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Islamic finance: what does it change, what it does not?

Structure-objective mismatch and its consequences

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Abstract

This paper raises the issue of an initial structure-objective mismatch in the launching of Islamic finance. The abolition of interest and promotion of growth with equity were goals of the conceived system. These goals expressed a long run vision to improve the condition of the Muslim communities across the world. However, the organizational form adopted for Islamic finance was of the existing commercial banks which provided essentially short-term loans on interest to trade industry and commerce. The choice thus involved an intrinsic mismatch between the structure and objectives of Islamic finance. The mismatch did carry some advantages, but on a more important side it exposed Islamic finance to commitments and influences which could not mostly align well with the goals the pioneers had in mind. Note that in focus here is not the reversal of the mismatch but its consequences that have forced the nascent Islamic system to convergence and competition with the mature conventional finance the West dominates. It is not the ground realities that are being adapted to Shari'ah norms; it is the norms that are being stretched to limit for meeting the demands of the conventional system. Ordinary Muslims who hoped to benefit from Islamic financing remain unattended. Thus, what Islamic finance can or cannot change will depend on where its ongoing integration with the conventional system leads it to. Currently, most merits claimed for the Islamic system defy evidence. The basic reforms financial systems require in the face of current crisis are the control of credit, leverage lure, and speculation. Islamic finance is in principle better equipped to achieve these ends.

1. Introduction

The theme of this workshop – what Islamic finance does (not) change – was intelligently kept murky so as to keep the choice of topics wide open for the participants. I did not take advantage of the discretion. My title, therefore, remains no less murky to cover what it contains. To illustrate, Islamic finance is wider than its banking constituent but that being its most dominant part, this paper restricts the term as referring mostly to banking.

Conventional (commercial) banks were and mostly remain the providers of *short-term* finance to trade industry and commerce, while some *long run* communal (Ummatic) goals including promotion of growth, improvement in distributional equity and the alleviation of poverty were initially conceived to be the focal points of Islamic finance for resource allocation. However,

* The author gratefully acknowledges the help of his students, Mughees Shaukat and Nurhafiza Abdul Kader Malim who helped him with the collection of material and went through several drafts of the paper to weed out typos. Occasionally they suggested useful modifications. The views expressed in the paper are not necessarily the views of INCEIF; the author presents them here in his personal capacity.

Islamic banks adopted the conventional organizational forms for making their appearance on the scene. These forms in retrospect are not found suitable for serving the objectives the early writers on Islamic finance implied they would. But the choice they made was not without reason.

Muslims had for long experienced commercial banks working around them as dealers in money. What these writers found unacceptable in their operations from Islamic viewpoint was the use of interest as price for loans the banks advanced or the cost for deposits they obtained. If interest were expelled from transactions of commercial banks, they were obviously to be the first institutions to attract attention as conforming to Islamic norms¹. Participatory finance of old days – *mudarabah* and *muskarakah* - based on profit/loss sharing could take, they thought, the place of interest as return on funds committed to business or paid to depositors: ‘no risk no gain’ was proposed and projected with little loss of time as the sole, inviolable and departing principle for Islamic finance. The proponents missed the point that structures erected to meet *short term* ends could rarely be efficient for achieving *long run* goals.

Islamic banking thus started with a *structure-objective mismatch* on road to progress. The removal of this mismatch is not the point of this paper; its consequences are². Even today, a large number of writings on Islamic finance continue sticking to the tradition and argue, rather innocuously, that the scheme of participatory finance is *the* answer to all the ills of modern finance; they do not care to find why that mode of financing is not picking up pace: its share despite the merits claimed has not yet crossed the 10 – 20 percent mark in the aggregate³. Any discussion on what Islamic finance does or does not change can hardly ignore without discomfiture the form-objective mismatch and what it led to. Indeed, the failure to realize this

¹ These writers in all fairness did make it clear that the Islamic economic system is much more than merely capitalism plus zakah minus interest. Nevertheless, they lacked the economic acumen to visualize the ramifications of choosing the nomenclature in conceiving banking without interest.

² Islamic finance has crossed the point of no return on this road but there is scope for course modification and that *is* taking place in some measure.

³ For hurdles in the way of participatory finance, see Zubair Hasan (2002) *Mudarabah as a Mode of Financing in Islamic Banking: Theory, Practice, and Problems*, Middle East Business and Economic Review Vol.14, No.2, Sydney, Australia, pp.41-53

vital fact lies at the heart of much divergent views on the convergence of the Islamic and mainstream financial systems.

On the one hand, we have those who argue that the convergence is imminent, though it might remain asymptotic⁴. This of course is no discovery: one could have easily seen this coming as the logical consequence of the organizational forms Islamic finance had chosen. On the other hand – and it is more interesting - there are those who stress that the scope for convergent evolution of the two systems is very limited due to the narrow range of Islamic financial instruments⁵ even if we ignore other reasons.

It is, indeed, elating to note that over the decades – especially during the past 10 years – Islamic finance has made great strides: the industry has experienced a dramatic growth and transformation. Its reach, coverage, risk diversification, development of regulatory frameworks professional education programs, and international funds movement have all improved and tend to pace up in a fast globalizing environment. Opportunities for Islamic finance are increasing, challenges too⁶. The total volume of Islamic assets held by banks – Islamic and conventional – is expected to cross the dollar one trillion mark by 2010. This is a comforting prospect. But one must not be oblivious at the same time to the fact that conventional finance has also been expanding at no less a pace, if not more. The result is that on a conservative estimation the shares of the two sectors in the market assets worldwide remain almost stuck around 1: 80. Islamic finance is yet no more than a candle facing the sun. Are the two realistically comparable on any performance or achievement criteria, more so when bulk of the business is with the Islamic of windows or subsidiaries of the Western banks? The phenomenon is the result of convergence of

⁴ See Askari, Iqbal and Mirakhor (2009): *Globalization and Islamic Finance: Convergence, Prospects, and Challenges*: John Wiley & Sons (Asia) Pte Ltd. Singapore. It echoes the same sort of realization that “the search for an alternative to Capitalism is [now] fruitless. ... Those who wish to reform the world should focus on the potential for change *within* capitalism.” *Capitalism, socialism, the welfare state and Islam*, Khurshid Ahmad (2007) IRTI Lecture.

