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In The Name of Allah,
The most Beneficent, The most Merciful

“O Believers: devour not Riba, doubled and redoubled;
and fear Allah, in the hope that you may get prosperity.”

Sura Ale-Imran (verse No. 130)

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# Journal of Islamic Banking and Finance

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Editor’s Note

After the financial crisis of 2007-2010, it is pertinent for the financial system to put the focus back on productive enterprise, bring economic recovery with job creation, limit and regulate speculative financial instruments and improve corporate governance by influencing the incentives. The two most important problems identified in a post-financial crisis look back are perverse incentives and de-linking of financial sector growth and activities with the real sector of the economy.

On the other hand, the Islamic finance principles link all their financial products with real assets. The Islamic finance industry has demonstrated its potential with steady 15-20% growth during the last two decades. Not only Muslim majority countries, but non-Muslim majority countries are also taking interest in using Islamic finance instruments to finance government projects. In recent years, UK, Luxembourg and Hong Kong had now issued Shari’ah compliant securities.

However, despite the stellar growth, Islamic finance has a long way to go to fulfill its promise for an egalitarian, inclusive, meaningfully participative and real sector oriented financial system that can provide solutions for commercial as well as public and development finance.

It is a fact that more than a billion people live in poverty even in the twenty first century. Most of the Muslim majority countries are generally poorer than the other countries on average. Most of the poverty resides in Africa and Asia and bulk of the Muslim majority countries are located in these continents. Half of the global poverty resides in the Muslim world while the Muslim population is 24% of the total global population.

According to Social Development Policy Institute (SDPI), in Pakistan, as many as 58.7 million people are living in multidimensional poverty with 46% of the rural population and 18% of the urban households falling below the poverty line. Other Muslim majority countries like Bangladesh and Nigeria also have poverty headcount ratio of 43% and 62% respectively.

In Middle East, there is immense potential to use solar energy alongside oil. Lack of financing is one of the major obstacles for minimal use of renewable energy in developing countries. Financial sectors of developing countries are often underdeveloped and are unable to efficiently channel loans to produce renewable energy.
Developing countries spend about $1 trillion a year on infrastructure and an additional $1-1.5 trillion will be needed through 2020 in areas such as water, power and transportation projects, according to the World Bank. The Asian Development Bank (ADB) estimates that emerging Asian economies alone will require $8 trillion over the next decade to satisfy growing demand in the areas of energy, water and transportation. World Bank figures suggest that only about 50% of the infrastructure demands are being met annually across emerging countries.

Provision of public infrastructure is circularly related to investment, tax base and tax collection. Improvement in public infrastructure induces investment in the economy that can help in increasing the tax base with the entry of firms and increase in employment creation. As a result, increase in tax base can boost the government’s capacity to service sovereign Sukuk effectively.

Many Islamic banks do not have big enough balance sheets to issue large Sukuk with distant maturity dates. Bank financing for long-term infrastructure projects has become much less attractive under the new Basel III rules. In this regard, issuance of long term financial securities can be a more useful way of financing.

In this regard, Green Sukuk has the potential to become integral to financing the region’s ambitious renewable energy and infrastructure projects and could help mobilize essential finance needed to fund the rising number of clean energy initiatives.

By issuing sovereign Sukuk to scale up infrastructure investment, the governments can attract foreign direct investment by improving their public infrastructure. Projects to build toll ways, railways or even schools and hospitals, which generate revenues from tangible assets, are consistent with the Islamic finance ethos and principles.

Going forward, the current weak oil price may change the servicing capacity of the oil-rich governments and change their respective Sukuk ratings. Geopolitical crisis may also affect ratings of sovereign Sukuk. MYR in which most Sukuk are denominated has undergone steep depreciation. This increases the currency risk and hence premium on MYR denominated Sukuk if the trend persists. However, Islamic financial institutions have excess liquidity which they can cost effectively bring towards capital formation in their respective countries of origin by issuing more capital market securities.

This issue of Journal of Islamic Banking & Finance documents scholarly contributions from authors around the globe. Contributions in this current issue discuss the theoretical underpinnings of an Islamic economy, contemporary issues in Islamic finance and performance based empirical studies on Islamic banking and finance. Below, we introduce the research contributions with their key findings that are selected for inclusion in this issue.

In his article “Risk-sharing versus risk-transfer in Islamic finance: An evaluation” Zubair Hasan, professor at the Global University of Islamic Finance (INCEIF), Malaysia, argues that risk-sharing is not basic to Islam as Islam encourages profit sharing of which sharing of risk is a consequence not the cause. The article
concludes that the case is for reform, not for replacement, of the current debt dominated system marked with increasing duality.

Abdullahi Salihu Ishola and Isa Olawale Solahudeen both with Universities and legal profession in Nigeria in their article “Conventional Bank Interest and the Murabahah Contract in Islamic Finance: Two sides of a coin or Two coins of different sides?” take up the topic of the legality of Murabahah under Islamic Financial Principles (IFP). Of all the criticism against its operation, the most pronounced depreciation against it posits that, Murabahah is too close to interest transaction in the conventional banks, and cannot therefore be legally allowed in IFS. The authors examine the criticism and posit whether the criticism is tenable or not on the scale of the Islamic Law and given the financial market challenges facing the contemporary Muslim world.

In “Shari’ah Compliant Liquid Commodity Market: {An Expositional Study on Bursa Suq al-Sil’ah in Malaysia}”, Abdul Azeez Maruf Olayemi, Aznan Hasan, Uzaimah Ibrahim, Ahmad Hidayah Buang and Riaz Ansary, all researchers and associated with universities in Malaysia, talk about Bursa Suq al-Sil’ah which is a Shariah compliant liquidity commodity market. They show that this market is tremendously efficient and it can form a model for other countries to mitigate the problem of Shariah compliant liquidity management to a great extent.

The subsequent article entitled Money Economy and Contemporary World Economic Order: A Challenge of Identity and Survival for Islamic World by Hamzah Adesola Dawood argues that Banking and Finance are rooted in Islamic jurisprudence and thus, not an invention of this century's Islamic political movements. Ijtihad mechanism has thus become an effective tool in finding rightful conceptual and practical frameworks especially now that the world economy is being confronted with endless crisis. Specialists and stakeholders are struggling to proffer solution. In a challenge of identity and survival what is way forward?

In this paper “State Bank of Pakistan – Fueling the Growth of Islamic Banking in Pakistan” written by Obaid Usmani, says that the Pakistani Islamic Banking industry is set to become the hub of Islamic Banking of the region, the steps taken by the central bank in Pakistan to promote the growth in Islamic finance and to reach standardization in the regulatory framework have also been reviewed in this paper.

Two more scholars associated with the University of Malaysia, Mahadi Ahmad and Ibrahim Vamba Fofana in their article “The Jurisprudential Principles in Managing the Risks Available in Certain Islamic Finance Contracts” present a very interesting and well argued concept of risk in Islamic Banking Contracts. They say that Islamic banking rules are derived from divine laws which are enshrined in the Holy Quran and Hadith and that the Islamic financial institutions are first responsible to Allah and then to their shareholders and depositors. As such their responsibilities became higher than their conventional counterparts.
“An Empirical Assessment of The Displaced Commercial Risk In Malaysian Islamic Banking Institutions: Bank Profitability Model Evidence” by Noraziah Che Arshad, Roza Hazli Zakaria and Ahmad Azam Sulaiman, all associated with University of Malaysia, explain why Displaced Commercial Risk is more of a concern in Islamic Banks and how it can erode their profitability unless the choice of Islamic Bank by customers is based on religious preferences.

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Website: www.islamicbanking.asia
Risk-sharing versus risk-transfer in Islamic finance: An evaluation

By

Zubair Hasan

Abstract

Some recent writings on Islamic finance have resuscitated the old ‘no risk, no gain’ precept from the earlier literature in the wake of current financial crisis. They argue that the basic reason for the recurrence of such crises is the conventional interest-based financial system that subsists purely on transferring of risks. In contrast, Islam shuns interest and promotes sharing of risks, not their transfer. The distinction is used to make a case for replacing the conventional system with the Islamic; for that alone is thought as the way to ensuring the establishment of a just and stable crisis free economic system. Islamic banks have faced the current crisis better than the conventional is cited as evidence.

The present paper is a critique of this line of thought. It argues that risk-sharing is not basic to Islam. It encourages profit sharing of which sharing of risk is a consequence not the cause. The paper concludes that the case is for reform, not for replacement, of the current debt dominated system marked with increasing duality.

