thing, there is a need to distinguish between different nuances of Islamic finance in terms of social and
PRODUCT DEVELOPMENT IN ISLAMIC BANKS

legal requirements discussed above. In legal terms, discussion about the form and substance of contracts is important. Many Islamic banking products are controversial as these use several contracts which may be separately legal, but when taken together may produce outcomes that are in substance similar to prohibited transactions. Fulfilling the spirit of Islamic law would embody the social dimensions in the practice of Islamic finance. Given the different shades of Shari'ah requirements, a Shari’ah-compliant product would be one fulfilling the legal requirements both in terms of form and substance. A Shari’ah-based product is one that fulfils both the legal and social requirements. Thus, a Shari’ah-based product is a Shari’ah-compliant one and realises the social goals. Finally, a pseudo-Islamic product is identified as one that fulfils the form but not the substance of Islamic law.

A firm, including a bank, is identified by the sum of its products and services. Evaluating the practice of the Islamic banking industry would, therefore, require examining its products. Products do not appear in a vacuum. There is a process through which products are developed within an organisational and institutional (regulatory/legal) framework. Development of Islamic financial products adds another layer of complexity in the process as an additional requirement of complying with Shari’ah principles and values has to be considered. To comprehend the practice of the Islamic financial sector in terms of its products would require an in-depth study of innovation and product development processes. The objective of this book is to do the same. By examining the product development system in Islamic banks, various factors affecting the decisions to identify and develop different products will be explored. In doing so, the book attempts to explain the circumstances under which products are developed and ascertain why
Islamic banks are unable to use products that satisfy the legal and social Shari’ah requirements.

**Innovation and product development in finance**

In a rapidly changing world, survival of businesses will depend partly on how evolving demands can be met by supplying innovative products and services. Innovation involves transformation of idea into ‘product, process or service’ (Popadiuk and Choo 2006: 303). Innovations take place in an institutional environment and are driven by many factors that include societal stock and growth of knowledge, market conditions and organisational capabilities. The ability of organisations to innovate and produce new products will, therefore, depend on what Merton (1992) calls the ‘innovation infrastructure’ and their ability to adjust to changing markets and environments.

Financial innovations surged in the 1970s and since then have shaped the dynamics of the industry. The factors driving innovation in the financial sector can be broadly classified as institutional and functional. Miller (1992) identifies different institutional factors that initiated the rapid growth in innovations during the 1970s. After a long period of stagnation that started during the Great Depression and continued until the 1950s, the stream of innovations picked up as a result of continuous global economic growth thereafter. The breakdown of the Bretton Woods fixed exchange rate system in the early 1970s increased the foreign currency risks and encouraged development of many risk-mitigating instruments. An important input in the innovation surge was the information and computer technology revolution that enabled fast and efficient transfer of information and capital within and across borders.

Another institutional determinant of innovations was the
PRODUCT DEVELOPMENT IN ISLAMIC BANKS

legal and regulatory regime. While a stringent regulatory environment created incentives for regulatory arbitrage whereby financial institutions innovated to bypass prohibitions or costly regulations and/or tax regimes, deregulation induced them to produce new products to satisfy increasingly sophisticated market needs and demands. The Bank of International Settlements (BIS 1986) also identifies market competition and historical dynamics of innovation as supply-side factors affecting advancement in product development.

Tufano (1995, 2003) and Macey (1995–1996), however, point out that the traditional institutional explanations are unable to explain aspects of financial sector innovations. They suggest that the functional approach can explain these changes much better. A financial system performs certain core functions that are stable across time and place (Merton 1992). Even though financial structures may differ, these basic functions are common to all of them. BIS (1986) recognises functions of the financial sector as transfer of risks (price and credit), enhancement of liquidity and generation of funds to support enterprises (through credit and equity). Merton and Bodie (1995) identify six functions of the financial system as managing risks, transferring economic resources, dealing with incentive problems, pooling of resources, clearing and settling payments (to facilitate trade) and providing price information. Similarly, Levine (1997: 689) identifies the functions of a financial system as ‘the trading of risk, allocating capital, monitoring managers, mobilizing savings, and easing the trading of goods’.

The functional perspective views innovations as fulfilling one or more of these functions. Tufano (2003) summarises the role of innovation in the functional perspective by identifying six factors: complete incomplete markets, address agency concerns and information, minimise (transaction,
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search and marketing) costs, respond to taxes and regulation, react to increased globalisation and risk, and respond to technological shocks. If financial institutions do not innovate, existing products offered may become outdated and unable to perform the required functions efficiently and adequately.

Levine (1997) asserts that the functions a financial system performs can enhance growth by increasing saving and promoting capital accumulation and technological innovation. Experience, however, shows that certain new financial instruments can create risks that are not well understood and induce instability in the system.2 While unrestrained product development can lead to undesirable events and cause harm to economies, there is a general belief that financial innovations can improve efficiency and enhance economic benefits at firm level and drive financial and economic growth at macro level.3

Factors determining innovation in Islamic finance will be similar to the ones discussed above. As Islamic products must comply with the principles and rules of Shari‘ah, the nature of innovation will be more complex. From an institutional perspective, Islamic financial products would not only adjust to national laws and regulations, but also to Islamic commercial law. The functional perspective would imply that the Islamic financial products must be able to satisfy various functions. As the Islamic finance industry is relatively young, innovation in functional terms would take two forms. The first will be the inert type in which the industry has to provide various products that fulfil financial functions such as mobilising resources, allocating capital, managing risks, etc. These products already exist in conventional finance and inert innovation enables Islamic finance to catch up with the existing services offered by their conventional counterparts. The second from is creative
innovation whereby the industry would come up with new innovative products that have no precedence.

Product development: fundamental issues
A financial product entails a fusion of characteristics that include size, yield, various risks, duration, liquidity, marketability, pricing rules, etc. (BIS 1986). Innovations create new products with varying combinations of these features. Comprehending various aspects of product development in financial institutions would require answering three fundamental questions of why, what and how.4 ‘What’ relates to the nature of product development and the kind of new innovative activities that need to be undertaken. The second question of ‘why’ attempts to understand the rationale of developing new products from a financial firm’s perspective. Answering ‘how’ details the processes and people involved in implementing product development. Issues in each of these questions are addressed next.

Why develop new products?
Fuller (2005) identifies several reasons why new products need to be continuously developed. First, products have life cycles. The stages of the life cycle can be identified as introduction, growth, maturity and stagnation, and decline (Fuller 2005; Lovelock 1984). If firms do not develop products to meet the new needs and demand, it will also follow the cycle of its existing products. Furthermore, life cycles of different elements of a society (individuals, firms, industries and nations) also create new demands and needs (Tufano 1995). New products attempt to fulfil these new requirements. Second, new products create opportunities for growth in the future thereby fulfilling long-term business goals. Third, developing new products enables the firm to penetrate new markets and retain the existing ones that
change continuously. Fourth, new knowledge and technologies can enable development of new products that were not feasible before and existing ones at lower costs so that profitability can be increased. Finally, changes in legal and regulatory regimes may allow new profitable products that were previously not permitted.

BIS (1986) identifies demand factors driving innovation in financial institutions as mitigating risks, enhancing liquidity, generating debt and creating equity. Within each of these broader classifications, sub-classes can be identified. For example, risk-mitigating innovations can include those alleviating market risks, credit risks, liquidity risks, etc. Market conditions and legal/regulatory regimes will determine the demand for a particular function that needs to be satisfied. For instance, countries with legal systems protecting creditors’ rights more rigorously than equity-holders’ rights will produce more debt-based instruments than equity-based ones. Similarly, if there is more uncertainty in markets, instruments that mitigate market risks would appear to reduce the vulnerabilities. Note that some instruments may perform multiple functions.

**What is product development?**

Product development is understood and defined in different ways. Ulrich and Eppinger (2008: 2) take a market perspective and define it as ‘the set of activities beginning with the perception of a market opportunity and ending in the production, sale, and delivery of the product’. Smith and Reinertsen (1998: 167) view product development as an information problem and define it as ‘a process of gradually building up a body of information until it eventually provides a complete formula for manufacturing a new product’.

Output of financial firms differs from physical products as they produce intangible services that are essentially
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processes (Shostack 1982). Given the intangibility, a service requires a structured blueprint that outlines all the features, steps and functions needed for the service to be provided. Cooper et al. (1994: 296) assert that the performance of intangible products like financial services is ‘intimately tied to the customer contact people and their skills: these people almost become the product!’ Thus, developing financial products requires diligent planning not only of the product features, but also of the delivery infrastructure.

The scope of product development in a financial firm is wide and can be viewed in different ways. Lovelock (1984) identifies six types of innovations in developing products. In descending order of the extent of change required, these are major innovations, start-up business, new products for currently served markets, product line extensions, product improvements, and style changes. Avlonitis et al. (2001) identify four general types of innovations in firms providing services: new-to-the-market service, new-to-the-company service, changes in the operating or delivery process, modification of service. Similarly, Kelly and Storey (2000: 48) define new products as those that are new-to-the-world, new-to-the-company, improvements over existing ones, and supplementary and value-added services. Note that the more innovative a product is, the riskier and more costly it will be to produce.

How are new products developed?
Product development is a complex process involving various stages and sequencing several steps within each stage. The product development cycle usually includes idea generation, converting the idea into product, and launching of the product. There is no unique product development system that fits all organisations. To succeed would require a good strategy and plan that can be implemented efficiently.
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As product development is a multifaceted process involving several steps, it involves coordinating input from different departments of the organisation. Baxter (1995) asserts that successful product development is closely tied to mitigating risks. Risks of failure can be minimised by choosing to develop products that are in demand, provide value to customers and produced at reasonable costs. New products also have to comply with internal organisational requirements/policies and external laws/regulations.

Overview of the chapters

Being a relatively new industry and due to the uniqueness of the Islamic banking products, no in-depth study has been done on the processes of product development for Islamic banks. Most of the publications on Islamic banking and finance discuss the basic principles, Shari’ah-related matters and specific topics such as risk management, corporate governance, regulation, etc. While a few publications touch on some aspects of product development-related themes (such as Shari’ah foundations, financial engineering, etc.), none has studied the product development process in its entirety. The aim of this book is to provide a comprehensive coverage of issues related to product development in Islamic banks. In doing so, the types of products being developed and the associated legal and social features will be explored.