⁵ See Honohan, Patrick (July 2001) *Islamic financial intermediation: economic and prudential considerations*, Development Research Group and Financial Sector Strategy and Policy Department, World Bank.

⁶ Bank Negara Malaysia (October 2008) Governor’s keynote address *Islamic finance: A global growth opportunity amidst a challenging environment*, at State Street Islamic Finance Congress 2008, Boston.

systems largely being *unidirectional*: one sees so far little impact of Islamic finance on its mainstream counterpart.

What Islamic finance can change or what it cannot in the near future would largely be determined by the facts stated above. On matters of product designing, rules and regulations, fixing of standards, bench marking, risk management and rating procedures Islamic finance has already been sucked in by the mainstream whirlpool: follow the leader has been the underlying truth of the story. Islamic finance may hopefully have some impact on the moral ethical regulatory and social responsibility aspects of the global financial architecture in course of time for reasons we shall have occasion to mention later.

This paper is spread over five sections including the present one. In the following Section 2, we shall discuss in some detail the reality with reference to the much talked about convergence between the Islamic and conventional financial systems. Section 3 we shall devote to some problems internal to the Islamic system itself, especially relating to the divergent interpretations of the Islamic injunctions across countries. In Section 4, we shall elaborate on a few problems that threaten the future of the world financial systems irrespective of their types: Islamic or mainstream. We shall evaluate in particular the claims Islamic finance makes in that context. Section 5 contains a few concluding observations.

2. Convergence: nature and consequence

Convergence has been an increasingly used term in the more recent literature on Islamic finance. Interestingly, most of the writings talking of convergence are emanating from the West, more so from the economists working with the international financial institutions, the World Bank or the IMF⁷. Even so, the nature and implications of convergence remain largely unexplained. Convergence means the movement of two objects from opposite directions such that the gap between them steadily tends to become narrower. This would be rather fast if both objects approach each other with the same speed albeit convergence is still possible if one remains sticky

⁷ The Arab Financial Forum at Harvard University some time ago focused the yearly discussion on the convergence issues. A paper of this author dealing with sustainable development and Islam was also included in the proceedings because it was seen as implying another area bearing promise to promote convergence of the two systems.

while the other alone moves. Differences in these two processes – bidirectional and unidirectional that Figure 1 depicts - may not have the same message or consequence.

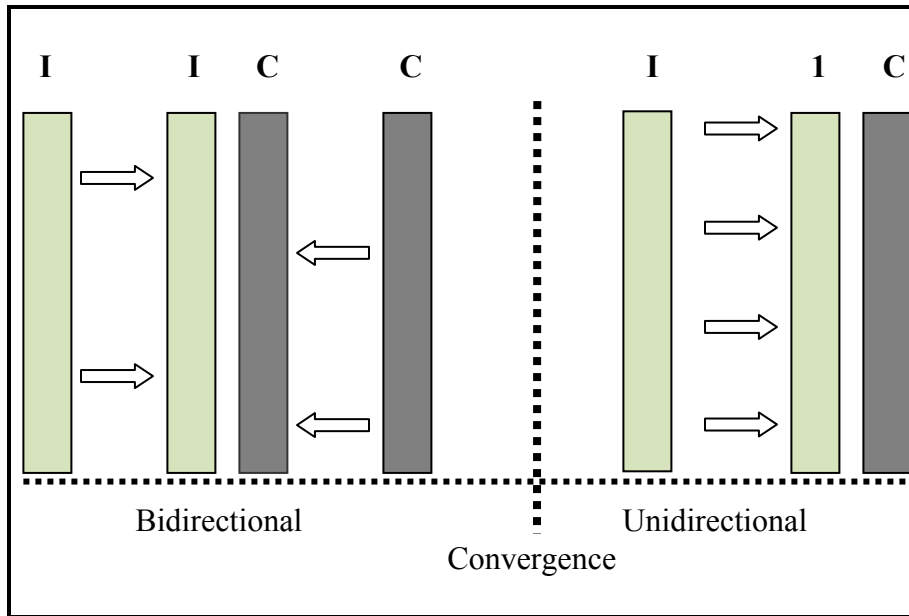


Figure 1: Convergence types between Islamic (I) and conventional (C) financial systems

The ball was set rolling with the hope of a presumably bidirectional convergent evolution of Islamic and conventional finance as prudential risks were considered for Islamic intermediaries as high as for the conventional ones because the difference between instruments the two used was not found as much as was usually imagined⁸.

Convergence has benefited Islamic finance and contributed to its rapid growth in many ways. For instance, product designs were found ready at hand for modifications to make them meet Shari’ah requirements. It is seen as a great facility. In fact, a jurist who sits on the Shari’ah boards of a couple of banks informed me in response to a question that scholars on such boards invariably avoid initiating new products. Instead, they prefer to ask the bank managers the details

⁸ Patrick Honohan (2001): *Islamic financial intermediation: economic and prudential considerations*, Development Research Group, The World Bank. Indeed, some saw in this development “the first seeds of convergence” much later, See, Doromir Rudnycky (2009): *Market Islam in Indonesia*”, *Journal of the Royal Anthropological Institute* (N.S.), S183-S201. Zubair Hasan (2010): *Islamic Banks: Profit sharing equity leverage lure and credit control*, arrived at similar results with reference to five Islamic banks

of the conventional product for which they need to have an Islamic counterpart: for it is much easier he said to put on it the Islamic face than to structure an entirely new one. Imitation is, of course, easier than innovation and abounds, but this need not imply that Islamic finance has completely been devoid of innovations; in fact, there have been many and varied, some even novel⁹.