Key words: Financial crisis; Risk-Sharing; Risk-Transfer; Islamic Banking; KL Declaration

1. INTRODUCTION

Firms need finance to establish and expand their business. These needs can be met by issuing equity shares or by borrowing money from financiers if the firm owners are not having or willing to commit additional funds to business. There is no dearth of discussions in the literature on the circumstances appropriate for using either of the two sources or their proper mix in modern corporate businesses. In broad terms, reliance on equity is advised for imparting stability to business over the long-run while debt financing is considered suitable to cover temporary, rather smaller, liquidity requirements.

* Zubair Hasan is professor of Islamic economics and finance at the Global University of Islamic Finance (INCEIF), Kuala Lumpur, Malaysia. The views expressed herein are of the author and need not be attributed in any way to the institution where he works.
However, in recent years, the ease of combining the long-run advantages of equity finance with short-run debt leveraging gains via maturity transformation\(^2\) has led to an increasing reliance on debt financing (Hasan 2014, 192). Leveraging enhances returns on investment for both the seekers and the suppliers of funds albeit in different ways. In general, the lure has led to a reckless use of maturity transformation and the resulting gains have become one major causative factor in recurrent financial crises worldwide.

The 2007 crisis originating in the US is the latest example of such lure-led turmoil. Many financial institutions, mostly banks, soon discovered to their dismay that they were awfully short of liquid assets to meet deposit withdrawals because of the mounting debt defaults. Bankruptcy stared them in the face. The gravity of such eventuality necessitated massive bailouts from public funds as large sized financial institutions were considered as being ‘too big to fail’. The volume of resources these institutions held and the employment they provided made keeping them afloat a compelling social need. Cost estimates widely differ but big sums are indicated. By the year 2009 bailout cost touched, according to one report, $4 trillion in the US alone; almost 10% of the national GDP\(^3\). The turmoil has humbled the Schumpeterian pride of hailing capitalism for destroying the old structures only to innovate the better ones on its forward march to progress and prosperity.

At a time when the world is still groping to find a way out of the dark tunnel the equity-debt debate has once more assumed importance in the literature and with an additional dimension. Public waywardness is no less on the target than private lure. Due to a public-private mix in fomenting the trouble, the search for a solution to guard the future no longer remains restricted to monetary policy or national boundaries. It has spilled over to governmental machinations and transcended political jurisdictions in a big way as flows of men money and materials across border have grown in importance. There is talk of a paradigm shift in financial economics.

The shift has provided the proponents of Islamic finance with a fresh impetus to flog the conventional system and push the divine one, as they understand it, to the fore as a replacement. The development was in some way inevitable for Islam bans both interest and speculation arguably the major culprits in fuelling the current chaos. Contextual to the equity-debt debate, the ‘no risk, no gain’ dictum and discussion on it were not buried too deep in the literature.\(^4\) Its present restoration on the pedestal is led by Prof Abbas Mirakhor. Risk-sharing has been a major theme in his recent lectures and writings on Islamic finance including the books he has co-authored with others. The turmoil gave him the opportunity to postulate:

1. That the world financial system is inherently prone to instability and financial crises because it works through what he calls the transference of risk, not through its sharing.

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\(^2\) Maturity transformation refers to the use of rolling-over of short-term loan several times to finance long-term needs.


\(^4\) See for example, Chapra 1986) and for more critically examined in recent writings such as Hasan (2005, 11-12) and Syed Ali in Amer Al- Roubaie and Shafiq Alvi (Ed.) Islamic Banking and finance, Routledge 2010, Volume III,2-3)
2. That Islamic financial system which in his view allows nothing but risk sharing could alone pull back the world from the brink of disaster where it now stands.

The propositions coming from a senior academician and practitioner carry far reaching policy implications for the future of Islamic finance – its substance and direction. This paper presents a preliminary evaluation of the content and tenability of the propositions. It argues that the stated cause of turmoil has some important missing and the solution offered rests on inexplicable presentation of Islamic positions.

In the following Section 2 the paper takes a hurried look at the causes of the current turmoil to see what it indeed was that has to be blamed for the collapse of the system. In Section 3 we shall examine the genesis and place of the ‘no risk, no gain’ dictum in Islamic finance. Section 4 discusses the argument supporting Islamic system as a replacement for the conventional. It also evaluates if risk-sharing could be the exclusive base for organizing Islamic finance. Finally, Section 5 presents the findings of the paper and contains a few concluding observations.

2. THE DEVASTATION AND ITS CAUSES

We have referred above to an increasing inter-action between financial sector and public policy in modern economies. The continual erosion of the central banks’ freedom in regulatory matters allowed commercial banks to manipulate rules to become extra venturesome for self-enrichment only to land in trouble. As public policies were part of the trouble governments had to rescue them instead of the hapless depositors.

The frequency, depth, and the duration of financial crises have increased especially after the collapse of gold standard in 1971. Economic history of the two decades ending with the turn of the century bears ample testimony to the fact. The following Figure 1 sketches the experience of 10 developed countries showing the bank-bailout cost and its percentage to the GDP of each. Notice that all percentages, except for Sweden, have all been more than 10%, the current rate for the USA being equal to 100%.

![Figure 1: Cost of Bank Bailout as Per Cent of GDP](image)


Even the much maligned sub-prime debacle as initiator of the current crisis was not entirely the result of the bankers’ oblique risk-transfer behaviour. The Fed unthinkingly
followed a policy of alternating dear and cheap money regimes in quick succession; the latter making the real rate of interest even negative. Figure 2 highlights the point. Here, the 12-month change in the price index is subtracted from the month-end 10-year Treasury Notes’ yield. However, the same time a home expansion public policy announcement continued pushing up property prices unabated. Figure 3 puts the two parts of the story together. A comparison of its X, Y and Z sections unmistakably brings out a negative relationship between interest and property price changes. We are not building a defence against systemic failures that Islamic critics have highlighted. Our point is that one cannot be oblivion to the contribution of human mischief contributing to the crisis in no less a measure than such failures. (Katalina and Bianco 2008).

Real 10-Year T-Note Yield since 2005

Figure 2: Real interest rates are negative

Figure 3: Low interest rates pushed up property prices but before the buyers could take in profit hikes in interest rates caused the crash in the property market. Foreclosures mounted. Mortgage market debacle snowballed to other sectors of the economy and across countries.

5 A dear money policy is a response to deficient money supply and is likely to make an adverse impact for household and businesses; indeed, for the whole economy. More so in the current context (Rosengren 2011).
The leverage lure we alluded to earlier lead to massive failures of banks and other financial institutions in the wake of the 2007 subprime US debacle and catapulted in the process the equity-debt issue out of the business finance box on to the vast arena of public policy. The change has imparted to the debate macro-dimensions of magnitude and significance. The enormity of the issue has defied all conceivable limits. Attention has shifted fast to a search appropriate action to overcome the economic fiascos that threatens to engulf the globe so often. Paramount has become the question: what could be done to obliterate the devastating debt menace to make finance harmonize with the broader economic objectives of growth, stability, full employment, amelioration of poverty and improve justice in wealth distribution? These objectives commensurate well with the Islamic maqasid.

To reiterate, the search for a remedial action has revived the equity-debt debate in the literature leading to a sort of transformation of thinking in economics. The opportunity is seized upon to offer the Islamic system as a replacement for the conventional.

3. FINANCIAL CRISIS AND ISLAMIC BANKS

One demonstration supportive of the replacement proposal is that Islamic banks have shown greater resilience during the recent financial turmoil compared to their conventional counterparts for the facts that they have had comfortable liquidity buffers, low leverage ratios, better managerial skills, and more customized sort of products. The demonstration doubtless has much material content but not all for the stated reasons. A counter argument seems no less weighty. It is said that Islamic finance is yet too small in terms of market share; it has not yet developed sufficient connectivity with the global system to catch the cold. Overall, Islamic banks do have better liquidity cushion but more as a problem than merit – many are not able to use effectively the investible surplus they are able to generate in terms of deposits. The evidence cited is as follows.

![Figure 4: OIC countries: Share in internal and international trade](image)

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5 The inter-bank transactions (between Islamic and conventional) were not presumably large enough for the transmission of the contagion.
Trade is the transmission channel for the spread of a contagion across countries; its volume measures the strength of their mutual connectivity. The economies of 57 OIC countries are a highly heterogeneous group; 22 of them are among the least developed nations of the world; 19 are the fuel exporting rich. The share of OIC countries in the global trade was just 10% in 2010.

Furthermore, this share is very unevenly distributed; the major portion going to the fuel-rich exporters. And, it was the magnitude of these countries trade that some gulf banks did come to grief during the turmoil (Hasan 2010, 50-51). As the OIC countries develop over time, the increase in their global trade channels can be controlled only through increasing the intra-OIC trade to contain possible infection. Efforts in that direction are being made. There is a plan in place to attain a 20% share of total OIC trade within the group. However, the impact of diversion is quite slow due to the very diverse nature of exports and imports of the member countries as Figure 4 pertaining to their trade reveals.