The initial chapters of the book provide the concepts and principles that will serve as foundations for the latter chapters on product development. The groundwork material includes presentation of principles of Islamic commercial law and an overview of the Islamic banking industry. The focus then turns to products and the product development system. By using theoretical analysis and empirical results from surveys on product development, issues related to
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alternatives available and choices made by Islamic banks are critically evaluated.

Chapter 2 introduces concepts and principles of Islamic law related to finance and outlines the features of traditional Islamic nominee contracts. Among others, the concepts of *riba* and *gharar* will be discussed and traditional Islamic nominee contracts related to transactions will be presented under three main categories – exchange, accessory and gratuitous. The chapter concludes by presenting *Shari‘ah* principles related to financial transactions in general and product development in particular.

Chapter 3 provides the background material related to Islamic banking at three levels: institutional, organisational and product. The chapter starts by presenting the legal and regulatory regimes under which Islamic banks operate and then presents various Islamic banking models. The banking models affect the structure of the balance sheet and have implications regarding the products offered by banks. As financial products are different from physical products, their nature and features are evaluated. The chapter then examines the nature of a financial product and identifies different levels of its structure. Finally, risks in a sample of Islamic financial modes are presented.

Product development is a complex process and requires involvement of the whole organisation. Chapter 4 discusses various aspects of the product development system under the headings of strategy and plans, structure and resources, and product development process. A product has to go through different phases of development before it is ready for use by the clients. In order to incorporate product development at different levels of any financial institution, it has to be a component of the strategic goal that is implemented through annual operating plans. As product development is costly, it would require commitment and support in terms
of resources. The chapter explains various steps in three main phases of the product development process: idea generation and acceptance, converting concept to product and commercialisation.

Chapter 5 presents findings from a survey on product development in Islamic banks. Results from a questionnaire-based survey for a sample of 20 Islamic banks from different parts of the world show the strategic approaches, resource availability and the various features of the product development cycle. These results are supplemented by information gathered from interviews with senior officials responsible for product development in a few Islamic banks based in Malaysia and the UAE.

Chapter 6 discusses some critical issues related to the types of products developed and used by Islamic banks. Using different features of product structure, the chapter provides definitions of Shari’ah-based, Shari’ah-compliant and pseudo-Islamic products. The concepts of potential product space and feasible product set are also introduced. While the potential product space includes all possible alternative modes that can be used for a particular product, the feasible product represents the modes that Islamic banks can use under the institutional and organisational constraints. The chapter distinguishes between cases in which Islamic banks may be forced to forgo Shari’ah compliance due to unavailability of products in the feasible set and cases where banks choose pseudo-Islamic products even when Shari’ah-compliant products are available.

The concluding chapter discusses some concerns raised on the types of products used by Islamic banks and suggests ways to resolve these. To minimise the external constraints, accommodating and amenable legal and regulatory environments for Islamic banks are needed. Other than investing in research and development to produce new knowledge that
can be the basis of new products, the chapter proposes to go beyond the product level to seek solutions for a Shari‘ah-based financial system. The chapter suggests using different organisational models that can satisfy the legal and social Shari‘ah requirements. The future credibility of the Islamic financial industry would depend partly on moving towards Shari‘ah-based products and systems. One way of doing this is by strengthening the Shari‘ah governance regimes.

Notes
1. For a review of the current state of Islamic finance, see Siddiqi (2006b).
2. For example, some new instruments such as interest-only loans, collateralised debt obligations and credit default swaps are partly blamed for the current financial crisis.
3. For a discussion on the impact of innovation on economic performance, see Merton (1992).
5. ‘Institutions’ are used in a broader sense and refer to the legal and regulatory environment under which Islamic banks operate.
Maqasid Foundations of Market Economics
by Seif Ibrahim Tag el-Din

A Sample From Chapter 1:
ECONOMICS OF MAQASID

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CHAPTER 1
ECONOMICS OF MAQASID

Preview

This chapter approaches the objectives (that is, maqasid) of Islamic law (that is, Shari'ah) in the socio-economic context as an enquiry into how Shari'ah prioritises the allocation of scarce economic resources in the pursuit of socio-economic goals. The enquiry culminates into a three-stage development model that prioritises human wants, justly and sequentially, from Necessities (darurat), to Needs (hajiyat) to finally Perfections (tahsiniyat). The analysis of maqasid departs from the five Necessities considered to be the core structural elements of socio-economics giving room to further development through Needs and Perfections. Ranked in order of importance, the five Necessities are: religion, human life, mind, progeny and wealth. Al-Shatibi’s (n.d.) analysis makes it possible to translate the five Necessities into strategic bases of socio-economic well-being. Thus, ‘religion’ is the strategic vision of well-being; ‘self’ is the overall socio-economic goal; ‘mind’ is the productive human resource; ‘progeny’ stands for intergenerational continuity; and ‘wealth’ is the material economic resource. ‘Needs’ emerge as intermediate targets to empower the strategy of well-being beyond the satisfaction of Necessities whereas Perfections are secondary targets to enhance the quality
of well-being. To bring forth the logical consistency of the above prioritisation in Necessities and the complementary roles of Needs and Perfections, this chapter explains the importance of each element in the overall strategy of well-being.

1.1 Introduction

Central economic problems (what to produce?, how?, to whom?) have always marked the human struggle against shortages in the ongoing pursuit of better living standards. Historians and archaeologists have unravelled articulate modes of economic behaviour since time immemorial involving money and reflecting various patterns of livelihood against hard-pressed scarcities. Although the historical origin of ‘economics’ refers to the Greek term ‘Oikonomikos’ as first adopted by Xenophones to describe the art of estate management in autonomous Greek towns, it is impossible to determine the time when clear economic reasoning first appealed to people’s minds.\(^1\) Apparently, prudent economic thinking has infiltrated custom, tradition and political wisdom across innumerable human cultures and civilisations, thus making it impossible to mark the time when clear economic reasoning first appealed to people.

Alternatively, the questions are when and how people’s inborn economic reasoning became crystallised into a coherent body of economics. Again, these remain contentious issues in modern economic history. Adam Smith’s *The Wealth of Nations* (1999 [1776]) is usually cited in the Anglo-American tradition as the first authoritative book in ‘economics’ (or political economy as it was known in eighteenth-century Britain), a claim that has been forcefully contended by the Austrian School and other Western critics.
of Adam Smith. Even within the British School considerable reservations exist against this claim. Mark Blaug argues that ‘[o]ne cannot pretend that Adam Smith is the founder of political economy. Cantillon, Quesnay, and Turgot have a better claim to that’. Nonetheless, Blaug has rightly hailed *The Wealth of Nations* as ‘the first full-scale treatise on economics containing, as it does, a solid core of production and distribution theory’. There is no denying the fact that the work of Adam Smith inspired the leading seminal contributions of Nassau William Senior, John Stuart Mill and John Elliot Cairnes who laid down the early foundations of positive economics. This has largely accounted for the development of a coherent methodology of economic knowledge focusing on matter-of-fact questions of what is as distinct from normative questions of what ought to be.

Simply stated, Senior–Mill–Cairnes’ methodology is a proposition of a *value-free* science of economics to handle ‘what is’ matter-of-fact questions independently of normative questions ‘what ought to be’ questions. It resounded the philosophy of positive knowledge that was already popular through David Hume’s assertion that ‘what is’ will never imply ‘what ought to be’. Positive economics has thus taken shape gradually through two centuries of serious academic discourse to place modern economics at the heart of technically sophisticated disciplines. In particular, the law of scarcity, which is the proposition that economic resources are limited relative to unlimited human wants, stands out as the technical backbone of economics. This proposition has underscored the importance of economic efficiency in the use of scarce resources and opened up broad horizons for mathematical model building in economics. Equilibrium analysis, for example, helped greatly in modelling various microeconomic structures and macroeconomic systems
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通过一个数学的方法从物理的理论被借用来的。

在达到前所未有的数学精密化时，经济的理论现在成为科学哲学的批评的对象。正如它所显示的，经济理论几乎成为应用数学的一个分支。对技术精密化过多的重视似乎使得经济理论处于成为社会上和实际上无意义的危险中，这正是为什么经济方法论的问题在目前的文献中取得新的立足点的部分原因。主要的问题是怎么样使经济理论恢复其道德目的并且将技术精密化用到社会上有益的应用中。这是下一章节的主题，其中在伊斯兰的视角中经济方法论被显示得更多的是关于促进人的幸福而不是从科学哲学的角度去质疑经济的规律。

在最终的分析中，经济是关于理解人的行为，首要的目标是促进幸福，这意味着设立社会经济的目标去促进商品和服务的满足状态。这正是长期以来在伊斯兰经济学中的一大忧虑。只要可靠的研究工具存在来帮助定义和实现这些值得的经济目标，经济工具的精密化就是手段而不是目标。目前对经济分析工具的数学兴趣将是非常值得赞许的如果它被适当地用于实现值得的经济目标的话。
1.2 Law of scarcity as a trigger of *maqasid* economics

There is one technical law of compelling importance to the key question of *how best to promote human well-being*: the law of scarcity. The law of scarcity emphasises the problem of limited economic resources relative to unlimited human wants. Under the law of the jungle people would fight against one another selfishly and brutally in order to try to satisfy insatiable economic wants out of limited resources. Yet under ethically civilised social codes humans would normally come together to share scarce resources compromisingly and to prioritise economic wants accordingly. Thus, the law of scarcity is the sole trigger of ethical values in economics as it reduces the above key question to how ethical values constrain human behaviour with a view to the problem of limited economic resources and unlimited human wants. More particularly, Muslims’ code of civilised social order is *Shari’ah* – the Islamic Law – that makes it possible to re-state the question as how Shari’ah prioritises scarce economic resources in the pursuit of socio-economic goals.

The above restatement brings the question to the jurisdiction of *Shari’ah* objectives – the *maqasid* of *Shari’ah* – a special field of enquiry through which early Muslim scholars worked out clear criteria of how *Shari’ah* approaches socio-economic goals. The *maqasid* enquiry emerged as an independent field of jurisprudence from the work of leading Muslim scholars including Al-Ghazali, Ibn Abdelsalam, Ibn Taimiyah, Ibn Al-Qaiyim and most notably Al-Shatibi in his widely acclaimed book *Al-Muwafaqat* that crystallised *maqasid* into an elaborate scheme of core values shared by almost all human societies irrespective of religion, culture and history.⁶ Al-Ghazali was perhaps the first to describe...
the hierarchy of human wants as Necessities, Needs and Perfections, which is particularly relevant to the key question of how Shari’ah prioritises the allocation of scarce economic resources in the approach to socio-economic goals. This makes up a three-stage development model starting from the satisfaction of Necessities, (darurat) to the satisfaction of Needs (hajiyat) and finally towards the satisfaction of open-end Perfections (tahsiniyat).