The fast expansion in the volume of Islamic finance in recent years has led many to see a clear functional parallelism between most of the modern Islamic and conventional financing instruments to the extent of postulating – rather overly - that Islamic finance in most areas of economic activity is at par with mainstream capabilities. In any case, the expansion has led to a convergence which essentially is *unidirectional*. Conventional system because of its size, age and maturity has had tremendous magnetic pull that the nascent Islamic system could hardly resist. Islamic products are and will increasingly be structured for the global market place thus hastening convergence to universally accepted mainstream norm. Policy makers for Islamic finance are relentlessly pushing the system to that destination. The governor of the State Bank of Pakistan was candid on the point when she observed.

Practically, the Islamic industry currently is bank based. Product diversification, albeit slow, is emerging but returns are *engineered to ensure conformity and convergence* with conventional industry¹⁰. [Emphasis added]

The convergence of Islamic finance towards the mainstream positions has resulted in making Islamic instruments seen as a sub-set of those available in conventional finance. The pressure for making products simpler, appealing to customers, and more diversified, to be conforming to mainstream standards is being insisted upon for being more competitive. Is it not strange that countries have so often advanced and used the infant industry argument to protect their manufactures, insurance and shipping for example but initiators of Islamic finance ventured to

⁹ See Honohan (2001) *op. cit.* for some interesting examples from Iran, the Sudan, Malaysia and Pakistan

¹⁰ Shamshad Akhtar (April 2008): *Islamic finance: Authenticity and innovation – a regulator’s perspective*. Indeed, convergence has already been replaced with integration. Note that the Seventh Harvard University Forum on Islamic Finance (April 2006) was entitled as “Integrating Islamic Finance in the Mainstream: Regulation, Standardization, and Transparency”.

challenge the giant from day one? Palpably, the sort of convergence that is being forged must serve more the interests of developed countries than others in two ways.

1. Conventional banks that dominate and control the global financial system can do in the Islamic finance area what they cannot do in the conventional system. To illustrate, in the mainstream system the rate of interest must observe the central banks' ceiling, there are yet no such restrictions on mark-ups used in Islamic transactions. In participatory finance, using interest rate for bench marking the dividend distribution enhances leverage benefits for bank owners. Islamic finance is potentially more profitable for them¹¹.
2. Currently, there is much liquidity in Muslim countries, especially in the Middle East because of high and often times rising oil prices. Most of this money came from the developed countries. Islamic finance promises to enhance the possibility of a larger flow of this money back to from where it comes. Western countries are eyeing a larger share in this wealth¹². This observation can be an important topic for research.

The compulsions for unidirectional convergence have put experts and scholars alike under pressure to making Shari'ah norms somehow adaptable to the demands of modern finance and its increasingly willful mechanisms. Islamic finance now operates more as supplement to the conventional system rather than as parallel in competitor. This has made public opinion in the Muslim world turn to another presumably more potent issue: the convergence between the instruments Islamic finance has been using and their compliance with the Shari'ah norms. In Malaysia, both the Governor of Bank Negara, and the chairperson of the Security Commission have recently voiced this concern. The Governor Zeti Akhtar Aziz drawing attention to the ongoing development of mechanisms for risk mitigation and liquidity management made a significant observation: "Of importance are the solutions needed to converging the market

¹¹ Laurent Weill (2009): *Do Islamic banks have greater market power?* Working paper (<http://courmot.u-strasbg.fr/large>) observes that returns on saving deposits are found to be similar for Islamic and conventional banks in Turkey (Refers to Kuran) and an Islamic bank explicitly mentions that its loan rates are similar to those of conventional banks (Refers to El-Gamal) p.9,

¹² Islamic Finance Report (2009) just released concludes: "*Islamic finance has moved beyond uncertain experiment during its embryonic life. Teething problems remain but with the right tools, collaboration between regions and greater transparency, convergence towards Western conventional markets and a greater share of investors' portfolios is well within reach.*" The Project Finance International (PFI) Tuesday, 9 February 2010.

requirements and the Shari'ah compliance"¹³. Zarina Anwar the SC Chief is candid that Islamic finance products must be strictly Shari'ah compliant but she believes that convergence to law could have spatial differences to internationalize Islamic finance. Her more significant observation we feel is "There is always the need to explore how Islamic finance can help the Muslim community (the Ummah)"¹⁴ – a point we referred to in the Introduction above. This brings us to our next section on the issue of shari'ah compliance of Islamic financial instruments.

3. Divergent views on compliance

In recent years Islamic finance has seen the surfacing of some serious differences on what instruments and practices have or have not been Shari'ah compliant. Most of the controversy centered on the activities of banks which hold bulk of the Islamic assets followed by sukuk issues, investment funds and takaful¹⁵. The modes of business these banks use mostly involve murabahah transactions and the issuance of sukuk. Both have run into difficulties on Shari'ah compliance issue in recent years.

Commodity murabaha has so far been the most widely used financing instruments in Islamic banking. But some court decisions going of late against Islamic banks in Malaysia on murabahah contracts have put people in a quandary; it is being increasingly asked if commodity murabaha defies Islamic requirements? Evidently, in principle it does not. Commodity murabaha falls in the same generic category of '*uqud al-mu'awadhat*' or exchange contracts that covers all types of transactions that Islam allows. In exchange contracts, a given quantity of one commodity is traded for a given quantity of *another* commodity, including money. The money value of a commodity is called its price. The delivery of a commodity and the payment of price may be simultaneous i.e. on the spot or the obligation of one of the parties may be *deferred* to a future date. Contracts involving commodity murabaha belong to the *deference of obligations* group. A

¹³ See Zeti Akhtar Aziz (2008): *A global growth opportunity amidst a challenging environment*, Governor's Keynote Address delivered on 8 October at State Street Islamic Finance Congress, 2008, Boston U.S.A The observation is bit cryptic on the nature of convergence she implied.