Interestingly, the Islamic Financial Services Board (IFSB): Stability Report 2013 also negates the much publicised thought that Islamic finance was not affected by the current crisis.

The following Figure 5 shows that in 2007 the three variables - assets, financing and deposits – of Islamic banks were almost equal. In 2008 the industry was booming – financing was much higher and assets were both at their lowest ebb leaving much of deposits unutilized. The shrinkage in GDP and trade was the conduit, not the much talked about financial markets.

Anyway, the validity of the reasons given for Islamic banks facing the crisis better is not the issue in dispute. In dispute here is the claim that interest promotes the transfer of risk the abolition of which in the Islamic system that allows only risk-sharing would cure the malady. In other words, sharing of the risks sans transfer is an imperative for escaping the recurrent financial crises and which is what could alone ensure stable economic growth. It is on this premise that Abbas and others present Islamic finance as an alternative to the current interest-based system. The following section attempts to measure the strength of this line of argumentation.
3. RISK SHARING: THE SOLE BASIS OF FINANCING?

We raise three issues to scan the replacement advocacy

i. How we define risk and fix its measurement?

ii. The implication underlying the claim that Islam does not allow using financial instruments other than those based on risk-sharing tenable?

iii. Finally, can a risk-sharing financial system be shown as logical just and operable?

We look at the issues these questions raise in that order.

Risk: concept and applicability

Risk refers to the possible shrinkage in the value of something due to uncertainties of the future course of events; the shrinkage could be partial or total. Income, assets, employment, health, goodwill, self-esteem, prestige, environs and so on are all exposed to risk in the stated sense. Apparently, one risk might look independent of (some) others but in the individual and social dynamics they mesh together as do colours in a painting for creating an overall intuitive effect.

A cardinal measure of risk based on probability theory is dubious and cannot be relied upon for ensuring justice in its sharing. In any case, it can be insured against at a cost. Un-measurable uncertainty poses true risk. But that brings in only windfalls unconnected to effort. That distinction apart, we cannot show a one on-one correspondence between risk and ex post profit and there is no objective proxy for sharing risk equitably except profit. More damaging to the risk-sharing proposition is, we shall see, the fact that it is not risk but ownership in the product that is relevant to justify the share in distribution of product revenue among the factors of production. The bifurcation of factors into the hired and un-hired ones in Frank H. Knight is irrelevant as a justification for profit going to the latter (entrepreneurs); it is alien to the Islamic thinking. A demonstration takes us to the discussion on some ill-conceived propositions in Islamic finance.

A. ‘No risk, no gain,’ really?

The resurgence of risk-sharing is the echo of the ‘no-risk-no-gain’ adage paraded long in the literature as the sole principle for organizing Islamic finance during the latter half of the preceding century. The present author had a detailed discussion on the precept in an earlier article (Hasan 2004, 16-18). Its restatement under review tends to rely essentially on evidence extracted from the mainstream sources rather than from earlier reasoning and analysis in Islamic finance. The mainstream literature in economics is so vast and growing so fast that evidence can often be marshalled on either side of the debate on a position –risk sharing included- with impressive documentation. More important is to examine the logic behind a theoretical proposition.

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6 Chapra (1986) epitomized the mention in the prevailing literature in the adage; See especially PP 64, 166.

7 The classification of the notes and references in one such study of repute confirms the generous borrowings from the mainstream sources; some even from the heterodox literature. The bibliography contains 325 entries. Only 75 of these are from Islamic writers. Of the 75 no less than 40 belong to the writers of the book itself. Thus, for the criticism of the mainstream positions too our scholarship essentially draws on the mainstream!
The risk-sharing precept got currency in Islamic finance literature with the passage of time until it was challenged in the mid-1980s first by some professional bankers in Malaysia and later in academic writings. There was a pause for a while but it could not continue for long. The 2007-2008 financial turmoil gave a fresh stimulus to the precept. Some acclaimed writers, working papers from international institutions like the IMF also took cognizance of the notion (Hasan & Daridi, 2010) and attention is now being paid to it even at the level of doctoral research in some educational institutions of repute. Let us examine the logic and tenability of the resurgent proposition.

The argument for the ‘no risk no gain’ proposition rests on a questionable interpretation of the Qur’anic verse 2:275 which in the relevant part declares:

\[ \text{Allah hath permitted trade and forbidden usury. (Yusof Ali Abdullah)} \]

The verse ordains that all economic and financial transactions are to be conducted through contracts of exchange (\textit{al-bai’}) and not through interest-based debt contracts. This much no one can dispute. However, the proponents further insist that requiring contracts to be based on exchange implies that Islam considers contracts based on interest unfair and inequitable because it shifts the risks of financial transactions to the borrower. It is argued that exchange being the characteristic of sale \textit{allows} the risk of transactions to be shared (Osman & Mirakhor 2014, p.65 emphasis added).

Now, \textit{riba} is banned not because it transfers risk to the borrower but because the lender offers no compensatory value for it in real terms; more on this later. Exchange allows but does not insist on risk-sharing being a necessary condition for a valid contract. \textit{Al bai} in its generic sense encompasses all contracts whereby a given quantity of one commodity or service is exchanged for a given quantity of another commodity - including money – or service unless forbidden by \textit{Shari’ah}. The transaction may be completed on the spot; both parties gain without facing risk. Also, the obligation of one of the parties may be deferred for completion to a future date by mutual agreement – \textit{salam} sale, sale on order (\textit{istisna}) or leasing (\textit{ijara}) are the leading examples. Such transactions do involve risk but the essence of the contract, we shall see, is not risk sharing.

\textbf{B. Capital alone is the factor exposed to risk in production}: This assumption is a matter of definition; risk and reward are both pinned to capital investment in the free markets doctrine. The risk that human beings face while working in various sorts of production lines are ignored even as such risks could be more persistent and damaging to limbs and life compared to loss of money. Men, women and children working in coal mines, glass blowing, cement factories, cotton ginning, on oil-platforms in open seas, on nuclear reactors or even controlling traffic at the crowded road crossings face hazards no amount of money can compensate. During cyclical ups and downs who suffer more – capital or workers -depends on the terms of contracts that govern their employment. If there is a case for risk (and profit) sharing among the providers of capital, there is one even stronger for sharing between labour and capital, especially from Islamic viewpoint (Hasan 1975).

\textbf{C. That interest-based finance is entirely risk-free}. This is difficult to concede. Conventional lenders do face risks of default regarding the principal and/or
interest. Interest rate faces fluctuations via the bond market. If interest-based finance were entirely devoid of risk, could mighty financial institutions have collapsed as they did in the current turmoil? Is there any worthwhile estimate as to how much risk they could transfer to others? What capital faces in deferred payment Islamic contracts is not much different from conventional risks even as mortgage provides cover in both cases. If there is difference between equity and debt with

**D. Sharing is not transfer:** The difference between the sharing of risk and its transfer is dubious. There may be cases like sleeping *mudarabah* where one can legitimately see risk-transfer in risk-sharing; the demarcation need not always be clear.

**D. Fixed versus variable payment:** It is argued that fixed return to capital is not allowed in Islam, not even its use as a benchmark is permitted. This is only partially true because Islam does allow a time value to money as part of price in deferred payment contracts based on *murabahah*, the cost plus an agreed fixed margin financing mode. All deferred payments sales involving mark-ups are debt based transactions. We are not aware of any juridical preference between contracts involving profit sharing on the one hand and those stipulating pre-determined returns on the other if both meet the stipulated Shari’ah requirements.

Furthermore, Islamic financial institutions are all using the conventional interest rate as the benchmark to fix mark-ups in their sale contracts. If a sharing of risk with interest-banned replaces the present conventional arrangement, what shall we use as a reference point to gauge the fairness of profit rate in the economy is not clear? There has to be a base as the sea level in geography for measuring heights.

**E. Risk preference versus risk aversion:** Last but not the least; risk-sharing theory assumes that all people or at least all capital owners are venturesome with zero risk-aversion. This is incorrect. And, it is also not true that some people are venturesome while others are risk averse. Risk-taking and risk-aversion are not exclusive categories. Any line of demarcation that one may attempt to demarcate *categories* would only be arbitrary. The distinction is analytical – the same individual can be venturesome or risk averse depending on his assessment of situation. The difference between people on risk-taking is of degree not of kind and that difference is circumstantial. Figure 6 clarifies this point. Here the curve RP₁ shows the possible risk-profit combination having positive relationship. It is convex to the X-axis implying that risk increases at a faster rate than profit as we climb up the curve. Also, the lower curve RP₂ promises more profit if risk remains unchanged (point B).