1.3 The three-stage development model

The economics of maqasid owes much of its logical appeal to Al-Shatibi’s elaborate analysis of maqasid that departs from the proposition that all worldly affairs involve ‘meaningful objectives’ – ma’qul al-ma’na – in contrast with worshipping deeds that had to conform strictly to Revelation and the tradition of Prophet Mohammed (peace be upon him). In agreement with Al-Ghazali and other predecessors, Al-Shatibi defines five fundamental Necessities: religion, self (for human life), progeny, wealth and mind, believing that they are recognisable in all creeds. What makes Al-Shatibi’s work particularly relevant to economics is the provision of a clear analytical insight into a three-stage development mode incorporating Needs and Perfections as direct derivatives of the five Necessities. Al-Shatibi defines Necessities as the bare minimal requirements of sustainable human livelihood that usually involve hardship in their satisfaction. Thus, the role of Needs is to remove hardship and to extend conveniences (tawsi’ah) in the satisfaction of Necessities. Perfections amplify the satisfaction of Necessities further through refinements and excellence in quality. This drives home the fact that Islamic economics is not reducible to a basic-needs strategy. The maqasid scheme accommodates ever-changing human wants so long as the
process of economic satisfaction remains governed sequentially and justly in accordance to the above defined three-stage development model.

Putting them in proper order, these five Necessities can be logically synthesised into a consistent strategic basis of socio-economic well-being. Incidentally, it is the order that Al-Ghazali lists them sequentially: (1) religion, (2) self, (3) mind, (3) progeny and (5) wealth. In this order, the *maqasid* strategy of socio-economic well-being brings together the specific contribution of each of the five Necessities as follows: ‘religion’ is the strategic vision of well-being; ‘self’ is the central socio-economic goal; ‘mind’ is the productive human resource; ‘progeny’ is the intergenerational goal; and (5) ‘wealth’ is the material economic resource – that is, one strategic vision, two primary goals and two kinds of productive resource. Necessities are irreducible core values of decent human life; Needs are intermediate targets to empower the strategy of well-being beyond the satisfaction of Necessities; Perfections are secondary targets to enhance the quality of well-being. This is shown in Figure 1.1 through a regular pentagon having the five Necessities as core structural elements of ‘well-being’ developed further through satisfaction of Needs and Perfections. This follows directly from Al-Shatibi’s remark that ‘Necessity (*darurat*) is the foundation [asl] of Needs and Perfections’.\(^9\) To define Needs and Perfections on the basis of Figure 1.1, reference is made to Al-Shatibi’s assertion that ‘[e]very element of Need and Perfection is subservient to one foundational element of Necessity’.\(^{10}\) This assertion is translated through Figure 1.2 where each of the five Necessities generates its own Needs and Perfections so that Needs and Perfections emerge as outright extensions of Necessities.

To give a simple illustrative example, Necessities are comparable to the bare red-bricks’ structure of a multi-storey...
building consisting of rooms, ceilings, floors, doors and windows but nothing more. This structure is habitable, but most likely with enormous hardship and frustration for anyone living there. Therefore, to remove hardship and introduce habitable conveniences, ‘Needs’ must be met through the introduction of water pipelines, electric connections, toilets, bathrooms and kitchens. Other needed conveniences may include wall plastering to cover the bricks inside the rooms and perhaps heating and air-cooling devices for the different seasons. Finally, the stage of Perfections brings in all additional refinements that help enhance the quality of the building including colourful painting, wall and ceiling decorations, tiled or laminated flooring, sophisticated electric appliances and a beautiful backyard garden. Architectural planning (for example, the organisation of rooms, halls, utilities and ventilation) can also be perceived as Necessity since bad planning will render all subsequent conveniences and refinements nearly pointless. Hiring the planning service of a trained architect rather than an amateur is perhaps a Need rather than a Necessity.

The above example of a multi-storey building helps reveal how serious are the possible imbalances resulting from a failure to comply with the strict sequential process of Necessitates, Needs and Perfections. For example, shallow building foundations, fragile bricks or loose mortar means a failure to satisfy Necessities, thereby ending up in a shaky structure unfit to accommodate habitable Needs. Bad architectural planning (for example, very small rooms, irregular halls, misallocated utilities or poor provisions for ventilation) is also a failure to satisfy Necessities as it renders all subsequent convenient Needs and quality Perfections largely pointless. Similarly, Needs must precede Perfections in as much as wall plastering must precede wall decoration, or in as much as the Need to hire a good architect must
precede Perfection in the implementation of high-quality building.

The crux of *maqasid* is to build the structure of socio-economic well-being through a three-stage development process that proceeds *sequentially* and *justly* from the satisfaction of Necessities to Needs and finally to Perfections. The five Needs are the structural elements that have to be firmly established and maintained before admitting Needs and Perfections. Failure of strict compliance with the above sequential process causes serious imbalances comparable to those of the above building simile. Hence, to appreciate the *maqasid* strategy of socio-economic well-being and bring forth the logical consistency of the above prioritisation in Necessities and the complementary roles of Needs and

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**Figure 1.1 The five Necessities of Maqasid Al-Shari‘ah (Religion: R; Self: S; Mind: M; Progeny: P; and Wealth: W, in order of strategic importance)**
Perfections, the importance of each element in the overall strategy of well-being will now be explained.

1.4 Religion: the strategic vision of well-being

Religion comes first because it caters to the socio-economic vision of well-being to harness the satisfaction of economic wants. It is the worldview derived from the Qur’an and the Prophet tradition (the Sunnah) as against alternative world-views derived from alternative religions, belief systems and philosophical outlooks in human societies. Differences in worldviews are described in the literature as paradigmic differences to distinguish them from ordinary differences in social, economic and political viewpoints. Admittedly, there are more commonalities among humans than differences
particular in the appreciation of justice, honesty, fair governance, ethical values and moral constraints in socio-economic interactions. Yet, the Islamic worldview of moral integrity revolves around *Tawhid*, which means belief in the One God (Allah). *Tawhid* is not only about belief in God but most significantly in God’s contact with humans through the sending of Prophets. The ultimate objective of sending prophets is to prescribe norms of good conduct thereby placing *Tawhid* at the heart of the worldview that Allah has created life for a well-defined moral purpose. The Prophet (peace be upon him) has said, ‘I have just been sent to accomplish noble morals.’ In the Qur’an, it is clearly asserted that God’s creation cannot be without purpose: ‘Did you imagine that We created you for no purpose and that you will not be brought back to Us!’ (Qur’an, 23: 115).

The antonym of *Tawhid* is polytheism or *Shirk*, which stands for idolatry worshipping and denial of the Day of Resurrection (that is, the Hereafter when people stand accountable to God). ‘Your god is One and those who disbelieve in the Hereafter have their hearts denying it arrogantly’ (Qur’an, 17: 22). Historically, idolatry worshipping developed as pragmatic contrivances to symbolise loyalty and assured bonds of allegiance towards powerful dynasties who often ruled people and controlled their social wealth in the name of the idols. As a matter of fact, God matters in socio-economic life only if people believe in accountability to Him, whereas denial of accountability creates a mindset heedless to God even though He is believed to exist. It is commonly cited in the Qur’an that *Shirk* proponents do admit the existence of God as Creator and Sustainer but due to the denial of the Hereafter they hold no scruples against mischievous deeds and injustices. *Shirk* is thus associated in the Qur’an with the irresponsible pursuit of pleasure, the adoration of wealth and a tampering with the concept of

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justice. *Tawhid*, on the other hand, brings moral purpose to life through God-revealed commandments that regulate the pursuit of life pleasures through clear standards of justice.

Now that Needs and Perfections are complementary qualifications of Necessities, this must apply equally well to religion. In this context, Needs and Perfections have an effect on religion as long as the worldview of *Shari’ah* extends through *ijtihad* to encompass new ideas, rules, measures and values to match newly arising economic wants in the everlasting endeavour to satisfy additional Needs and Perfections. The history of Islamic scholarship is a good testimony of how *Shari’ah* has consistently expanded along the Islamic worldview to accommodate newly arising methods and styles of livelihood and how it acknowledged new social customs (*a’raf* plural of ‘urf) over the last fourteen centuries. This is clearly accommodated in the extended sources of jurisprudence (*usul al-fiqh*) along the guidelines of the Qur’an and Sunnah. For example, the Malikite School includes analogy (logical deduction) and disposable utility (*masalih mursalah*) as legitimate sources of jurisprudence. The finality of Islam has meant that *Shari’ah* must remain relevant to all places and times through the open provisions of *ijtihad*.

### 1.5 ‘Self’: the central goal

‘Self’ is human life. It embodies the ultimate goal of human well-being on Earth as asserted in the verse ‘It is He who created for you all that which is on Earth . . .’ (Qur’an, 2: 29). ‘Self’ comes second after religion because the strategic vision must precede the socio-economic goal. At the outset all provisions for self must comply with the *Shari’ah* vision that human life has to be regarded with honour and dignity. This is conveyed through the Qur’anic verse: ‘We
have certainly honoured the children of Adam and carried them on the land and sea and provided for them of the good things and preferred them well over much of what We have created’ (Qur’an, 17: 70). Therefore, provisions for human life must transcend the mere animal survivalist strategy to include well-balanced nutrition, suitable shelter and clothing, protection from disease, literacy, access to a decent income-earning activity and equal opportunity to share the fruits of well-being. These basic items make up for absolute Necessity that must be satisfied before moving towards Needs and Perfections.

Notably, the provision of equal human opportunity follows from the very definition of self as the undifferentiated human life with no grounds for preferential positions under Shari’ah. ‘Oh mankind fear Allah who created you from a single self . . .’ (Qur’an: 4, 1). The prevalence of extreme poverty when luxurious consumption prevails elsewhere is a stark discrepancy from equal human opportunity. Satisfaction of Needs through the removal of hardship (haraj) and the introduction of better conveniences (tawsī’ah) must apply uniformly to all society members before the introduction of quality refinements to other society members through Perfections. This the crux of the three stage development model of maqasid as defined above.