¹⁴ Zarina Anwar in an interview with Anna Maria Aug/Sep. 2008 down loaded from SC web site.

¹⁵ Of the total global assets of Islamic finance estimated at US \$951 billion for the year 2008, commercial banks accounted for about \$704 billion or 74%. For investment funds, sukuk, other funds and takaful the percentages were 10, 10, 5 and 1 respectively. Source: Islamic finance 2010, IFSL Research, January 2010.

client may, for example, request a bank to purchase a car for him on a cost plus basis. The arrangement *per se* does not contain any element of interest. Mark-up pricing is allowed on the ground that “time has a share in price” (*lil zamani zun fil thaman*). Indeed, it is this juristic pronouncement that constitutes the justification for allowing the deferring of obligations in Islamic contracts. It was not the principle but the structuring of contracts¹⁶ that went wrong in the cases mentioned. The reasons for the current disquiet are to be sought elsewhere.

Commodity murabahah contracts may not defy the Shari’ah norms if viewed on a case by case basis i.e. in a micro frame of analysis, but their overwhelming use at the aggregative or macro level is working against the Shari’ah *spirit*¹⁷. Debt transactions dominate the scene at the cost of real economy. The use of deferred contracts seems to have already been carried too far. Of late, even Zeti the governor of Bank Negara Malaysia had to advise Islamic banks to curb the use of fixed return transactions. Presumably, it is time to apply the principle of *saad-al-dharai* that closes the potential avenues for circumventing the Shari’ah: more so its objectives and spirit. It is not the permissibility of murabaha contracts *per se* but their defective structuring and indiscreet use which is fueling the perception that the Islamic bankers are providing cover to the taking of interest from the back door¹⁸. *Debt sales, inah* and *tawaruq* have palpably divided juristic opinion within and across countries. Malaysia and the Middle East stand poles apart on the issue of their permissibility. Here, two observations may not be out of place.

¹⁶ On the structuring of contracts also opinions differ considerably. A significant example is the commonly upheld prohibition of multiple contracts in a single sale transaction. But Yqubi argues that the prohibition refers to specific instances where the combination of contracts is used as a legal device to permit or facilitate *riba*, or where the combination leads to any other textual prohibition (e.g., *gharar*). He supports the view that the strict rules of combining contracts can be relaxed in certain cases to facilitate Islamic finance contracts: *Ijara, murabaha* and *musharaka*, are, to him, the clear examples. Harvard University Forum on Islamic Finance, (April 2006). Eyebrows may be raised on this interpretation of the Hadith.

¹⁷ Shari’ah scholars tend to miss the point what may look perfectly permissible at the micro level may become violative of the spirit of the law at the macro level. On this see Mohmoud A. El Gamal: (2009) *Macro vs. micro-considerations in Islamic financial ijihad*, Lecture IIFF Istanbul

¹⁸ Zubair Hasan (2009): *Islamic banking: Commodity murabahah remains in a lurch – Note*, International Journal of Islamic and Middle-eastern Finance and Management, Vol.2, No. 1 (Emerald) pp. 77-79

- Islamic economic system has social implications related to economic development, especially for the fulfillment of basic needs and achieving distributional equity. Islamic banking operations are not contributing to these goals; they are essentially guided by profit considerations. Admittedly, profit is important, rather imperative for Islamic banks too as for any other business but it cannot be the sole criterion in evaluating their performance. Econometric models on the performance of Islamic banks invariably consider profit, cost, or size as determinants of efficiency. Their structuring blemishes apart, no social welfare measure appears in such models presumably because quantification is not possible on a uniform basis.
- Islamic banks too are diverting - like their conventional cousins - the savings of those at the lower rungs of society to the upper classes aggravating the income inequalities¹⁹. In addition, the distribution of earnings between the owners of banks on the one hand and their depositors on the other is much skewed in favor of the former²⁰. The combined GDP of 57 Muslim countries is estimated at more than one trillion dollars but the question how *does* Shari'ah compliant Islamic finance benefits him is the sort of the questions the man in the street still stands asking. Workshops like this could hardly be meaningful if they evade this sort of questions.

Islamic sukuk (bond) is mostly based on commodity murabahah and is one Islamic instrument that has recently been getting all the attention. Broadly speaking sukuk are asset-backed, Shari'ah compliant trust certificates. They are generally used in conjunction with two types of contracts: (i) Ijara structure where the lease rental provides an income (profit) to the holder or (ii) musharakah structure, where profit share becomes his income. The juridical validity of sukuk became suspect since the time Sheik Taqi Usmani cast doubts on their

¹⁹ Wide income inequalities are not the bane of developing economies alone; affluent societies are also not free from that malady. Even in the U.S as of 2007, 20 percent households get 85 percent of private wealth while the remaining 80 percent households had to be content with the remaining 15 percent. See G... William Domhoff as quoted in Muhammad Taqi Usmani (2009): Post crisis reforms – some points to ponder, presented at the World Economic Forum.

²⁰ Zubair Hasn (2010): arrives at similar results in his Islamic banks: Profit sharing, equity, leverage lure and credit control, (Forthcoming) JKAU Journal Islamic Economics, Vol. 23, No. 1

Shari'ah compatibility in 2008²¹. His reasons for declaring 85% of sukuk as non-compliant of the law were in brief as under.