The two IC curves show risk-profit indifference combinations. The lower of the two curves is preferable as it shows a lower risk level. Suppose X is in equilibrium at point C the tangency point of RP₁ with IC₁. Now if X wants to move to point A you may call him venturesome but if he decides to stay at A he could be dubbed as risk averse. There is no precise measure of risk-aversion – the AB distance. Enterprise and risk-aversion demarcation appears in the Frank H. Knight’s division of production factors into un-hired (entrepreneurs) and the hired ones. Like other factors capital too has the choice to join either of the groups – investors for possible profits or lenders for pre-fixed returns. This is true for Islamic finance as well.
Mainstream economics regards risk-bearing a service solely undertaken by the capital owners in production; the society rewarding them for that with a payment called profit. But amusingly the reward could be negative as well. Islam grants a share in distribution of output only to those who contribute property or work effort or assume some liability in the process of production. Capital owners, workers and insurers all carry one or the other sort of risk inherent in the future being uncertain but none gets what he does for risk taking. Sharing is a matter of negotiation, custom and circumstance.

Islam does recognize profit as an income accruing to capital but whether or not it is a reward for risk-taking from Islamic view point is questionable. It is argued that risk is neither a commodity which the so-called risk-taker (capitalist) offers to society nor work commanding valuation.

Islamic theory of production does not recognize any gain, reward or income as legitimate unless consequences of an action. Two options are open to him:

(i) He must desist from the action if he cannot overcome the fear of adversity, or

(ii) He must conquer his fear and act whatever be the consequence. As evidence consider the following examples

**Abolition of interest:** One justification capitalism advances for charging interest is the element of risk involved in lending. Thus, the lender has a right to compensation in the form of interest. No Islamic economist can deny that loans carry risk; why then Islam bans interest? Simply because interest is not the result of any productive exertion undertaken by the lender

**Ban on gambling:** Like interest, Islam prohibits gambling and earnings based on it albeit gamblers take great risks, are even ruined. The reason again is that labour in gambling is unproductive in the Islamic sense.

The ban on gambling extends to the sharing of individual earnings pool also. To illustrate, *Shari‘ah* would not allow two teachers entering into partnership to take tuitions separately but pool their earnings to be shared in a pre-agreed ratio. Why, to avoid risk of anyone of the two not getting the just reward for his work due to the possibility of a plus or minus element brought in by the sharing of risk.
**Tools of production:** The tools of production are not allowed to have a share in the profits of a venture even though they too are exposed to risk in the process. But tool owners are not denied a return; they gain in the form of fixed returns (Rentals).

**Some other earnings involving risk disallowed:** Certain sources of income (gain) like magic, witchcraft, fortune-telling or jugglery are not allowed in Islam even if risk is involved because they do not contribute to socially useful production.

These all and the like are the ways of eating each other’s wealth in vanity as no trade with mutual consent is involved (Qur’an 2:188; 4:129). Even as risk may be involved, gain/profit may not be legal. The permissible way of generating profit and its sharing are allowed in all cases where participants can be shown as contributing to socially useful production. Baqir-as-Sadr (1984, 76) laments as follows:

“Many have fallen into error influenced by capitalist thought which has a tendency to explain the point and its defence on the basis of risk. They say or have said that the profit allowed to the owner of the stock-in-trade (cash capital or commodity) in the mudarabah contract is theoretically based on risk because even though the owner of the stock-in-trade does not do any work yet he bears the burden of the risk and exposes himself to loss over his cash or commodity to the agent trafficking with it; so it is the duty of the agent to make proportionate percentage of compensation against the ventured risk out of the profit agreed upon in the mudarabah contract between them.

But the fact has been made fully clear in the previous discussion that the profit which the owner of the cash or commodity obtains as a result of the agent’s trafficking of it is not based on the risk but receives its justification on the basis of proprietorship of the owner of the cash or commodity with which the agent traffics”.

If one wants to make risk-sharing the unshared fulcrum of Islamic finance, one must elaborate the extended view of risk and show its applicability in various socio-economic conditions as harmonizing with Islamic norms of justice. An attempt to do so has to be comprehensive and complete. Any such attempt would raise insoluble problems.

Presumably, the risk-reward connection is being grossly overdone; the profit which the owner of a commodity obtains through its sale is based not on the risk he takes but on the basis of the commodity proprietorship, even if the price increases due to his transferring the commodity to the market for ready availability to the consumers, for he continues to remain its owner (Baqir-as-Sadr 1984, 75 -76).

At times the proponents of risk-sharing switch over from mundane to the cosmic world in their expositions without notice or forging a link between the two sets of argumentation. To us, the possible link seems to be in interpreting cosmic as application of the Divine intent to the totality of social existence. If this view is acceptable, risk-sharing must be applied in all walks of life not among business capital providers alone.

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8 Many classical jurists had indeed classified *mudaraba* as *ijara bi-l-gharar*; hire with (forbidden if excessive) uncertain wage. The contract may even include an element of *riba*, if the profit share is not commensurate with the work done, fairness being determined by the market wage. (El-Gamal 2014)
Take just one illustration at the micro level: the labour-capital relations in production. Both factors are exposed to risk of different sorts though. Market capitalism is worried about the risk of losing money and material but wary of the risks to which limb and life of the workers are exposed. Palpably, both labour and capital join hands in producing the resultant output; it is the outcome of their combinational productivity. Its current division between profit and wages is arbitrary unless labour gets a share in profit subject to a minimum wage constraint (Hasan 1975 and 1983). The proponents of risk-sharing in Islamic finance invariably remain silent on such issues in their cosmic discussions on Islamic injunctions.

No less dubious is the exclusionist approach of the risk-sharing advocates. Consequently, some crucial questions remain unanswered: Would mainstream finance that rest essentially on the institution of interest and is blamed for risk-shifting welcome the proposed replacement, given its global dominance? More than that, can Islamic finance survive purely on risk-taking? Arguably, it is not the case of risk-sharing or risk-transfer; it is a case of building appropriate trade-off between the two, irrespective of the system – conventional or Islamic. If conventional banks could indeed shift all their risk to clients in the current crisis, the clients alone would have suffered. That mighty banks crumbled like sand walls was only proof that they had taken excessive risks i.e. beyond their capacity. In the same way, the participatory finance in Islam entails the shifting of risk partially to the depositors. Calling it risk sharing or shifting is a matter of taste, not of principle.

5. CONCLUDING REMARKS

This paper aimed at examining the logic and feasibility of an old precept recently revitalized in Islamic economics. The precept says that Shari’ah permits no gain unless risk is involved in its earning. It is argued that risk-sharing alone is commensurate with Islamic norms of financing.

They blame increasing crises on the interest-based finance because it promotes transfer of risks not their sharing. Islam bans interest and allows only sharing of risks in financing – not their transfer. Thus, there is a case it is argued to replace the conventional crisis prone system with the risk sharing Islamic regimen as such replacement alone can ensure justice and stability free of crises in modern economies. It is claimed that better performance of Islamic banks during the current turmoil compared to the conventional is evidence enough to clinch the point.

This critique has highlighted unacceptability of the above argument on both the juridical and feasibility fronts

Interest based financing is not altogether devoid of risk taking; nor all transactions in Islamic finance are based on risk-sharing in the same way as equity. A fixed return benchmark is as much needed in financing – conventional or Islamic - as the sea level for measuring heights in geography. It is interesting that the Kuala Lumpur declaration of October 1, 2012 on Risk-Sharing as an alternative to interest based finance skirted around the proposal only to say this much:

“Governments should endeavour to move away from interest-based systems towards enhancing risk-sharing systems by levelling the playing field between equity and debt”.
The paper concludes that ‘no risk, no gain cannot be defended as an exclusive principle of Islamic finance. Risk is not a tradable commodity or an act in itself contributing to the value of output. Many transactions involving risk are not allowed while many transactions not involving any risk are. Sharing of profit and loss is valid but its basis is not the existence or absence of risk. Required is reform of the current arrangements not their replacement, especially due to the inevitability of financial dualism continuing across the global. Striking a judicious balance and building appropriate trade-offs between equity and debt is what we need.

Finally, in evaluating a situation and its causes the moral and ethical dimension invariably escapes our attention. Principles of economics are essentially principles of economic policy and no policy is worth more than what it is in implementation. An IDB publication aptly says:

“At its heart, Islamic finance is a moral system of finance. It emphasizes the balance between for-profit activities, or the market, and not-for-profit activities, including social and philanthropic activities. No economy can enjoy sustainable prosperity without the two domains in healthy equilibrium. Just as a bird cannot fly smoothly without the two wings properly functioning in tandem, an economy cannot “fly” without the two domains properly operating and serving the common good of the society.”