However, it is impossible to set universal standards for Necessity in human life; it is not only the case that the qualitative boundaries are shifting consistently between Necessities, Needs and Perfections, but also that development stages tend to reflect different living standards in different societies. Thus, the standards of Needs and Perfections may qualify as Necessity in more developed societies or at some future times. The hallmark of technological progress is to keep re-defining hardship and convenience in an endless effort to make life easier than before. As the set of ‘minimal
standards’ comprising Necessity develop to higher standards through technological process, remarkable changes happen in social customs to warrant a fresh outlook at the architecture of well-being. For example, having a private car was Perfection fifty years ago in many counties but now it tends to be regarded as a social Need. No matter how boundaries are placed, the objective of Shari’ah is to maintain the above-mentioned three-stage development model whereby human wants get satisfied sequentially and justly from Necessities to Needs and finally to Perfections.

1.6 ‘Mind’: the human resource

‘Mind’ is the human resource that thinks, evaluates, plans, manages and produces the goods and services of well-being along the Islamic worldview, hence taking third position after religion and self. Shari’ah is an outright address to the human mind as it is regarded as the focal centre of social and family reasonability across all human cultures. The first five verses revealed to Muhammad have been a call for meaningful literacy: ‘Read in the name of your Lord who created, – created man from a clinging substance. Read and your Lord is the most Generous, Who taught by the pen. Taught man that which he knew not’ (Qur’an, 96: 1–5). Therefore, education from early childhood up to later ages, whether religious or moral, ranks as a primary Necessity of mind. Regardless of academic formality or scientific sophistication, the objective of education is to produce morally conscientious, socially responsible and economically productive individuals. The essence of a well-balanced human resource strategy is to help create leadership qualities and develop technical skills to create jobs and raise productivity.

Needs and Perfections in human resource development are simply the means to upgrade Necessary education
towards further knowledge and greater sophistication. As human societies develop to higher economic horizons, skill-building becomes all the more demanding. Education would then transcend sheer memorisation and understanding of received knowledge, towards developing more analytical, imaginative and creative competencies to help tap into God’s endowments on earth along the Qur’anic verse: ‘And He has subjected to you whatever is in the heavens and whatever is on the earth – all from Him . . .’ (Qur’an, 45: 13). Obviously, the tapping into God’s endowments must fall in tandem with the three-stage development of maqasid. The failure to comply with maqasid will result in serious imbalances as, for example, where Perfection precedes Necessity. This can be the case of delving into highly technical education where the moral and religious foundation is shaky. From the maqasid perspective, human resource development is not only about skill-building, but also about creating well-behaved and socially responsible generations. This makes up particularly for financial responsibility as it will shortly emerge under the fifth structural element, ‘wealth’.

1.7 ‘Progeny’: inter-generational goal

‘Progeny’ comes next in order to account for the goal of intergenerational continuity of socio-economic well-being subject to the Islamic worldview. This goal brings forth the importance of family as a core educational circuit to help transfer a particular sense of direction and moral purpose to the new generations. Adherence to the institution of marriage and the maintenance of strong family values are therefore Necessary elements for intergeneration continuity. Thus mind must logically precede progeny. Obviously, the aim is to maintain the above worldview throughout the intergenerational process rather than to stifle creativity,
innovation and intellectual progress to new and better future horizons. The social outcome of continuity from generation to generation is to ensure maintenance of moral responsibility towards family parties (husband versus wife, children versus parents and children versus children), extended family members and society at large. The possible prioritisation of this moral responsibility into Necessitates, Needs and Perfections underscores the fact that they are not equally important. For example, marriage is an utmost Necessity for intergenerational continuity whereas one’s duty towards the larger society is an intergenerational Perfection. Similarly, caring for one’s own children is Necessity whereas caring for members of your extended family is Need.

Intergenerational responsibility depends, not only on family, but also on social and governmental institutions with a clear mandate to guard the intergenerational continuity morally and financially (for example, facilitating marriage, supporting young families and counselling services).

‘Let the one of means spend according to his means: and the one whose resources are restricted, let him spend according to what Allah has given him. Allah puts no burden on any person beyond what He has given him’ (Qur’an, 65: 7).

1.8 ‘Wealth’: the material economic resource

Finally, material economic resources must ensue adequately to empower each of the above constituent elements of socio-economic well-being along the three stage development process of maqasid. Wealth stands for all material economic resources (land, natural resources, energy, semi-finished goods, equipments, machinery and money). Ranking in last position among the five Necessities is not at all an indication of being of least importance; it is rather
an acknowledgement of wealth as subservient to the satisfaction of all Necessities, Needs and Perfections as they relate to each one of the constituents of well-being. This conforms to the common standard of national economic planning that normally departs from a statement of strategic visions, down to strategic goals, human resource targets and finally budgetary questions on economic resource requirements. Wealth is therefore the means to achieve goals and targets rather than an adorable idol that parts with the Islamic worldview in two ways. First, it invokes an act of *Shirk* and pre-empts wealth from moral purpose. The Prophet condemned the adoration of wealth for its own sake, saying, ‘Miserable is the servant (*'abd*) of Dinar and Dirham’ (*hadith*). Second, it accentuates concentration of wealth into few hands, thereby inflicting grave injustices and causing serious imbalances in the socio-economic pursuit of well-being.

*Shari'ah* recognises and fosters all customary rights of private property under the provision that wealth is a trust from Allah to test how his servants deliver moral and social obligations through the management of their wealth. ‘Believe in Allah and His messenger, and spend out of what He has made you vicegerents’ (Qur’an, 57: 7). This is one major reason why the Qur’an forbids entrusting private property to immature /irresponsible people (*sufaha*) who mismanage wealth. ‘Do not give the sufaha your wealth that Allah has given you to maintain; [but] feed and clothe them from it, and speak kindly to them’ (Qur’an, 4: 5). This point brings back the above role of mind, which now re-emerges as the focus of financial responsibility. To avoid waste, wealth management in the Islamic perspective requires striking the right balance between the enjoyments of Allah’s bounty for oneself and delivering incumbent moral obligations towards family and social causes. ‘And do not make
your hand chained to your neck or extend it completely and [thereby] become blamed and insolvent’ (Qur’an, 17: 29). Wastage of wealth is a grave sin, particularly when a misallocation of resources in luxurious spending reflects in extreme shortages of important social services such as housing, public health and education.

To see how grave injustices may arise from imbalances in the satisfaction of human wants, reference is made to Figures 1.3a and 1.3b, where the Production Possibilities Frontier (PPF) brings Needs and Perfections as two alternative groups of goods. These are shown, respectively, on the horizontal and vertical axes of the PPF. The PPF is a useful tool of economic analysis showing how alternative allocations of scarce economic resources may produce alternative goods or categories of goods – in this case Needs versus Perfections. Points along the PPF represent full capacity utilisation of resources while all points below the PPF represent below capacity utilisation. The concavity of the curve reflects the Law of Diminishing Returns. Hence, assuming that resources are fully utilised, the production of more Needs is only possible through the production of less Perfections, which is the essence of the law of scarcity. Figure 1.3a is obviously non-conforming to the Islamic worldview as it represents a critical imbalance favouring the production of more Perfections than Needs due to wealth concentration into few hands. By contrast, Figure 1.3b is more in line with the Islamic worldview since it allocates more resources to the production of Needs than to Perfections. Now, this raises the question about the practical approach whereby an economy embarks on the balanced three-stage development model.
Figure 1.3a  More Perfections ($P^*$) satisfied at the cost of less
Needs ($N^*$)

Figure 1.3b  More Needs ($N^*$) satisfied at the cost of less
Perfections ($P^*$)
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Summary

1. Prudent economic thinking has no founder. It has prevailed since time immemorial in response to the three central economic questions: What to produce? How to produce it? For whom to produce it?

2. Modern economics is mostly an offspring of Senior–Mill–Cairnes’ methodology that set the foundation of a value-free science of positive economics.

3. The need to restore moral purpose to economics underlies the Islamic cause of concern with methodology. Undue emphasis on technical refinement at the expense of moral purpose is a major cause of concern about modern economics.

4. The law of scarcity is the primary trigger of ethical values in economics whereby civilised human societies develop ethical codes to govern the satisfaction of unlimited human wants out of limited resources.

5. This brings forth the key question of maqasid economics: How does Shari’ah prioritise scarce economic resources in the approach to socio-economic goals? Al-Shatibi’s approach proves particularly relevant to answering this question.

6. The gist of maqasid as regards the satisfaction of human wants is to prioritise them along a three-stage development process, from Necessities, to Needs and finally to Perfections.

7. Necessities consist of five elements (religion, self, mind, progeny and wealth) representing the structural constituents of well-being that can be amplified by Needs and Perfections.

8. ‘Religion’ is the strategic vision; ‘self’ is the goal of well-being; ‘mind’ is the human resource; ‘progeny’ stands for
intergenerational continuity; and ‘wealth’ is the material economic resource.

Questions

1. Why is it impossible to identify a founder of economic reasoning?
2. What is the difference between positive economics and normative economics?
3. What kind of methodological concern arises from the Islamic viewpoint towards the mathematical sharpening of economic tools?
4. How would you respond to the claim that the law of scarcity is irrelevant to Islamic economics?
5. What is the key economic question from the maqasid perspective?
6. How would you respond to the claim that Islamic economics is all about the satisfaction of basic needs and the elimination of poverty?
7. Explain why Needs and Perfections are admitted to amplify Necessities in the pursuit of socio-economic well-being.
8. List and define the five Necessities in proper order and briefly explain the logical consistency of this order.
9. Where do moral values belong in relation to the five Necessities?
10. What does ‘religion’ represent in terms of the five Necessities, and how could ‘religion’ develop along the three-stage maqasid model?
11. What does ‘mind’ represent in terms of the Five Necessities, and how does it develop along the three stage maqasid model?
12. Why should wealth come last in the order of the five
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Necessities, and how does it develop along the three-stage maqasid model?