- There have been cases where the assets in the sukuk were the shares of companies that do not confer true ownership but which merely offer to sukuk holders a right to returns.
- Most sukuk issued today are identical to conventional bonds with regard to the distribution of profits from their enterprises at fixed percentage bench-marked on interest rates. The legal presumption regarding sukuk is that no fixed rate of profit or the refund of capital can be guaranteed. And this brings us to the third point.
- Virtually, all sukuk issued today guarantee the return of the principal to holders at maturity - just as in conventional bonds – through a binding promise from either the issuer or the manager to repurchase the assets at the stated price regardless of their true or market value at maturity.

However, in one of his recent writings referred to earlier Taqi Usmani does not touch the issue. Rather he appears to approvingly quote an AP Business writer where she says: “Sukuk are the equivalent of bonds, but instead of selling a debt, the issuer sells a portion of an asset which the buyer is allowed to rent.” In that sukuk avoid causing a mismatch between purely money and real transaction.

As though anticipating such positions, Islamic economists have been arguing from the very beginning that the sharing of profit (loss) is the basic distinguishing feature of interest free finance. Indeed, participatory finance they claimed to be the alchemy for numerous ills of the conventional financial system²². Of late, the claim has been shouting louder. It is being vociferously stated that one of the most serious gaps in Islamic finance is the reluctance of market players to promote risk-sharing equity-styled financing and investment. Thus, the promotion of institutions supporting risk-sharing, partnerships is vital to realizing the full

²¹ Harbhajan Singh (February 11, 2008) : *Sukuk debate rages- Shariah compliance questioned*, News Analysis: Islamic Finance, The Malaysian Reserve, p.5

²² This argument implies the need to research the evolution of the capital structures of modern corporations as we find them today and nullify the arguments against having equity shares alone the source of funding’

potential of an Islamic financial system. On this economist, jurists and central bankers are all seen in the line. However, claims do not win conviction, evidence does. And despite all efforts participatory funds currently do not constitute more than 10-15 percent of Islamic financing worldwide.

What blocks the way is again the structuring of Islamic banking on the conventional pattern. Mainstream banks could bring long term investment financing under their umbrella by introducing what is known as universal banking though they still remain short-term credit providers. Islamic banks because of their infancy, small size, and lack of adequate funds, in addition to a dearth of managerial skills, may find it difficult to go universal. Western banks running Islamic windows or subsidiaries are a different category in this context.

Finally, the mismatch is a complicating factor in interpreting the law. In that it has also been in some measure contributory factor causing the regulatory regimes for IFIs vary across countries. The variations may possibly widen as Islamic financial centers gain strength in places like London, Singapore, Hong Kong, and now France in conventional environment. Some difference may be allowable but narrowing them down is always advisable. International organizations have been established to set standards that are expected to strengthen and eventually harmonize prudential regulations as they apply to IFIs²³. It is hoped that evolving regulatory frameworks will entail convergence of the practice of Islamic financial intermediation with its conceptual foundations rather than led by conventional imperatives.

One possible reason of divergent interpretations of the Islamic law could be the dearth of qualified jurists giving rise to oligarchic competition among them. A recent study – Shariah Scholars in the GCC: A Network Analysis Perspective – provides valuable insights into the engagements of the jurists in financial institutions within and across the GCC. It finds that 94

²³ Dahlia El-Hawary, Wafik Grais and Zamir Iqbal (2007): *Diversity in the regulation of Islamic Financial Institutions*, The Quarterly Review of Economics and Finance, Volume 46, Issue 5, pp. 778-800. See Table 2 even as it is based on 2000-2001 data. The situation may have since changed substantially.

Table 2: Oligarchic concentration of advisory positions in Islamic financial institutions

No. of advisory board positions	Total number of scholars	Occupancy per scholar (minimum)	Occupancy per scholar (mean)
467	94	2	5.0
400	38	4	10.5
339	20	6	16.9
253	10	15	25.3

Source: Constructed using data provided in the report “Top Shari’ah Scholars in GCC: Funds @Works 18.09.09”²⁴

Scholars, from 19 countries, sit on 467 advisory board positions with 5 positions per head. This looks reasonable. But the distribution of positions among scholars is far from being uniform as Table 2 so clearly brings out. Some doubt that small groupings of scholars tend to work in unison for promoting mutual interests. It is intriguing, if true.

4. Islamic finance and Current crisis

Islamic finance has won much praise from the bankers, experts, scholars and jurists for remaining resilient and stable during the current global crisis. In my view, it is partly valid but largely overdone: it ignores the relative position of the two systems. One may argue that Islamic finance being risk averse, short-term, and liquidity oriented is not yet developed enough to attract crises. Still, some Islamic banks did go down because of the turmoil. For example, Investment Dar in Kuwait, Amlak and Tanweer in Dubai, Islamic Bank in Qatar, Gulf Finance House in Bahrain, and Islamic Bank of Emirate all came to grief in 2009 one way or the other²⁵. Anyway, in a storm it is the oaks that are uprooted, not the reeds. The crisis originated in the conventional system for a variety of reasons; the main ones are the credit creation race in the banking system, leverage lure, expansion of secondary markets, heightened speculation and reckless fiscal policies of the U.S Administration, all being the results of wrong market incentives²⁶. Fortunately, Islamic financial system has not yet developed the connectivity with these

²⁴ Three scholars -Sheikh Nizam Mohammed Saleh Yaqubi from Bahrain, Dr. Abdul Sattar Abdul Karim Abu Ghuddah, and Dr. Mohammed Eid Elgari both from Saudi Arabia - alone make up 50% of the positions of the top 10, or 26% of all positions in the GCC institutions.