Most of the writings in the area of Islamic economics and finance are oblivious to the fact that the moral wing of the bird today is utterly non-functional, if not broken. They present their postulates on the tacit assumption that people are reasonably committed to moral and ethical norms which unfortunately is not the case. When confronted with the choice of reaping economic benefits or obeying religious imperatives worldly concerns tend to overweight the hereafter considerations even among the pious.

Ground realities and their compulsions are not as much flexible as instruments suggested to transform them would require. The proponents of making risk-sharing the sole basis of Islamic finance should not only re-evaluate its Shari’ah base they should also evaluate the feasibility of such suggestions as erecting a new stock exchange that they think would enable equity-based financing replace debt-based instruments like sukuk that have become well-entrenched in the system and dominate it. (Rudnyckyj, 2014, 123).Their indiscreet acceptance may lead to non-delivery, possibly to disastrous result. The least the proponents can do is not to shun debate on their proposals and deal the question marks being put on their thesis.

No finality is claimed for the observations made or conclusions drawn herein. A major objective of this paper was to initiate debate and discussion on an important subject in the area of Islamic finance. Comments and criticism if any are welcome for revision.

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Presumably, such exclusivity has no historical evidence as well. Murat Cizaka, the acclaimed historian of Islamic finance writes: "Thus, it follows that Islam prefers risk sharing to risk shifting (2014, 1)."
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Conventional Bank Interest and the 
*Murabahah* (cost-plus-profit) Contract in 
Islamic Finance: Two Sides of a Coin or two 
Coins of Different Sides?

By

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Abstract

The emergence of the Islamic banking system led to the introduction of some 
financial transactions which were not hitherto considered in the classical 
books on Islamic financial system. *Murabahah* is one of such innovations. 
Like most of those newly introduced products of the Islamic Financial System 
or Arrangement (IFS or IFA), otherwise referred to as Products of Islamic 
Banking (PIB) or Products of Islamic Finance (PIF), arguments have been 
 canvassed for and against the legality of *Murabahah* under Islamic Financial 
Principles (IFP). Of all the criticism against its operation, the most 
pronounced depreciation against it posits that, *Murabahah* is too close to 
interest transaction in the conventional banks, and cannot therefore be 
legally allowed in IFS. This paper examines the criticism and posits whether 
the criticism is tenable or not on the scale of the Islamic Law and given the 
financial market challenges facing the contemporary Muslim world.

*Key Word:* Bank Interest, Murabahah, Islamic Banking, Financial System

1. **INTRODUCTION**

“A *murabahah* facility may appear similar to conventional bank financing with the 
profit rate or mark-up being contemporaneous with the rate of interest. Indeed the 
distinction between the two may disappear if proper care is not exercised. *Shari’ah* 
therefore imposes several constraints and prescribes certain norms in order that a

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murabahah facility is free from *riba*. Conditions that aim to keep the product free from prohibited *gharar* are also prescribed.”

One of the innovations of the modern Islamic Financial System (IFS), otherwise called Products of Islamic Banking (PIB), is *Murabahah*, translated as *cost-plus-sales sales*. *Murabahah*, which has become the backbone of contemporary Islamic banking, is commonly used for financing the purchase of raw materials, machinery, equipment, and consumer durables. By its nature, it is a form of trust sales in IFS and it is one of the five categories which sales as exchanges can be classified into under IFS. Because of the trust involved in its operation and the aspiration of people which *Murabahah* is able to meet, it has been widely embraced and customers of Islamic banks all over the world have been making a preferred choice for it over other PIBs.

In grounding the legality of *murabahah* under Islamic Financial Principles (IFP), reliance has been placed on the major proofs of Islamic law and practices of the early generations of Muslims. However, notwithstanding the seemingly proofs found for its

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4. It is called trust sale because of the confidence the contracting parties have in the valid information given by the seller about the cost price. See Bakr Abdullahi Abu Zayd ‘Fiqh al-nawaaziq qodoya fiqhiyyah mu’asiroh,’(Riyad, Muassasatu al-risalah,vol.2.1401AH),p.67
6. For instance, Murabahah is commonly used by Islamic banks for the short-term trade-financing needs of their customers. see Bala Shanmugam and Zaha Rina Zahari,above note 3,p.31
7. Ashurst Islamic Finance Institution, in its January 2009 Briefing, while making reference to the *Middle Eastern Insurance Review December 2008*, observed that, “At the end of 2008, the size of the Islamic finance market was estimated to be US$1tn. Of this, the commodity murabahah market was alone estimated to be US$100bn”. See [http://www.ashurst.com/doc.aspx?id_content=4298](http://www.ashurst.com/doc.aspx?id_content=4298).
9. These are the generations of the Companions of Prophet Muhammad (*Ashabu Rasul*); of those that followed them (*Tabi’*) and of those that followed *Tabi’* (*Tabi’-tabi’*). For a study on the nature of these generations and the landmark contributions they made to the
justification, *murabahah* has not been completely free from the shackle of criticism and condemnation of some contemporary jurists, for example M. Siddiqi. The most pronounced of such deprecation against its operation is the argument that, *murabahah* is too close to bank interest, which is condemned as a form of *riba*, or even that, it is the same as bank interest, but just not so called or called with another nomenclature. In essence, some Muslim scholars reject *murabahah* because, to them, it is another *riba* product packaged in another brand, but with the same ingredients and taste which bank interest gives in the conventional banks. Certain reasons were advanced for this criticism.

Accordingly, this paper examines the arguments canvassed as criticism against the operation of *murabahah* as one of the PIB in the contemporary world. The significance of this study is to disclose if there is truly no dichotomy between *murabahah* and bank interest; i.e. if both are placed on a liberal scale of Islamic law, will the scale tilt to adjudge them as the same? The paper will provide answers to this poser. The paper will take a position on whether the criticism is tenable or not.

II. **PURPORT OF MURABAHAH AND HOW IT OPERATES**

In a simple term, *murabahah*, which is also called bai’ as-salam al-hal (immediate forward sale) can be explained as a sale on a cost-price basis where payment of the price (including the mark-up) is deferred to a later date. It is a financial arrangement whereby a fixed profit is agreed to between the seller and the buyer while both of them have the knowledge of the cost price of the commodity. Siddiqi describes it as follows: “*Murabahah may be defined as a sale in which the margin of profit is mutually agreed upon between the buyer and the seller. The payment of sale price, inclusive of the agreed profit margin, may be immediate or deferred and either in lump sum or in instalments*”.

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Bakr, above no 4, p. 67.


The quantum of profit agreed to can be in form of specific amount or stated in ratio or percentage form. The seller (i.e. the Bank) to the ultimate buyer (i.e. the Bank’s Customer) essentially stands in the position of a financial facilitator between the original vendor and the ultimate buyer, while it also, through that facilitating role, transacts business and makes profit. At its initial introduction and operation, *murabahah* was a form of sales arrangement, but it is now utilised primarily as a mode of financing in the modern Islamic financial institutions. On the strength of this, *murabahah* contract is of two forms, namely simple *murabahah* and *murabahah* to subscribers. The former is “when the seller market their goods to the buyer at a price corresponding acquisition cost plus a profit margin desired” while the latter, which is the form that is commonly operated by modern Islamic banking in financing, “involves three parties, namely the subscribers, the buyer and seller...also involves as an intermediary buyers for their expertise or because the buyer will need financing”.

Operation of the *murabahah* transaction in Islamic Financial institutions can be illustrated as follows:

*Person A is in need of commodity X. A approaches Bank B. B buys X from vendor/supplier V at price P. This price is also known to A. Next, B sells X to A at a marked-up price, say P+M, where M is the agreed profit or mark-up taken by B. Typically, the mark-up charged will be based on a benchmark such as LIBOR plus a margin. The payment of price P+M is now deferred to a future date and is made in full or in parts.*

The operation of *murabahah* in the modern time as illustrated above can, according to Bakr, take three forms:

1. It may be that the contracting parties i.e. the bank and its customer, mutually make unbinding promise to enter into this arrangement and without mentioning a marked-up price in advance before the delivery of the commodity.
2. This is akin to the first form above except that a marked-up price is mentioned before the delivery of the commodity.
3. Here, the contracting parties mutually agree that both parties are liable to complete the contract and a marked-up price is mentioned before the commodity is delivered.

The first form is allowed because there is no binding promise between the parties as to the completion of the contract and that the customer is not liable to compensate the bank in case the commodity perished before the final delivery to the former. Also, there is the presence of risk as the bank is not even sure that the customer is going to buy the

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18 Atima Shofawati, above note 17, p.4
20 See Bakr, above no 4, pp 79-80
commodity from it with profit. However, the second and third forms are unlawful because in the second the profit accruable to the bank has been fixed before the actual delivery of the commodity while in the third form, which is akin to arrangement obtainable under conventional banks, both parties have agreed as to the liability of the parties to the completion of the contract and fixed profit accruable to the bank even before the actual delivery of the commodity. Also both have mutually stipulated that one of them is liable if the commodity is perished.