Notes
1. This point of view is demonstrated in Backhouse (2002), *Penguin History of Economics*, pp. 11–24.
3. Ibid. p. 61.
5. ‘Hume’s guillotine’ is a way of contrasting positive and normative disciplines as equivalent antonyms (*positive/normative, is/ought, facts/values, objective/subjective, descriptive/prescriptive, science/art, true/false and good/bad*); see Hume cited in Blaug (1997), pp. 112–13.
10. Ibid. p. 19.
Islamic and Ethical Finance in the United Kingdom

by Elaine Housby

A Sample From Chapter 1:
Introduction
**Discussion of the term ‘ethical’**

Islamic finance is routinely described as ethical. This reflects the fact that self-described ‘ethical’ finance is a large and growing sector of the market. It has a very positive image with which Islamic financial services seek to associate themselves. The claim that ‘Islamic’ and ‘ethical’ are synonymous is rarely seriously examined, and nor is the claim that there exists a consistent and generally understood definition of ‘ethical’ practice. The case studies in this book have been chosen because they shed light on the difficulties of arriving at a consensus definition of what ‘ethical’ means and of positioning the Islamic sector as a sub-set of the ethical sector. At its worst the term ‘ethical’ has become little more than a marketing label. This detailed consideration of providers which all position themselves as ‘ethical’ is intended to get beyond this to see what the term means in the diverse practice of these providers.

There is no doubt about the extent of public interest in alternative financial services which are perceived to be more principled and more socially useful than the conventional kind. The banking crisis of 2008 and subsequent scandals and crises in the major banks have led to a great deal of
public anger and a search for anything that seems to do things differently. One example of this is the Move Your Money campaign, which seeks to persuade the public to close their accounts with the major high street banks and open new ones with ‘mutually owned, community focused or ethically minded banks’.1 It has had some success in increasing awareness of the existence of smaller and less familiar names in banking, most of which report a large increase in enquiries over the last few years.

The original intention of this study was to produce a working definition of the term ‘ethical’ at the outset as a guide to where to look for illuminating case studies. In practice it has proved more useful initially to consider any organisation which describes itself as ‘ethical’ in its own publicity and then try to analyse what it means by this. To limit the field of study by restricting it to a prior definition of what ‘ethical’ means would miss the most interesting and significant aspect of the study, namely the remarkable diversity of principles and practices which are described by their own promoters as ‘ethical’ and the widespread reluctance to offer customers clearly stated definitions of what exactly the provider regards as un-ethical. It is this lack of clarity which provides the sharpest contrast with the Islamic sector and the most instructive lesson for those attempting to position religiously inspired services within the wider ethical sector.

There is a great deal of writing and discussion in all forms of media – printed, broadcast and online – about ‘ethical investing’, ‘socially responsible investment’, ‘responsible credit’, ‘corporate social responsibility’, ‘transparency in corporate governance’ and ‘sustainable finance’, and this is not an exhaustive list of expressions indicating alternative finance and business models or at least believed to do so. Unfortunately much of this material is repetitive and derivative and does not consider the issues involved from first
principles. It is full of unexamined assumptions about what is good and bad, particularly in relation to environmental issues and to the respective roles of business and of the voluntary sector. Many writers on the subject tend to quote the same sources and also each other. The term ‘sustainable’ is used loosely and inconsistently, often in a way which confuses financial sustainability with the environmental kind. There is some interesting work being done developing the idea that a business can only be truly sustainable in the financial sense if it promotes sustainable environmental and social practices, but this has not yet found its way into much of the promotional material of the self-described ‘ethical’ sector. In this lack of clarity the secular ethical sector compares unfavourably with the Islamic sector, where the fundamental principles are rigorously set out and conformity with them is assessed by experts.

The Islamic sector has been one beneficiary of this widespread quest for alternatives, but in the present volatile state of public opinion there is no certainty that it will be successful in the long term in attracting and retaining interest from non-Muslims who are looking for a supposedly ethical alternative. In its current state it presents some challenges to customers from different cultural traditions and fails to satisfy some criteria which are commonly accepted as part of the wider alternative finance movement, sometimes by simple omission and sometimes because they are not compatible with Islamic principles. It has been fairly slow to take up environmental concerns and is still handicapped in this area by a perception that it is too reliant on support from Arab oil states. It cannot hope to attract much custom from non-Muslims whose liberal views on gender roles and sexuality are central to their perception of what is ‘ethical’. On the other hand, the centrality of the prohibition of bank interest in the Islamic financial tradition
makes practical co-operation with interest based alternative financial models very difficult, even for those Muslims who are otherwise sympathetic to the general aims of such alternatives. One of the main themes of this study is to explore what possibilities there really are for convergence between the Islamic and the non-Islamic ethical sectors.

The basic principles of Islamic finance

This book is not intended to provide a detailed guide to the principles of Islamic finance, which can be found in other books in this series, but for readers whose main interest is in the wider field of ethical finance and who are unfamiliar with the tradition of Islamic thought on finance and economics, the following brief summary may be useful.

The most important and best known principle within this tradition is the prohibition of *riba*, a term now identified with bank interest. Its basic meaning is an increase of capital through the payment of a fixed or guaranteed return. The only permissible ways to increase capital are through sale and purchase and through investment in business, where there is some risk, however theoretical, of losses.

A less well-known but equally fundamental prohibition is that of *gharar*, usually translated as speculation. This covers a spectrum from outright gambling, which is strictly forbidden in Islam, to contracts which contain unacceptable elements of uncertainty. Only expert Islamic scholars can form authoritative opinions on the more subtle forms of *gharar* which may be present in contracts and financial instruments. Some lay people, particularly those from non-Muslim backgrounds, find it difficult to understand why the payment of a return is only permissible if the capital is at risk and yet gambling and speculation are forbidden. It is quite clear within Islamic law that the purchase of shares in
a company and direct investment in a new venture are legitimate forms of business activity and are not gambling or speculation, and the study of this distinction is a useful corrective to the simplistic approach sometimes found among enthusiasts for ethical finance which sees all investment in equities as a form of gambling.

Underlying the technical prescriptions of Shari‘ah is a fundamental concept of sharing risk rather than transferring it. It is this which makes Islamic finance attractive to those disillusioned by a steady stream of revelations about the ingenious methods employed by conventional banks to protect themselves against any risk of loss and oblige their clients and account holders to suffer instead. In practice the behaviour of Islamic banks has not always lived up to this ideal of a partnership in which both losses and rewards are shared, but that only makes those who are committed to the ideal more determined to see its full potential realised.

Another way of looking at this would be that the principle of mutualism is central to the Islamic tradition. This is one of the most interesting points of intersection with the secular tradition of ethical business in Britain, where mutual and co-operative models have been historically important.

Much of the overall character of Islamic finance comes from its avoidance of debt financing and preference for sale and leasing contracts rather than the structures typically used in conventional finance. This is often interpreted by practitioners as the principle that all forms of finance must be based on real assets. Again, in practice the underlying assets in these transactions are not always as straightforwardly tangible as this principle implies, but it is this probably more than any other aspect of Islamic finance which has attracted new interest to it since the banking crisis, a crisis which to many members of the general public seemed
to have been caused by trying to produce money ‘out of thin air’.

Mention may be briefly made of some Islamic financial structures which embody these principles. The Islamic version of insurance, *takaful*, is a mutual assurance scheme in which the risk is shared by all the members and any profit is divided among them as well. In the venture capital model known as *mudarabah*, the financier who provides the funds to the entrepreneur has to share any losses, because the work and effort of the latter is considered to be of equal value. The most common forms of home purchase finance, *murabahah* and *ijarah*, embody the use respectively of sale and purchase contracts and rental contracts as legitimate ways of gaining an increase on capital. The ‘bond like’ instruments of *sukuk*, which pay a return in the form of income generated, in most cases, by a piece of real estate, are the clearest expression of the principle that all finance must be based on real assets, and lack of clarity about the nature of the claim on the underlying assets has aroused scholarly concern.

Some other principles of *Shari‘ah* are relevant to a consideration of the relationship between Islamic and other ethical practices. The consumption of alcohol and pork is not permitted. There is no explicit injunction against tobacco but in recent times scholars have tended to regard it as an unacceptable intoxicant. Muslim views on matters connected with sexual relationships are generally more conservative than those typical of British society as a whole.

At the most fundamental level, to be compliant with *Shari‘ah*, the path of Islam, any kind of financial or business activity must be concerned to promote human development towards a religious ideal and to avoid anything that would hinder this. It must help individuals to live full, dignified and worthwhile lives, first by providing the material conditions necessary for this and then by avoiding the encouragement
of any activities which tend to damage and weaken either individuals or communities. It is at this most fundamental level that there is the greatest possibility of convergence and co-operation with other forms of ethical striving, whether by those of other religious traditions or that which arises from a secular aspiration to make a better world.

An outline of Christian thought on finance

That this section is longer than the previous one on Islamic thinking may seem inappropriate in a series expressly concerned with Islamic finance. The justification for it is that the Islamic tradition is extensively described elsewhere and that those most familiar with Islam may not be familiar with the existence of a body of Christian thinking on finance. The Christian tradition is central to understanding the non-Muslim ethical sphere in the UK and the ways in which it relates to the Islamic sector. Even though the national census of 2011 found that only 59 per cent of the population were still prepared to describe themselves as Christian, the culture of the country is strongly coloured by the historical importance of the Christian churches.

Christian attitudes to money

When the Occupy the London Stock Exchange group set up camp outside St Paul’s Cathedral, and the governing body of the cathedral found itself confronted with the dilemma of whether or not to support moves to evict the protesters, the situation captured the imagination of the British public and dramatised the unresolved tensions within the Christian tradition about the appropriate attitude to wealth.

A well known passage of the Gospels describes an attempt to entice Jesus to express hostility to the government which would justify his arrest by asking him whether it was
religiously acceptable to pay tax to the Roman occupiers. He responded by pointing out that coins were stamped with the name and picture of the Emperor, and saying, ‘Give to Caesar what belongs to Caesar, and to God what belongs to God’ (Matthew 22: 21). Although in its historical context this reply seems to have been intended as strategically ambiguous, Christians down the centuries have tried to derive guidance from it on what their relationship to money and to earthly power ought to be. In the context of the dilemma faced by the clergy of St Paul’s Cathedral, Caesar took the form of the Corporation of London, the secular authority responsible for the ‘City’, the district in which the London financial services industry is concentrated.

One response to the dichotomy implied in this passage is the millenarian strand within Christianity, that is, a rejection of all worldly concerns as irrelevant and inappropriate and an exclusive concentration on the next life or the anticipated divine transformation of this earthly one. There are a number of Gospel passages which support such a position, notably ‘my kingdom is not of this world’ (John 18: 36). Throughout the last 2,000 years this tendency has periodically expressed itself in outbursts of radical fervour. In the present day it finds a congenial home in the environmentalist movement, where religious apocalyptic language is easily converted into the climate change kind.