²⁵ For details see Rashid Siddiqu (2010): *Cross-sell of Islamic finance, Islamic Finance Report 2009*, Project Finance International of Reuters. Taqi Usmani also support this view

²⁶ See Joseph Stieglitz (2009): *Freefall: Markets and the sinking of the global economy*, Allen Lane. He blames the current (2008) meltdown on three such perversions under regulation of markets, liquidity the Federal Reserves poured into the post.com economy that found way to house owners (who lacked credit-worthiness) and agent fees, and the massive bailouts that maintained bankers’ bonuses.

mainstream maladies to get molded. A detailed analysis of the causes of current global meltdown falls outside the scope of this paper. Relevant here are two characteristics of the conventional financing systems that often tend to bring them down on knees as recently: credit creation and speculation, especially in the bubbly derivative markets.

Commercial banks are able to create an inverted credit pyramid –see Figure 2 below - because they do not give the amount of credit (loans) granted to a client across the counter: he must deposit it in his account with the bank. The average cash withdrawn daily by the clients from their accounts is normally a small fraction of the total deposits – cash and credit. This allows banks to generate a spiral of credit through an operator: the multiplier. It is easy to understand its working. Suppose the amount of legal tender money in an economy is C dollars of which people keep with them only F fraction under the Keynesian liquidity preference function while the central bank wants commercial banks to maintain R as the cash-deposit ratio. We then have the credit multiplier M as under:

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

To illustrate, if a bank has \$50 million in cash deposits, people retain F = 0.1 fraction of their incomes with them and the central bank of the country requires commercial banks to maintain a minimum cash-deposit ratio R = 0.05, the credit multiplier M will then be 9.5. The \$50 million cash deposit with the bank will enable it to have deposits worth \$475 million. From that amount if we take out cash deposits, the remaining \$425 million will be the loan deposits the bank has generated. The interest received on this amount minus the part of it payable for cash deposits and

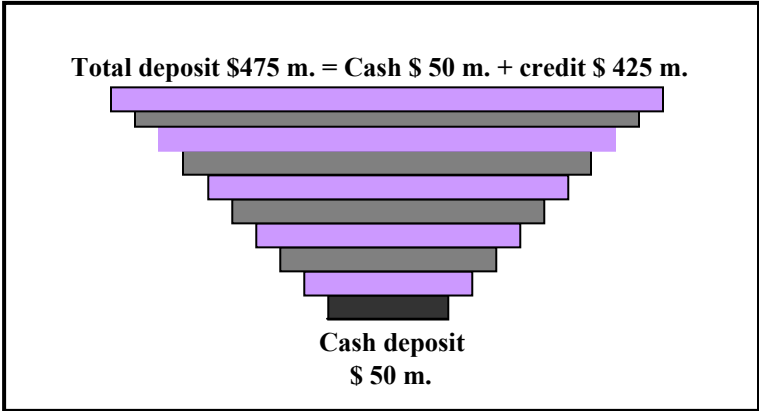


Figure 2: Inverted credit pyramid with F = 1 / 10 and R = 1 / 20 (Multiplier M = 9.5)

other operating expenses will all belong to the bank. Banking is thus an exceedingly lucrative business. Bank owners reap handsome leverage benefits. So do the businesses that take loans from banks as the rates of interest are usually much lower than returns the borrowings provide. They are tempted to finance even long run projects from short-term loans because in good times easy renewals can convert them into long-term funding. Leverage gains tend to make businesses over adventurous. But continued pumping in of the air ultimately causes the credit balloon burst, economies roll down the hill and unemployment tends to become rampant.

Banks, businesses and society all suffer in a crisis. Governments tend to become hostage to big business. Large banks cannot be allowed to fail; rescue packages and bailouts involving trillions of dollars have become the order of the day. For instance Barry Ritholtz, in his forthcoming book, *Bailout Nation*, puts the estimate of United States rescuing costs until now at \$4.6165 trillion. He calls the figure conservative, still notes that the current credit crisis bailout is the largest outlay in American history²⁷. We see lay bare the latest axiom of capitalism: *Profits are private, losses public*. Islamic banks are not yet part of the story because they do not indulge in multiple credit expansion like their conventional counterparts

The expansion of credit and its consequences explained above bring us to our second point. Mounting loans in current crisis fuelled the expansion of the derivative markets and got in turn a boost from that expansion²⁸. The risks of rise in loans were covered by complex derivatives, but those exotic instruments only generated an unending cover-risk-cover chain fueled by traders' greed for enhanced commissions and short-term capital gains (Stieglitz 2009).

Derivatives draw their value mostly from the value of an underlying asset: a security, commodity, or other financial instrument. Futures, forwards, options, and swaps are the most

²⁷On credit creation mechanism and consequences see Zubair Hasan (2008): '*Credit Creation and Control: An Unresolved Issue in Islamic Banking*', International Journal of Islamic and Middle Eastern Finance and Management, UK Vol. 1; No. 1, PP. 69-81 (Emerald)

²⁸ "I believe that banking institutions are more dangerous to our liberties than standing armies. Already they have raised up a monied aristocracy that has set the government at defense. The issuing power [of money] should be taken away from the banks and restored to the people to whom it properly belongs." [Thomas Jefferson <http://129.3.20.41/eps/mac/papers/0203/0203005.pdf>]

common types of derivatives²⁹. Markets for derivatives have their advantages, especially in the mitigation of risks, but of late they have become unregulated dens of high risk credit bets; they can cook up any kind of leverage device including caps, collars and floors “to bet the hell out of virtually anything³⁰. Some 25 years ago, the derivatives market was small and domestic. Since then it has grown impressively – around 24 percent per year in the last decade – into a sizeable and truly global market.³¹ Today, it has assumed a size of \$1.14 quadrillion (1 quadrillion = 1000 trillion). It is more than - almost 20 times - the entire GDP of the world in the year 2009. Table 1 compares the volume of the U.S derivatives with major macro variables: world stocks and bonds,