It would be observed that the object of transaction upon which the whole activities involved in murabahah is the commodity which the customer of the bank is in need of. This point must be noted as it is going to serve lots of purposes in appreciating the extent of justification or otherwise of the arguments of those who condemn murabahah transaction. Before proceeding, it is necessary to understand the conditions and principal steps in murabahah transaction.

III. CONDITIONS AND PRINCIPAL STEPS IN THE MURABAHAH TRANSACTION

Generally, five major conditions have been laid down to be fulfilled for any sales on murabahah arrangement to be valid under Islamic law. Also, four principal steps have equally been designed to be followed for murabahah transaction not to be observed in a way bank interest is practiced in the conventional banks. For an easy appreciation of the conditions and the steps, the paper will look at them one after the other as examined below.

i. Conditions for a Valid Murabahah Sale

a. Knowledge of the initial price by the parties: There must be certainty about the original price of the commodity or object of sales as at the time of the agreement. This is to avoid transaction involved in gharar (uncertainty). The sale based on murabahah arrangement will be invalidated for defectiveness if the initial price of the commodity is not known to either or both parties.

b. Knowledge of the Profit Margin: As parties enter into the murabahah agreement, they must specify the quantum of profit to be made by the seller, which may be expressed in terms of cash sum, ratio or percentage. Failure to do this will defeat the whole essence of murabahah and invalidate the transaction as a whole.

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21 See Bakr, above no 4, p.90
22 See Bakr, above no 4, p.90
25 Al-Zuhayli, above note 2, p.355, Bakr, above no 4, p.68
26 Mansour A. Al-Meather and Chris J. Mitchell, above note 23, p. 664
27 Al-Zuhayli, above note 2, p.355
c. **That the original price is fungible:** This implies that the price must be measurable in terms of number, weight or volume. For example, if the commodity, subject matter of the *murabahah*, is measured in tons, the price of a ton of the goods must be capable of usage in calculating and ascertaining the original price. If this cannot be done, then the *murabahah* will not be valid.28

d. **The goods in which the murabahah is traded must not be eligible to riba:** It is required that the transaction is conducted in a way that will not give room to riba. Thus, the focus of the transaction must be on the commodity itself and not on bringing about increase on the money released.29 However, in a situation where the customer defaults, bank can impose penalty if stipulated in the original contract of *murabahah* even though same cannot be included in income of the bank but instead be spent for charitable purposes.30 Notwithstanding that the bank can impose penalty in case the customer defaults, certain conditions are required, namely penalty is imposed during the pendency of murabahah transaction and that the customer is in fact in good financial status to complete the murabahah contact but he chooses to deceive the bank.31

e. **That the initial contract is valid:** It should be noted that there are two contracts involved in *murabahah* transaction. One is between the Bank and the Vendor of the commodity while the other is between the Bank and the last buyer of the goods, who is the customer of the Bank and in whose favour the contract of *murabahah* has actually been prepared.32 What this condition therefore stipulates is that if the contract between the bank and the vendor is defective or invalid for whatever reason, the contract of *murabahah* built on it will equally be defective or invalid, as the case may be.33

ii. **Principal Steps in Murabahah Transaction**

In Islamic finance markets, the following have been identified as the principal practical steps that must be followed for execution of a valid *murabahah* sale:

a. The client indicates an interest in purchasing a particular asset from the bank for a certain price (a combination of cost price plus profit) at a certain time (the utilisation date)34.

b. The client identifies the vendor, selects the goods and advises its particulars, including the vendor’s name and its cost price to the bank in writing. Often the

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28 Al-Zuhayli, above note 2, p355
29 Al-Zuhayli, above note 2, p356
31 Rifki Ismal,above note 30,p.109
32 Al-Baraka Release, above note 9,also Mansour A. Al-Meatier and Chris J. Mitchell,above note 23, p.664
33 Al-Zuhayli, above note 2, p356.
34 This is the reason why modern murabahah transaction is also known as’*murabahah to the purchase orderer‘ (bai’*murabahah lil amir bish- shirai‘).See bakr,above note 4,p.81,also Bala Shanmugam and Zaha Rina Zahari,above note 4,p.32
bank will appoint the client as its wakil (agent) to acquire the asset on the bank’s behalf.

c. The bank acquires the asset and offers to sell it to the client. The vendor will typically make delivery of the asset to the client (as the bank’s agent). Delivery need not to be physical, it can also be constructive (i.e. evidenced by delivery of documents of title).

d. The agency comes to an end. The client accepts the offer and the bank immediately sells the asset to the client, with payment due on the agreed date in future.”

It is worth noting that all the analysis made so far on murabahah is to give a general background knowledge on the whole essence of the transaction. Without doing this, one may not appreciate what the paper intends to bring out on the relationship between murabahah and bank interest, which has informed the condemnation made against murabahah. The paper will therefore proceed to briefly look at the basics of interest in the conventional banking system.

IV. INTEREST IN THE CONVENTIONAL BANKING SYSTEM

The word “interest” on something in finance parlance is lexically defined as ‘money charged for borrowing money, or paid to somebody who invests money’. In the legal parlance, interest ‘signifies a sum payable in respect of the use of another sum of money, called the principal’. Activities involved in the transaction based on interest revolved round preservation of the money given out. Bank interest is identified as a product of capitalist economy which is antithetical to the Islamic economy system. More significantly, bank interest arises in money-lending business, which is equally not permissible in Islamic financial system. This explains why the Qur’an condemns those who equate money-lending business with trading that is permitted in Islam.

What may occur to parties in money-lending business, which is the basic activity in which interest is involved, but, which cannot happen, to those who are involved in murabahah transaction, can be explained in the following terms:

“…one person lends out capital in the form of a debt, and a second person puts in his labour; if there is a loss, it has to be borne by labour, but, profit or loss, interest does accrue to Capital in any case”.

The point being made is that, in the transactions involving bank interest, the loss that may occur on the loan is not attached to the loan while the loan capital will continue to yield benefit to itself whether profit is made or not. This is contrary to the practice and

39 Shafi, above note 19, p16.
40 See Qur’an 2: 275.
41 Shafi, above note 19, p16.
ethics of business transaction allowed in Islam in a situation where a person borrows second person’s money for the purpose of business or for any purpose howsoever. Shafi draws home the point as follows:

“Thus, under the Islamic system of economy, if a man wants to lend his money to a businessman for being invested in business, he will have first to decide clearly whether he wishes to lend this money in order to have a share in the profit, or simply to help the businessman with his money. If he means to earn the right to a share in the profit by lending his money, he will have to adopt the mode of ‘partnership’ or that of ‘Co-operation’. That is to say, he too will have to bear the responsibility of profit or loss – if there is eventually a profit in the enterprise, he shall have a share in the profit; but if there is a loss, he shall have to share the loss too”.  

The foregoing has illustrated the mode of financing in the conventional banks; how and why it attracts interest. The point must be made that the parties under that arrangement have no concern for mutual benefit of each other particularly the bank is not bothered about the benefit of the customer. This is unlike what is obtainable in Islamic Financial Institutions products, including murabahah.

V. BANK INTEREST AND CRITICISM AGAINST MURABAHAH

i. Overview of the Criticism

As earlier observed, reliance has been placed on the major proofs of Islamic law to ground the legality of murabahah under the Islamic Financial Principles. In the same token, it has equally been noted that bank interest did not receive the sanction of Islamic financial system. In fact, this is the major reason why Islamic banking system is otherwise variously referred to as “Interest-Free, Zero-Interest or Non-Interest Banking System”.  

The general principle of Islamic financial system is that, the risk inherent in the capital engaged in any business is borne mainly by the capital. This is why Islam has therefore put in place different ways in which capital can be invested in a business venture, not inclusive of the money-lending method. Thus, once the moral objectives of the Islamic financial system is preserved, Islamic banks would be justified to adopt new financing policies and methods and explore new channels of investments which may encourage development and support the small scale traders to lift up their economic level. To this end, operation of murabahah in Islamic Financial Institutions may be justified.

42 Shafi, above note 19, p17.
43 For analysis of Islamic Banking System with all these nomenclature, see Nejatullah Siddique, Banking Without Interest (Markazi Maktaba Islam, Delhi, 1979); Waqar Masood Khan, Towards an Interest-Free Islamic Economic System – A Theoretical Analysis of Prohibiting Debt Financing (The Islamic Foundation, U.K. and The International Association for Islamic Economics, Islamabad: 1985); and, Muhammad Nejatullah Siddiqi, Issues in Islamic Banking (The Islamic Foundation, 1983).
It is interesting to note that, the argument that *murabahah* has close similitude or proximity to bank interest has been advanced based on the similarity in the operation of the two systems. An illustration will draw the point home. When the conventional bank advances loan to its customers, the amount to be paid as interest is fixed and agreed upon. Similarly, in *murabahah* transaction, the mark-up or the profit margin to be made by the Islamic bank is also fixed and agreed upon. Besides, under either of the two arrangements, the payment of the principal sum or cost price, as the case may be, and the interest charged thereon or the profit put on it will be paid in deferment either in cash or instalments. There is no doubt that these two activities are too close for one not to take them as the same. But, it will be too premature for that conclusion to be drawn.