There has always been a tendency within Christianity to idealise poverty. This is an important difference from Islamic attitudes to wealth, which developed in a trading culture. Islam never developed a monastic tradition in the way that Christianity did. The orders of monks, friars and nuns were founded on an idealisation of both celibacy and poverty and in some cases of mendicancy (begging), giving a spiritual interpretation to the relationship of dependency between holy beggars and those who supported them. This
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A strand of Christianity keeps re-appearing to complicate attempts to develop a theology about money. Elements within Christianity simply dislike all monetary relationships, even business, and dislike the financial services industry most of all. The classic Biblical reference here is the incident of Jesus driving money-changers out of the temple precinct (Matthew 21: 12). His description of them as ‘robbers’ suggests it was mainly their dishonesty he objected to, but it has often been taken to indicate that involvement in sordid financial services is inappropriate for Christians.

A particularly problematic Gospel text is the story traditionally known as ‘the parable of the talents’ (Matthew 25: 14–28). This relates the story of a man who left his three servants in charge of his business, giving them respectively five, three and one coins (a talent being a unit of currency) to take care of while he was away. The first two increased their capital by wise investments but the third hid his for safekeeping and returned only the original amount. The servants’ master was delighted with the first two and angry with the third. This parable is heavily ambiguous and has confused many generations of Christians. It has often been explained as an entirely metaphorical exhortation to make the best use of our abilities. It can also be taken at face value as an endorsement of the legitimacy of lending at interest and prospering through business acumen. On the other hand it seems to contain a strong criticism of the master’s behaviour. The reprimanded servant says, ‘I knew that you are a hard man, harvesting where you have not sown and gathering where you have not scattered seed’. The master replies that since he knew that, he ‘should have put my money on deposit with the bankers, so that when I returned I would have received it back with interest’. The story concludes with what could be taken as an entirely cynical observation on the way the world works: ‘For whoever has will
be given more, and they will have an abundance. Whoever does not have, even what they have will be taken from them’. Close reading of these verses suggests a condemnation of those who make money out of money rather than by productive labour and of financial practices which make the rich richer and the poor poorer, a sentiment very similar to that found in the Quran.

Christian views on charging interest
Historically the church forbade usury, and left it to the Jewish minorities of Europe, who were permitted to practise it with non-Jews but not within their own community.³ The church’s opposition to interest bearing transactions lasted through the medieval period but finally gave way under the pressure of emerging capitalism. Some Christians however have never felt entirely reconciled to usury. As recently as 1942 the then Archbishop of York, the left-leaning William Temple, was worrying about the power of financial systems based on interest to distort social priorities and create inequality. He put forward the idea, then radically innovative but now sounding rather familiar to anyone who has studied Islamic finance, that ‘so soon as the interest paid on any investment is equal to the sum invested, the principal should be reduced by a specified amount each year until the claim of the investor to interest or dividends was extinguished’.⁴ It is interesting to note that it is the point where the principal has doubled that is felt to be the limit of acceptability. The most famous Quranic injunction against the charging of interest is ‘devour not riba, doubled and redoubled’ (3: 130). Temple’s proposal was never likely to be adopted by any British government.

Tawney, in his famous study of religious attitudes to capitalism, says that the feeling against usury ‘survived as a sentiment long after it was repudiated as a command’
and refers to the ‘innumerable fables’ about usurers meeting unpleasant ends as an expression of the deeply rooted popular animosity towards money-lenders. This suggests that all formal religious opposition to usury is drawing on deep wells of innate resentment. Arguably the wave of popular hostility to banks following the crisis of 2008 is just the latest expression of this fundamental folk sentiment against bankers, usurers and anyone who seems to profit from other people’s poverty. In this present context it is natural for Christians as well as Muslims to re-examine their own religion’s earlier condemnation of usury, and for both traditions to attract wider interest.

**The social and political role of the churches**

Running alongside this popular sentiment against money-lenders has always been a feeling of resentment against the wealth of the institutional church. There is an obvious contradiction between the life of an itinerant preacher presented in the Gospel story of the founder of Christianity and the considerable wealth and secular power which has been acquired by the churches over the centuries, and protests against the churches’ wealth have been a recurrent feature of Christian history. A recent exponent of this popular sentiment was the caller to a radio programme who was indignant at the extensive collection of artefacts made of precious metals on display in his local cathedral and called for them all to be melted down and the proceeds given to the poor. This of course overlooks the artistic and historical value of such objects and of many church buildings. All of the long established Christian denominations, and the Church of England in particular, have an obligation to protect and maintain these which they sometimes find burdensome. They also have to pay salaries and pensions to their clergy. The Church of England’s investment
policies are therefore of interest to a study such as this.

The Church of England also has an important constitutional role; the monarch as head of state is also head of the Church and its bishops sit in the House of Lords and thus help make the law. Contrary to popular belief they are there because of the role of the Church as a very large landowner, not as representatives of religious faith. The bishops are formally described as the ‘lords spiritual’ as opposed to the ‘lords temporal’, the usual aristocratic landowners. In practice however in the present day the bishops in the Lords do see their role as being to provide a Christian perspective on the issues of the day. The only occasion in recent years when their votes have proved decisive was in the rejection of a proposal to amend the laws on gambling to permit the opening of a large casino in north-west England. This reminds us that, while Christianity does not prohibit gambling entirely, as does Islam, that does not mean that Christians are unconcerned about it. (The same applies to the use of alcohol and other intoxicants.) The Church of England has produced an excellent paper on gambling drawing on Christian sources as far back as St Augustine. This paper clearly explains why investing in stock markets is not the same as gambling, in distinction to some public opinion but in conformity with the principles underlying Islamic finance.

By contrast the newer Christian groups are much less encumbered with commitments to buildings and personnel and can be more nimble in responding to changing social circumstances. For example they can begin working in a deprived neighbourhood simply by renting cheap office or residential accommodation there. This is one reason why such newer groups, who are usually more evangelical (proselytising) and fundamentalist in their approach to scripture than the older ones, are becoming a significant force
in social and financial activism in Britain. Among some of these groups a new financial theme has emerged, the ‘prosperity gospel’, the conviction that material success is a sign of God’s favour, or in its crude form merely that going to church and observing Christian principles in life will lead to prosperity.

**Christian attitudes to the welfare state**

Jesus had a ‘tax collector’ as an apostle, which was considered shocking because such people were loathed by the populace. St Matthew seems to have been something more similar to what we would call a tax farmer, in effect a licensed extortionist, than to HM Revenue and Customs (HMRC), the tax collecting authority in present-day Britain. In modern times the majority view within British churches has been that it is a duty to pay secular taxes because this is the main means of wealth distribution in society. Our taxes go to pay for the welfare state, which in this perspective is regarded as a secular expression of the Christian exhortation to care for the sick, elderly and unfortunate. Historically the labour movement in the UK has had strong Christian elements, which is something that should be borne in mind by readers familiar with countries where the churches are more likely to be aligned with the right in politics.

There are however substantial differences of opinion on this issue among Christians. The Church of England bishops in the House of Lords voted against reductions in welfare benefits but were criticised for this by a former Archbishop of Canterbury, George Carey, who wrote a newspaper article arguing that they ought to have been more concerned to reduce the national budget deficit. His article also criticised the way that long-term reliance on benefits puts obstacles in the way of the full development of human potential that Christians should encourage. A lively public debate on
the appropriate position for churches to adopt on ‘the culture of welfare dependency’ ensued.

_Protestant ethics and Islamic modernity_

Max Weber’s famous work _The Protestant Ethic and the Spirit of Capitalism_ makes regular appearances in writing by Islamic economists, being cited in support of diverse and sometimes mutually exclusive positions. In most cases it seems safe to say that the writers are referencing the version of Weber’s thesis that has entered popular culture, rather than engaging seriously with the original text. In this simplified version, Western capitalism was a product of the culture of Protestant Christianity. In some Muslim interpretations, this explains what is wrong with Western capitalism and demonstrates the need for an Islamic alternative.

_The Protestant Ethic_ includes an assumption that rationalism as understood in modern capitalism never appeared in the Islamic world, which would be antipathetic to most Islamic economists. Weber himself avoids expressing this as a belief in the superiority of European culture, but most Muslims would see this as implicit. It is possible to argue that Islamic finance and the associated notion of Islamic modernity represent the Muslim world’s version of the Protestant ethic and thus demonstrate the equal capacity for rationalism of the Islamic world, and it is possible to believe that everything wrong with Western capitalism today is a result of its abandoning Christianity’s historical opposition to bank interest. However, it is not possible to maintain both of these positions simultaneously, since the triumph of the Protestant ethic represented the acceptance of the legitimacy of charging interest.

If, as Weber famously expressed it, rationalist modernity represents the ‘disenchantment’ of the world, and if the world of modern finance is the supreme expression of
that disenchanted rationalism, then Islamic finance, and possibly ethical finance as a whole, could be seen as an attempt to re-enchant the world. Certainly much writing on ethical finance is coloured by a desire to make transactions less impersonal, warmer and more human, while Islamic finance represents by definition a commitment to maintaining the religious spirit which Western sociologists have in the past classified as pre-modern within the bureaucratic rationalism of modern banking.

Such a notion of Islamic modernity is a key rhetorical trope among writers on Islamic finance and economics. This usually involves a conscious rejection of the Western tradition of writing about Islam as backward and a barrier to progress, presenting it instead as intrinsically rational, global and modern, and depicting Islamic banking as the outstanding expression of this. There are now Islamic branding experts who talk about ‘Muslim futurists’, arguing that Muslim consumers are actually in the vanguard of current market trends. There is some tension between this post-colonialist assertion of indigenous modernity and the tendency of non-Muslim ethical activists to reject modernity, or at least to refuse to grant the term positive connotations, in favour of an imagined simpler and more sustainable lifestyle.

Enthusiasts for both Islamic and ethical alternatives who trouble to read *The Protestant Ethic* in detail will find it even more in tune with their vision than they might originally have thought. In the final few pages Weber makes some interesting points about the possibility of the ‘iron cage’ of bureaucratic modernity being replaced by new ideas and ways of doing things. He speculates that ‘at the end of this tremendous development entirely new prophets may arise’, a prediction which Muslims could perhaps choose to interpret as having been fulfilled by a belated flowering
in the West of their own faith. Weber also writes that the nineteenth-century model of ever expanding industrial capitalism will probably continue until ‘the last ton of fossilised coal is burnt’, a sentiment which will no doubt be seized upon by environmental activists as an indication that he was a proto-Green.