Table 1: U.S. Derivatives and Money supply and World stocks and Bonds (March 2009)

Particulars	U.S. Dollars (Trillion)
Derivatives U.S. commercial banks	1140
World Stocks and bonds	120
World GDP	60
U.S. Money supply (M3)	16

Source: compiled from IMF and World Bank data
Wikipedia, the free encyclopedia (27. 1 .2010)

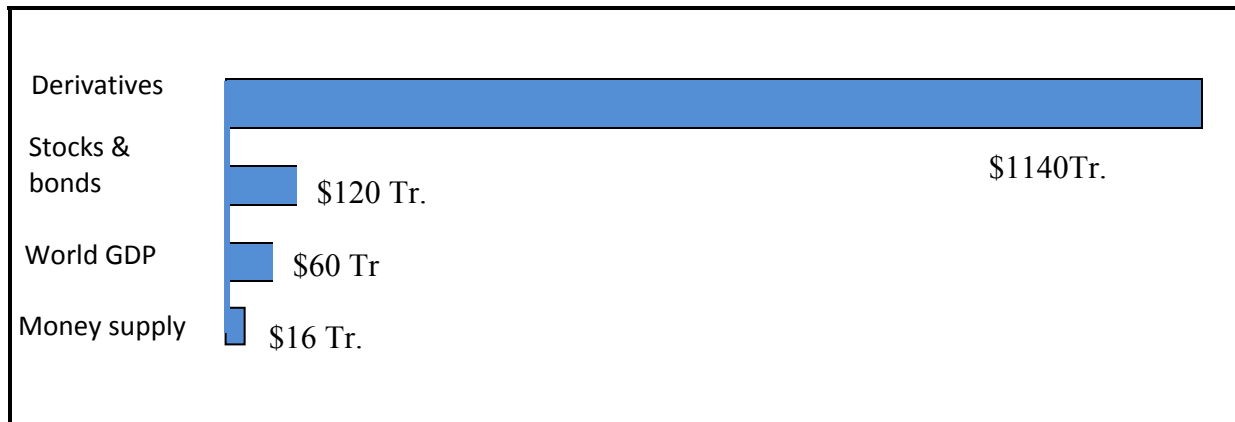


Figure 3: The growing monster of derivatives (U.S. 2009)

Source: compiled from IMF and World Bank data
Wikipedia, the free encyclopedia (27. 1 .2010)

²⁹ For definition and use of these contracts see for example, Downside World News <http://www.globalresearch.ca/index.php?context=va&aid=10265>

³⁰ Jutia Group (July 24, 2008: *Global derivative market now values at \$1.14 Quadrillion* jutiagroup.com/2008/.../24/global-derivatives-market-now-valued-at-114-quadrillion/

³¹ Duetsche Borse Group White Paper (April 2008): *The Global Derivative Market - An Introduction* Frankfurt/main Germany < www.eurexchange.com>

world GDP and U.S money supply for the same year. Figure 3 presents the facts of the table to make comparison sharper.

Figure 4 shows another and a more revealing comparison of a similar type. Here we see the expansion of U.S derivatives over the years vis-à-vis the growth of its wealth and the wealth of the entire world. The derivatives' expansion has been exponential, interestingly more so after 9/11 in 2001 (why?). To what *extent* has this growth in derivatives been responsible to set in motion the global melt down the first in its intensity and duration after the Great Depression of the 1930s may be a moot point but expert opinion is certainly awed by the speculation that gave rise to it. Initially, some jurists - Hashim Kamali in particular³² - claimed that there is scope in law for the creation of derivatives in the area of Islamic finance as well and a few were in fact launched also.

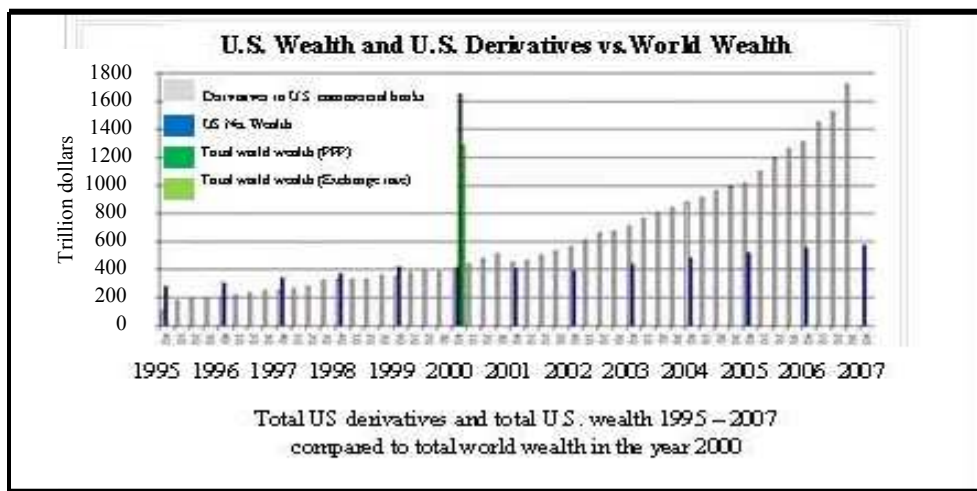


Figure 4: Growth of U.S derivatives relative to real wealth of the world
 Source: Jutia Group <http://www.istockanalyst.com/article/viewarticle//articleid/2432853/> (Edited)

However, currently it is being argued that derivatives are un-Islamic for a variety of reasons, especially because they are no more than bets on bets on debts on debts. One opinion is that “regulations and prosecutions are needed to punish and deter present and future self-paid corporate crooks looting and draining other people’s pensions and savings”³¹

³² Kamali, M. Hashim (2002): Islamic commercial law: An analysis of futures and options, Ilmu Pub.