It should be stated that *murabahah* has also been rejected by those who do not welcome it on the ground that, contrary to the arguments of the proponents of the transaction that it is supported by the proofs of Islamic law, it is based on a particular juristic opinion not shared by many eminent jurists. It has also been argued that, *murabahah* is a mere cover for continuing interest-based transactions. Thus, the whole fear expressed against *murabahah* vis-à-vis its proximity to bank interest has been summed up by Siddiqi as follows:

“Those needing finance for purchase or import of inputs would approach the banks to buy the item for them, with the commitment to buy it from the bank at a higher but deferred price. The mark-up will naturally tend to be higher the longer the period of time involved. The banks will have a guarantee of receiving back the price they actually pay plus a predetermined return as the result of the mark-up. For all practical purposes this will be as good for the bank as lending on a fixed rate of interest.”

Before concluding this segment, it is worthy of note that *murabahah* has equally been condemned as a *riba* transaction in disguise and especially regarded as a camouflage introduced to present Islamic banking as truly Islamic when in actual fact, the whole idea of Islamic bank has no valid basis in Islamic law. Thus, they posit that since Islamic banking system itself is *haram* (Islamically forbidden), *murabahah* is also *haram*. Their depreciation of the *murabahah* is finally hinged on the argument that, *murabahah* has the great potential of leading to *riba*, even if it is conceded that it is not by itself a *riba* activity; and, that the principle of Islamic law stipulates that anything leading to what is prohibited stands prohibited. The paper will now proceed to critically analyse the criticism against *murabahah* stated above.

45 Siddiqi, above note 9, p138.
46 Siddiqi, above note 9, p138.
47 Siddiqi, above note 9, pp138-139.
48 For a comprehensive argument against the institution of Islamic banking in this direction, declaring it as *haram*, see Umar Ibrahim Vadilo, *Fatwa on Banking and the Use of Interest Received on Bank Deposits* (October, 2006), available at [http://zakat.files.wordpress.com/2006/11/fatwaonbanking.pdf](http://zakat.files.wordpress.com/2006/11/fatwaonbanking.pdf)
49 Siddiqi, above note 9, pp139. For a study on this principle and other legal maxims of Islamic law principles, see Mohammad Hashim Kamali, “Qawa’Id Al-Fiqh: The Legal Maxims of Islamic Law” in Association of Muslim Lawyers, UK Journal.
ii. A Critique of the Criticism

The starting point is to look at the definitions of both *murabahah* and interest and consider the subjects or objects of transaction in the two financial activities. Without engaging in any unnecessary repetition, it is glaring from the previous analysis above that the two transactions are not equal in definitions and neither are their objects or subjects the same nor similar. The definition of *murabahah* falls squarely under trading or business transaction which is permitted in Islam while interest is within the scope of *riba*, which is not permitted. Thus, the basic dichotomy a critical study of both *murabahah* and the bank interest will show glaringly that, bank interest accrues to the bank without any attendant risk attached to it in the event of loss whereas in *murabahah* risk is attached to the capital advanced and even the goods purchased by the bank will remain the property of the bank until final valid delivery of same is made to the bank’s customer and in the event of any loss before such delivery, the customer will not share from it.  

Coming to the criticism of *murabahah* based on the fixed rate of benefits to accrue to the bank on the money released to the customer, which is common to both *murabahah* profit-margin or mark-up and bank interest, the criticism will seem not to have been properly placed. There is no principle of Islamic financial transaction against fixing of profits once the parties are *ad idem* on the arrangement and it is to their pleasure and mutual satisfaction, which is the ultimate goal of trading in Islam.

Further, the criticism against *murabahah* will also be unfounded considering the fact that all the conditions laid down to be fulfilled before any *murabahah* transaction will be valid are not stipulated and completely out of place in the transaction where bank interest is involved. Usmani properly captures this point when he expressed his view against the criticism as follows:

“I do not subscribe to the view of those people who do not find any difference between the transactions of conventional banks and Murabahah and Ijarah for perpetuating the same business with a different name, because if Murabahah and Ijarah are implemented with their necessary conditions, they have many points of difference which distinguish them from interest-based transactions”.

The point being made is that, the conditions prescribed to be complied with before a *murabahah* transaction can be valid, which are not of concern to the conventional banks, stands as a major ground while the criticism against *murabahah* as being close to bank interest cannot hold water. This paper also does not find the criticism well founded at all. Al-Baraka Bank also draws home the point further in the following words:

“The *murabahah* transaction does not come into existence by merely replacing the word ‘interest’ by the words ‘profit’ or ‘mark-up’. Actually, *murabahah* as a mode of financing, has been allowed by the Shariah scholars with some conditions. Unless these conditions are fully observed, *murabahah*

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50 Imran Ahmad and Ghulam Shabbier, above note 23, p.22
51 Quran 4, verse 29 vindicates this assertion when Allah says: “O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent”.
52 Usmani, above note 1, p97.
is not permissible. In fact it is the observance of these conditions which can
draw a clear line of distinction between the interest-bearing loan and the
transaction of murabahah. If these conditions are not observed, the
transaction becomes invalid according to Shariah”.53

A consideration of the basic features of murabahah will also bring into fore the
fallacy of the criticism against its operation in Islamic financial institutions. Such features
include the fact that, murabahah is not a loan given on interest; it is a sale of commodity
for a deferred price which includes any agreed profit added to the cost; and that being a
sale and not a loan, murabahah must fulfil all the conditions of sale laid down in Islamic
law54 and once this is done it would be contrary to the Islamic commercial principle to
equate such commercial transaction with trading in interest.55 The paper can go on and on
to demonstrate the favour of Islamic financial principle which murabahah enjoys and
showcase the weakness of the criticism against its operation. But, it seems the point has
been properly made.

IV. CONCLUSION

In any Islamic financial transaction, all norms of commercial ethics enunciated by
Islamic law must be observed. All new modes of financial transactions brought about by
the emergence of Islamic banking system have been concerned with compliance with the
Islamic financial norms. Out of those numerous newly introduced financial systems,
murabahah (cost-plus-sale) has been rejected by some scholars as being unable to fulfil
the required norms on the ground that it has proximity to bank interest. This paper has
examined the arguments canvassed within the terrain of that line of criticism. The
criticism has been critically analysed. The paper has disclosed that, giving a proper
understanding of the operation of murabahah, the criticism against its operation by
Islamic financial institution is misconceived and cannot be grounded. The demand of the
contemporary Islamic market will not favour the criticism.

54 Al-Baraka Release, above note 10
55 Just as Allah refuted justification of interest trade by those who engage in it on the ground of
its similitude with lawful transaction where profits are made, it would be legally
unacceptable to equate a lawful transaction like Murabahah with interest trade no matter
how closely they may look alike. In Quran 2, verse 275, Allah says: That is because they say:
“Trading is only like Riba(usury)”, whereas Allah has permitted trading and forbidden
Riba(usury).
Shari’ah Compliant Liquid Commodity Market: {An Expositional Study on Bursa Suq al-Sil’ah in Malaysia}

By
Abdul Azeez Maruf Olayemi, Aznan Hasan, Uzaimah Ibrahim, Ahmad Hidayah Buang, & Riaz Ansary

Abstract
One of the major challenges before the emerging Islamic financial Institutions is the dearth of Shariah compliant money market platform for the management of their liquidity. However, a viable panacea to the problem has been developed in Malaysia. One of the measures that was taken for the solving of the problem in the country was the creation of Bursa Suq al-Sil’ah which is a Shariah compliant liquidity commodity market. The market is tremendously efficient and it can form a model for other countries. This paper submits that the creation of a similar commodity market in the emerging jurisdictions will mitigate the problem of Shariah compliant liquidity management to a great extent. The study adopts Shariah method in its analysis in view of buttressing the mechanism of Bursa Suq al-Sil’ah as a model for the emerging jurisdiction.