It would be more productive if everyone involved in the search for Islamic and other ethical alternatives could take these thoughts as cues for a wider and better informed debate on the future of capitalism, rather than repeatedly rehearsing the clichéd version of Weber’s thesis about Protestantism.

The rationale for this book

The number of organisations working in some aspect of financial services which claim to be ethical is large and bewildering, and this study has had to be highly selective in choosing which ones to discuss in detail. The selection has been guided by the theme of the study, which is the relationship between Islamic finance and the wider field of ethical finance. The distinction is not simply between an Islamic approach and an entirely secular one; this is a misleading approach in the British context. Other religious traditions are well represented in the ethical sector, notably Christianity, since the United Kingdom is a Christian majority country with a long history of social activism by churches. This study seeks to explore the similarities and differences between Islamic and Christian approaches to financial matters as well as those between both of these religious traditions and a secular but self-consciously ethical approach.

The examples chosen are of three types: explicitly Muslim, explicitly Christian, and prominent names in the non-
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religious field. The secular examples are chosen because they illuminate key themes of the ethical approach, illustrate the difficulty of standardising policies within this sector, seem to offer possibilities for convergence with Islamic models or present important contrasts with and difficulties for Islamic principles.

The main questions which the book asks are: what possibilities are there for convergence between Islamic financial practices and other forms of ethical practice, and, is the marketing strategy of positioning Islamic finance as a sub-set of ethical finance rather than a completely distinctive proposition appropriate or misguided?

Notes
2. Such as the work of Tony Webb, founder of The Ethical Corporation, who writes at www.tobywebb.blogspot.com.
6. You and Yours, broadcast on BBC Radio 4, 8 November 2011.
7. This issue was discussed in detail on Beyond Belief, broadcast on BBC Radio 4, 13 February 2012.
10. ‘My fellow bishops are wrong: fuelling the culture of welfare dependency is immoral’, Daily Mail, 25 January 2012.
11. See the discussion of the work of Ogilvy Noor in Chapter 8, ‘The Concerned Consumer’.
A Sample From Chapter 1: Introduction

Legal, Regulatory and Governance Issues in Islamic Finance
by Rodney Wilson
The governance of Islamic finance is at the intersection of national and Shari’ah law, resulting in a wide variety of interpretations in different jurisdictions. These differences have implications for the regulatory systems under which Islamic financial institutions operate, with considerable variations in practices between countries. This complexity can result in uncertainty and even confusion, and there have been calls for the standardisation of Islamic financial contracts. However the variations in regulation and in the contracts offered has resulted in healthy debate about the merits of different approaches, and it is this which has driven the Islamic finance industry forward during the last four decades.

The aim of this guide is to explain how the complexities have arisen and why there is no single governance system which is suitable for all types of Islamic financial institutions or for the contracts which they offer. Although Shari’ah law on issues such as inheritance is detailed and precise, for most types of legal contracts it is concerned with general principles. Financial contracts are judged in terms of how equitable is the treatment of the different parties, and the extent to which the outcomes are fair and just. Islamic financial contracts have a moral purpose, and
are not simply concerned with maximising the pecuniary benefits of the signatories.

Islamic financial contracts are usually drafted by qualified lawyers either working for a law firm or within an Islamic financial institution. The legal work involved is the same as that when a conventional financial contract is drafted, the stress being on issues such as providing appropriate provision for what happens in cases of payments default, or how disagreements between the parties can be handled. What makes Islamic financial contracts different is that they are subject to scrutiny by a board of fiqh scholars conversant with Muslim jurisprudence to ensure that they are Shari'ah compliant. This involves the scholars satisfying themselves that the contracts are free from riba in all its forms, which can be interpreted as an addition to a sum lent, usually equated with interest. The scholars will be also concerned that there is no gharar or legal uncertainty in the contract, which would be present if there were clauses capable of ambiguous interpretation that could be exploited by one of the parties at the expense of the others.

**Islamic contractual principles**

It is important to note that Islamic jurisprudence is not only concerned with the enforcement of Shari’ah prohibitions in the wording of contracts, such as those on riba and gharar, but also with how financing is structured and how it is used. Financing is seen as a tool and not an end in itself, the concern being that merely making money from money is inherently unjust as it serves no useful purpose. Rather, financing should be used to facilitate productive activity that enhances the output of socially desirable goods and services and contributes to the creation of meaningful and respectable employment opportunities.
Returns from financing and investment have to be justified under Shari’ah law, and this can either be through work and effort or risk sharing. There are costs involved in appraising the viability of projects for which funding is requested and in estimating the risks involved. There are also administrative costs in arranging the disbursement of funds and the collection of repayments and service charges. Legal costs include those involved in drafting contracts and getting them approved by qualified scholars of fiqh. It is recognised that Islamic financial institutions have to cover these overheads and at the same time generate profits for their depositors and shareholders. Therefore Islamic financing is not necessarily cheaper than its conventional equivalent, and in some cases can actually prove more costly because of the additional provision for Shari’ah compliance. However, as a matter of good practice there should be transparency over how the costs are calculated and contractual certainty about what liabilities the client obtaining funding is actually taking on.

An important principle of Islamic finance is that commercial risks, which are seen as inevitable, should be shared rather than transferred to a weaker party who could be potentially exploited. The assumption is that burdens should be shared by the contracting parties, or in other words there should be brotherly solidarity which can itself be a source of strength. To achieve this it is not merely a matter of modifying conventional contracts, such as those governing loans, which if undertaken for purely commercial motives will never result in an equitable outcome. Rather, it may involve structuring new contracts, drawing upon the principles of traditional fiqh, but worded to comply with national laws and enforceable through state courts. Such contracts are described as being Shari’ah based, and include murabaha purchase and sales contracts, ijara operating
leases, *istikna* project financing, *wakala* agency agreements and *mudaraba* and *musharaka* partnership contracts, all of which are discussed in Chapters 3 and 4. The characteristics these contracts have in common are that they involve a degree of risk and profit sharing and facilitate real economic activity.

Conventional financial contracts can be accepted under *Shari‘ah* law even where they are not based on traditional *fiqh* principles. Hence, equity investment contracts are usually acceptable, even though the motivation of the investors is often to make capital gains rather than simply receive a share of any profit. The *Shari‘ah*-compliant funds discussed in Chapter 8 largely invest in equities, including private equity as well as shares in listed companies. Note that such contracts are deemed to be *Shari‘ah* compliant, not *Shari‘ah* based. However, to be *Shari‘ah* compliant the investment must be in companies engaged in *halal* or permitted activities rather than those engaged in *haram* or forbidden pursuits, such as lending with interest or the production and distribution of alcohol deemed intoxicating or pork products regarded as unclean.

If the *fiqh* scholars are satisfied that contracts are indeed *Shari‘ah* compliant, or even better *Shari‘ah* based, they issue a *fatwa* or ruling to indicate to the parties that the contract complies with Islamic law. This signals that the agreements can be signed by the parties with a clear conscience. It is the *fiqh* scholars who will ultimately be accountable to the Almighty for what they have approved, not the contracting parties who have accepted the *fatwa* as a matter of trust. This of course raises issues concerning the moral legitimacy of the *Shari‘ah* vetting and approval processes, matters that will be considered in greater detail in Chapter 2.
Legal challenges for Islamic financial institutions

Most Islamic financial institutions operate under existing bank laws and regulations without any special provision. The exceptions include Iran, where all banking is subject to the Law on Usury-Free Banking, which is discussed in detail in Chapter 5, and Malaysia and Indonesia, where there are special laws governing Islamic banking, and in the case of Malaysia, also a law governing Islamic takaful insurance. These laws are discussed in Chapter 6, where the provision in Kuwait is also considered, as it involved a significant addition to the existing banking law. In these jurisdictions Islamic banks compete with conventional banks operating under laws that provide for interest-based lending, such situations normally being described as dual systems.

Legal disputes over Islamic financial contracts will normally be dealt with by national courts and not Shari’ah courts whose remit is confined to family matters such as divorce or inheritance. As most disputes involve non-payment of financial obligations and breaches of contract, it can be argued that there is no justification for treating Islamic bank clients differently to those of conventional banks. However, there are differences as Islamic banking is subject to religious injunctions whereas conventional contracts are not. Of particular relevance to cases of default is the following quotation from the Quran:

If the debtor is in difficulty, grant him time till it is easy for him to repay. If ye remit by way of charity that is best for you if ye only knew. (Sura 2: 280)

Such provisions are unlikely to be explicitly written into Islamic financial contracts, but as the Quran is the ultimate source of Islamic law, and as the contracts are designated
as Shari’ah compliant, the religious teaching cannot be ignored.

The signatories to the contracts who have obtained financing could potentially cite this injunction if they fail to make the necessary repayments, arguing that if they are given time, they will meet their obligations. How should the court and the Islamic bank itself respond? If the judge takes the position that because the bank is Islamic, it should exercise leniency, this could result in the Islamic bank being placed at a competitive disadvantage to its conventional counterparts seeking full and prompt repayments. The court could be enforcing payments by the defaulter in the latter case, perhaps even by the handover of collateral or the sale of assets, while the defaulter of the Islamic bank is not subject to such measures, and perhaps escapes justice.

Where clients have financing from both Islamic and conventional banks there is the danger that they might give priority to repaying their interest-based loans first rather than honouring their Islamic financing obligations. This moral hazard problem has long been a challenge for Islamic banks, which unscrupulous clients may regard as a soft touch. When clients are late in making payments on loans, conventional banks charge additional interest, and such late payment obligations are usually specified in the credit agreements. Islamic financial institutions cannot impose such late payment penalties as the additions would constitute riba. Charging interest on the capital owed is itself condemned, and charging interest on unpaid interest soon results in a debt spiral which becomes exploitative.

The terms and conditions for Islamic financing have to be specified in the contract which the parties freely sign. In the case of major financing deals there will be negotiation between the parties rather than the standard contracts used for retail and small-business finance. In either case, once
the contract is agreed and signed, the parties are bound by its terms. Repayment delays or defaults constitute a breach of contract unless provision is specifically made for such contingencies. This can involve specifying the circumstances under which a standstill agreement can come into force in the original contract rather than trying to negotiate such an agreement after a payments default. Of course the implicit recognition of credit risk would therefore be built into the contract, which would be priced accordingly. In other words, the funding may cost more than conventional financing, but the client may believe it is worth paying a premium to reduce financing risk and avoid *gharar*, which is often present in conventional contracts, and which becomes all too apparent when relations between the parties break down as a result of contractual disputes.