5. Concluding Remarks

We discussed above the topic what Islamic finance does change, what it does not from a hitherto unexplored angle: the adoption of a short term financing structure of conventional banks to meet the essentially long run objectives of Islamic economics. True that the structure-objective mismatch has in some measure facilitated the expansion and growth of Islamic finance but on a more important side it has forced Islamic finance into convergence and competition with the grown up conventional system. Today competition among the grossly unequals is like the competition of the pond where the big fish swallows up the smaller ones. That process is on: the unidirectional convergence of Islamic finance seems leading to its eventual submergence with the conventional system.

It is neither expedient nor possible to indulge now in substantive structural departures in Islamic finance but it is still not too late for initiating some sideward diversions. Even remaining within the existing framework, there is much that can be done to make Islamic finance meet the ends it was initially meant to serve. However, one clarification may be sought here. Whose baby is Islamic finance? This is a decisive question³³. Our stand is that Islamic finance was conceived to serve the *ummic* interests and this objective need not be sacrificed at the altar of globalization. Others can of course benefit from the system if they so desire following the Islamic norms. It is with this perception that we venture below some observations for the consideration of scholars and the policy makers.

- One reform the Islamic system calls for is the separation of short-term from the long run financing. Experience shows that the two are difficult to handle efficiently under the same organization. Non-western Islamic banks attempted for instance to diversify their activities by introducing various types of funds in their ambit but the overall progress in the area has not been encouraging. The money flows into the Islamic funds from the Muslim countries is disappointing. It is reported that there is a very small number of Islamic funds – just 500 plus – and they held assets under their management in 2008 valued at a meagre about US \$25 bn.

³³ One argument advanced for a speedy convergence of the Islamic finance to mainstream requirements is that the system is not for Muslims alone, others can and are taking advantage of it, the rules of the game must be even handed.

even as the private wealth in the GCC alone was estimated at US \$1800 bn³⁴. Participatory (PLS) finance too, as indicated above, is not making much headway. Universal banking is not the answer for reasons explained earlier. Needed is the expansion of well-managed and cost effective specialized institutions like unit trusts, investment houses, and multipurpose cooperative societies.

- Industrial/commercial units in Muslim countries are on an average of much smaller size than in the West. Promotion of micro financing institutions can do wonders in alleviating the grinding poverty in many of the economies. What rural (grameen) banks have done in Bangladesh is an eye opener not only for what they achieved but for the trick they used. Note that it was much maligned interest-based financing, not the exalted banking without interest that won the day. Presumably, it was *the* message implied in conferring the Nobel Prize on Prof. Yunius, interestingly, not for economics but for peace!
- Another matter that is hanging fire in Islamic finance is of regulatory rules, procedures and authority allocation. Much laudable work has been done in this area but regulation will always remain an issue in finance for both economic and ideological reasons (Stieglitz 2009). The question in principle here is: how much regulation financial systems require? There is a clash between market freedom and policy intervention: to find a balance between the two and maintain it under volatile economies conditions and social aspirations today. The answer in fact depends on who commits the mistake of crossing the perceived limits. In the current crisis it is vividly the market misconduct that brought in the devastation. Naturally, the regulators have their tails up. In Islamic finance the regulators have got the opportunity to streamline *inter alia* the legal advisement system. The task may, for example, be centralized as in Malaysia. Finance is not without economics. For keeping the bigger picture in view to make implications of proposed regulations clearer, well qualified economists must be associated with advisement as full members at all levels.
- In Islamic finance we need sound governance, resistance to the conventional forms and sophistications that may result in avoidable complications and costs for a yet tiny segment of

³⁴ Project Finance International op. cit.

the global system.. It is not necessary to immitate each and every thing just for having the elation of being at par with the conventional system.

- It is futile to think of Islamic finance as being in competition with the mainstream institutions for sharing the market. In contrast, a favorable terrain for competing is of transparency in contracts, promotion of information equality, avoidance of detachment from the real economy and eschewing the temptation of murky dealings. It is the moral high ground where Islamic finance can lead the conventional system (but) by examplr; current meltdown has shaken the conventional system to its foundations and its proponents are realizing the virtues of being virtuous; they are searching for appropriate ethical norms to pursue.
- With the fast growth of Islamic finance, there has been also been an increase in the expectations gap between Islamic finance practitioners and civil society members about the role that Islamic financial institutions (IFIs) should play in society. The recently released AAOIFI standards cover 13 aspects of social responsibility such as client engagement, employee welfare, charity, environment, investment quotas and others. On these criteria, the overall response of the IFIs on social responsibility is found quite encouraing even as the performance varies widely between institutions³⁵. More has to be done until the man in the street feels that something for him is being done. Of the 57 Muslin countries 25 constitute half the least developed economies in the world.
- Finally, Islamic fonance is no more than a highway under construction in a vast road map of economies intended to develop with Islamic orientation³⁶. Related issues have to be attended simultaneously if Islamic finance is to deliver. Political will alone is the key that can unlock the doors to prosperity along the right path. And remember, no public policy, however well designed, is worth more than what it is in practice. Governments in various countries -

³⁵ Survey Report (2009) on Social Responsibility Trends at Islamic Financial Institutions

³⁶Anwar Ibrahim delivering his keynote address at the Seventh Harvard University Forum on Islamic Finance (April 2006), reminded the audience of the larger framework within which Islamic finance functions: the shari'a. Specifically, he stated that there was a need for an expanded discourse with global relevance and impact. It was appropriate, he argued, that we strive not only to be contractually shari'ah-compliant, but also to attempt achieving the main goals of the shari'ah.

irrespective of their shades - have to demonstrate that Islamic norms can well be converted into ground realities to become a way of life.

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