Those who receive Islamic finance of course take on some risk; indeed, given that risk sharing is an essential Islamic principle it is desirable that clients assume this burden. As an important attribute for successful business is skilled risk management, it is both equitable and efficient that risk should be shared. Islamic financial contracts that simply mimic the terms of their conventional equivalents are more likely to result in defaults, especially if the costs are based on interest. As interest rates are determined at the macro-economic level, usually as a result of decisions on monetary policy, business managers will have no comparative advantage in assessing such risk. In contrast, business risks at the micro level will affect the amount of profit to be shared with the financier, and in this business managers should be well placed to influence profitability and predict future performance.

Of course there will always be unanticipated contingencies that could cause defaults, even with Islamic financial contracts. Where these are the result of poor business
judgements and the clients breach their contracts, there is no reason why they should not be held liable for their repayments obligations. Where the default results from fraudulent practices or deception then the client should be liable not only for the contractual obligations for the financing, but arguably for compensation to the Islamic bank through fines or other penalties, including all legal costs. In extreme circumstances criminal prosecutions may also be justified, especially if the fraudulent behaviour has damaged the public interest, including those of Islamic bank depositors. In such cases imprisonment may be the outcome both to punish the defendant and as a deterrent to others.

If, however, the client is unable to meet their obligations because of unexpected illness or family crises, then there is a case for leniency, and for giving the debtor time to repay as stipulated in Sura 2: 280. In extreme cases of misfortune there may also be an argument for remission ‘by way of charity’, or in other words debt forgiveness. This of course will imply that the Islamic bank has to make complete provision for the bad debt, which may result in losses, clearly a practice that cannot be undertaken lightly or repeated too often. Ultimately the Islamic bankers will have to make a moral judgement, conditioned by fiqh, that the case for granting debt forgiveness outweighs their responsibilities to depositors and shareholders.

Is a different regulatory system required?

The three aims of bank regulation are firstly to protect the interests of depositors, secondly to encourage fair competition to keep down financing costs and thirdly to ensure that banks do not fail and require support from government using taxpayers money. These objectives are the same for Islamic banks as for their conventional counterparts,
reinforcing the case for them being regulated in the same manner. Furthermore, the risks faced by conventional banks, such as credit, liquidity and operational risk, also apply to Islamic banks. Risk management issues facing the regulatory authorities will be considered in greater detail in Chapter 7.

Islamic banks are confronted with additional risks to those experienced in conventional banking, notably the reputational risks associated with Shari’ah compliance; ownership risks arising from certain types of financial contracts, namely those covering murabaha and ijara; and market risk depending on how musharaka is structured and the exit conditions. For regulatory authorities the challenge is how such risks can be best managed, and whether there are any skill and organisational issues for the central banks themselves. As in all jurisdictions there can only be one regulatory authority for banks this implies that there can be no separate regulatory authority for Islamic banks. Therefore, the usual approach is to establish a division or department within the regulatory authority either to advise on the issues pertaining to Islamic banks or to actually undertake the regulation.

In some jurisdictions such as Malaysia, Pakistan and the Sudan the central banks have established their own Shari’ah boards which can advise, or in some circumstances, enforce controls over Shari’ah compliance policies and procedures within the regulated institutions. Arguably this can serve to mitigate Shari’ah compliance risk and enhance reputational confidence by having a national policy rather than the reputational risk being associated with an individual Islamic financial institution at the micro level. The central bank’s Shari’ah board can vet appointments to Shari’ah boards of the regulated banks, ensuring those appointed are appropriately qualified and experienced. They can also
provide definitive rulings when there are irreconcilable differences between members of the Shari'ah board of a regulated institution. In addition they can promote consistency in Shari'ah board rulings.

Most jurisdictions do not, however, have national Shari'ah boards, the counterargument being that they impose a straight jacket on fatwa, add to bureaucracy and discourage debate and innovation. There are often conflicting fatwa by the Shari'ah boards of different Islamic financial institutions, even within the same jurisdiction, and Shari'ah boards often change their opinions, resulting in inconsistency over time and uncertainty over precedent. Nevertheless, many feel these are prices worth paying to have institutional autonomy and the flexibility to offer different types of contracts to serve the needs of the clients of particular Islamic financial institutions.

Regulatory authorities worldwide are used to dealing with the credit risk which arises in conventional lending. There are international standards through Basel II and III as to how non-performing loans should be treated which will be considered in detail in Chapter 7. These rules also apply to financing by Islamic banks, even though they are not involved in interest-based lending. Although this has not proved a problem, the identical treatment from a regulatory perspective of non-performing debt, whether conventional or Islamic, is a factor explaining why all too often Islamic financial contracts mimic their conventional equivalents. In other words, the lack of regulatory challenges, although welcome, is a result of Islamic banks trying to make their financial products compatible with the existing systems rather than the regulatory authorities adapting and devising systems that would better accommodate the Islamic financial principle of risk sharing.

In particular, bank regulators are often unhappy about,
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and are uncertain how to manage, the ownership and market risks that inevitably arise in Islamic finance if the products are to be Shari‘ah based. Specifically, ownership risk is an inherent and essential component of murabaha and ijara contracts which account for a major share of Islamic banking activity. In practice Islamic banks seek to mitigate ownership risks, either by ownership passing to the client immediately after a murabaha contract comes into force, or by the ijara contract being given many of the characteristics of a financing rather than an operating lease. There is a view amongst some regulators that ijara would be better undertaken by leasing companies rather than banks given the ownership risks involved. Leasing companies are subject to much less scrutiny as their funding comes from their shareholders and not from depositors as is the case with banks.

Market risk arises in mudaraba and musharaka contracts if these are structured according to Islamic financial principles as the exit value for the financier cannot be guaranteed as is the case with debt finance, whether Islamic or conventional. However, in practice many regulators prefer to see exit values predetermined rather than dependent on market developments, or in other words mudaraba and musharaka becoming more debt- rather than equity-type contracts. Islamic banks can, and indeed do, argue that as a high proportion of their liabilities are in investment mudaraba deposits, the value of which cannot be guaranteed, rather than current accounts, which represent predetermined and fixed liabilities, they have more flexibility than conventional banks, all of whose deposit obligations are predetermined when the deposits are made. Hence if investment mudaraba deposit liabilities are matched in whole or in part by mudaraba and musharaka assets, market risk should not be a problem.
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In reality it is unlikely that the market-risk profile of the liabilities and assets will match, not least because investment *mudaraba* depositors will never want to see the value of their deposits written down. Given this reality from a regulatory perspective such deposits are treated as identical to conventional savings accounts. Therefore, if the value of liabilities is treated as a fixed obligation, this will have implications for the corresponding assets, hence the demand that they become debt instruments rather than equity. These issues will be considered further in Chapter 3 where the terms and conditions governing Islamic bank deposits will be explored in greater detail.

Implications of participatory finance for stakeholders and governance

This guide also covers governance issues including the responsibilities of the *Shari’ah* boards in the governance structures and the status of investment *mudaraba* depositors compared with shareholders, as it is the latter who are the owners of the Islamic bank. Clearly, in principle, there are significant differences between the types of governance structure appropriate for Islamic financial institutions in comparison to conventional institutions. There are also implications for the responsibilities and status of the different stakeholder groups with consequences for inputs into institutional decision making and the overall power structure.

The difference between theory and practice are as apparent for Islamic financial governance at the institutional level as they are at the regulatory level. The consequences of participatory finance, an essential feature of any Islamic financial system, for corporate governance have yet to be fully explored. In Chapter 11 the discussion is taken fur-
ther, but here it is appropriate to highlight some of the issues.

Participatory finance concerns risk and reward sharing, the issues being how this is accomplished and who gets what. There are inevitably conflicts of interest between different stakeholders in an Islamic financial institution just as there are in a conventional bank, but in the case of the former some of the conflicts are different and require particular types of management. As it is the corporate governance structure that provides the framework for the management of potential conflicts of interest, this will be distinctive in the case of Islamic financial institutions. The potential conflict over profit shares between investment *mudaraba* depositors and shareholders, for example, does not arise in conventional banks. There the issue is how much interest to pay to savings-account holders but this is directly influenced by the cost of central bank funding which is largely determined by their monetary policy stance. Hence interest rates can be regarded as an exogenous variable related to macroeconomic policy.

In contrast, the profit proportion paid to investment *mudaraba* depositors will depend on what is deemed to be a fair division of profits between them and the shareholders. This proportion is determined endogenously within the Islamic financial institution itself, subject of course to paying a competitive return to depositors while maintaining a dividend to shareholders which is sufficient to ensure that they continue to hold their investment rather than selling the shares. In other words, the profit-sharing proportions between the Islamic bank and its depositors are determined at the microeconomic level. It will be for the Board of Directors to reconcile shareholder and depositor interests, in contrast to the position of a conventional bank where the Board only represents the former. The implications for corporate
governance may be that the Board of Directors needs to be differently constituted for Islamic banks as there is not only the classic agency conflict between management insiders and external shareholders, but also a third party, the investment mudaraba depositors, who are also direct participants in the bank and whose income will be directly dependent on the profit shares agreed. Arguably their participation would be more meaningful if they have their own representatives on the Board of Directors, a governance innovation that most Islamic banks have yet to take on board.

It can be argued that if the Shari’ah board is allowed to nominate at least one member, possibly its chairman, to serve on the Board of Directors, this could be a way of serving the interests of the investment mudaraba depositors. There is an argument in any case, irrespective of serving particular stakeholder groups, for having such representation on the Board of Directors; firstly, that the Shari’ah scholars could give advice on matters of fiqh where an immediate opinion is required, rather than waiting for the Shari’ah board to meet. Second, there is the argument that the Shari’ah member of the Board of Directors would have oversight of what decisions were being made at the top of the organisation and could participate in the deliberations over those decisions. A counterargument is that the skills of the Shari’ah scholars are in fiqh, not in strategic management, the main function of the Board of Directors. Nor are the scholars’ skills in financial matters which might be relevant to the profit share allocated to investment mudaraba depositors.

These issues will be further discussed in Chapters 3 and 11. In the next chapter the focus is on national laws and the legal framework under which Islamic financial institutions function and how it accommodates Shari’ah in both principle and practice.
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