Keyword: Liquid Commodity Market, Bursa Suq al-Sil’ah, Emerging Islamic Financial Institutions;

1. INTRODUCTION
This paper studies the Malaysian Bursa Suq al-Sila’h which is an integral part of the Islamic Interbank Money Market in the country. The market is a commodity based

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liquidity management platform at both the Malaysian local and international banking system. It is the first internationally accepted Shari’ah compliant market for commodity trading. In another word, Bursa Suq al-Sila’h is an Islamic commodity trading platform for the Islamic money and capital markets. The market was established to serve as a multi-commodity and multi-currency platform, with the trading of CPO (Crude Palm Oil). It’s entrance is through the internet and it is entrenched in multiple security features. Its activities are under the purvey of ‘Bursa Malaysia Islamic Services Sdn Bhd (BMIS) which is a subsidiary of the Bursa Malaysia Sdn Bhd. The study relies on jurisprudential, conceptual and theoretical methods.

2. The Concept of Suq al-Sila’h

To start with, lexically, Suq al-Sila’h is an Arabic noun-phrase which literally means ‘commodity market.’ However, technically, it is a mechanism whereby a financial institution will buy a commodity at a known specified cost and sell it to a customer at a cost-plus-profit basis, while the customer itself, or through the proxy of the seller-institution, will sell the commodity back to the commodity market on the basis of spot cash payment. The transaction involves the sale and purchase of real physical assets. It operates under the contracts of al-Murabahah, al-Tawaruq and al-Musawamah, and the underlying asset is the Malaysian star product. That is, the Crude Palm Oil (CPO).

The Suq al-Sila’h was historically launched on 17th of August 2009 by Bursa Malaysia through its subsidiary Bursa Malaysia Islamic Services Bhd. Prior to the launching of the Suq al-Sila’h it was known as ‘Commodity Murabahah House.’ It serves the purpose of providing an internationalized Shari’ah compliant Islamic financing and short term instrument of liquidity management. It portrays Malaysia as the leading global Islamic finance hub. It is a Shari’ah compliant end-to-end system and it is designed to comply with the international standards of Shari’ah requirement.

Thus, Suq al-Sila’h is well accepted internationally, including in the highly selective GCC (Gulf Co-operation Council) market. Its uniqueness is embodied in the fact that it is the first global electronic platform for the facilitation of Shari’ah based commodity investment and financing transactions. Its activities are structured on the basis of Shari’ah requirement of real economic transactions. Thus, in the situation whereby an Islamic bank grants a financing on the basis of Suq al-Sila’h it must first of all purchase an asset and then sell it to the seeker of financing. The financing seeker will then sell such commodity by appointing the bank as its agent to carry out the sale. The proceeds of the sale will then be used for the purposes of the financing. Therefore, in Suq al-Sila’h the transaction of the sale of commodity, the transferring of its ownership and its delivery lends more credence to the activities of the Islamic financial market under the auspices of ‘Bursa Malaysia Bhd Sdn.

1 Bursa Malaysia, Commodity Murabahah in Deposit, at 7.
2 MIFC (Malaysia International Islamic Financial Centre), Bursa Malaysia, Press Release on World first shariah-based commodity trading platform to facilitate Islamic finance goes live, at 2.
3 MIFC (Malaysia International Islamic Financial Centre), Bursa Malaysia, Press Release on World first shariah-based commodity trading platform to facilitate Islamic finance goes live, at 1.
3. **Bursa Malaysia Bhd Sdn**

Bursa Malaysia Bhd is the Malaysian Exchange Holding Company which was established under the provision of Section 15 (2) of the Capital Market and Services Act 2007, which provides that; ‘The Minister may in writing, on the recommendation of the Commission, approve a body corporate as an exchange holding company, subject to any terms and conditions as he thinks fit, if he is satisfied that it is appropriate to do so.’\(^6\) It is vested with the functions of exchange services such as selling, clearing, settlement and other depository services.\(^7\)

Nevertheless, the history of Bursa Malaysia Bhd Sdn went back to the year 1930 when it was established as the first formal securities business organization in Malaysia, under the name ‘Singapore Stockbrokers Association.’ However, its registration was under the name ‘Malayan Stockbrokers’ Association’ in 1937. Moreover, in 1964, the Stock Exchange of Malaysia was established to create an avenue for the public trading of shares. However, after the separation of Singapore from Malaysia in 1965, the Stock Exchange of Malaysia became known as the Stock Exchange of Malaysia and Singapore. More so, in 1973, when currency interchangeability between Malaysia and Singapore stopped, the Stock Exchange of Malaysia and Singapore was divided into the Kuala Lumpur Stock Exchange Bhd and the Stock Exchange of Singapore. The Kuala Lumpur Stock Exchange was incorporated on December 14, 1976 as a company limited by guarantee and it started the operations as the Kuala Lumpur Stock Exchange Bhd in the same year. It was the Kuala Lumpur Stock Exchange that changed its name to Bursa Malaysia Bhd on April 14, 2004. The organization focused on various initiatives, which were aimed at improving product and service delivery, improving the liquidity and increasing velocity of the markets, as well as the efficiency of business operations in Malaysia.\(^8\)

Moreover, the regulatory framework of Bursa Malaysia Bhd is inclusive of the Capital Markets and Services Act 2007\(^9\), Securities Industry (Central Depositories Act) 1991\(^10\), Securities Commission Act 1993,\(^11\) Companies Act 1965,\(^12\) Offshore Companies Act 1990,\(^13\) and Labuan Offshore Securities Industry Act 1995,\(^14\) as well as the Memorandum and Articles of Association. The stakeholders of the company are the Securities Commission which is the regulator of Bursa Malaysia Bhd, the MIFC\(^15\) which is the main coordinator of Islamic financial services, Bank Negara Malaysia which is the regulator of the Islamic bank that are the participants in the market and also uses it as instrument of liquidity management, Bursa Malaysia which is in the position of the counterparty to the buyer and the seller of commodity in the market, the suppliers of

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\(^7\) MIFC (Malaysia Islamic Financial Centre), Malaysia Islamic finance directory, (Kuala Lumpur: CERT Publications, 2008), at 12.


\(^12\) Companies Act 1965.

\(^13\) Offshore Companies Act 1990.


\(^15\) Malaysian Islamic Financial Centre.
crude palm oil (CPO) which is the underlying asset of the instrument, the Islamic banks and the Islamic windows in the conventional bank that utilize it for the management of the liquidity of their various portfolios, as well as the brokers who are the agents of the banks and the suppliers.16

3.1 The Mechanism of Bursa Suq al-Sila’h

Bursa Suq al-Sila’h is designed to accommodate multiple currencies and many types of commodities as well as the issuing of E-certificate that represents the ownership of commodities in the depository of the Bursa Suq al-Sila’h (BSAS). In addition, only the participants that are registered by the Bursa Malaysia Islamic Services Bhd (BMIS) can participate in the trading activities of the market. The categories of the parties in the trading includes, the commodity trading participants (CTP), the commodity supplying participants (CSP) and the commodity exchange participants (CEP). The procedure of the delivery of the commodity includes the indication of intention of interest by the buyer through its broker or directly to the Bursa Malaysia Islamic Services Bhd. Then, the delivery date will be negotiated with the commodity suppliers through the assistance of Bursa Malaysia Islamic Services Bhd, within the period of a week before the date of the purchase of the commodity.17

In addition, the procedure of settlement to the commodity suppliers’ participants (CSP) is through the Bursa Malaysia Islamic Services (BMIS) which is the settlement agent. Such settlement includes trading and brokerage fee which are settled on a monthly basis and the delivery price as well as the delivery process fee which must be settled on the spot. In short, the trading session in the market is between 10.30am to 6.00pm on Monday to Thursday. However, there are two sessions on Friday. The first session on Friday is between 10.30am to 12.30pm, while the second session starts after the break which is between 12.30am to 2.30pm. The session holds between 2.30pm and 5.30pm.18 The trading agreement is on the basis of Murabahah.

However, in the context of the Islamic interbank money market, the commodity Murabahah program is the newest of all the Islamic interbank money market instruments in Malaysia. The instrument was developed in 2007 as a commodity based instrument of liquidity management. The underlying asset is Crude Palm oil (CPO). The mechanism is that an Islamic bank will purchase palm oil from a broker and sell it to Bank Negara Malaysia, the Central Bank of Malaysia, based on the contract of al-Murabahah, which is a ‘cost plus profit contract’. The agreement between the bank and the Central Bank will include a term that will stipulate that the buyer which is the Central Bank will pay on deferred basis. Meanwhile, the Central Bank will appoint the seller as its agent to sell the commodity on its behalf. Thus, the bank will sell the commodity to another broker, and credit the proceeds of the sale in the account of the Central Bank. The activities signify that the Islamic bank has placed its excess fund in the Central Bank. The activities can also be done in reverse in the situation whereby a bank is in need of liquidity. However,

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16 Bursa Malaysia, Commodity murabahah in Deposit, at 8.
17 Bursa Malaysia, Commodity murabahah in Deposit, at 10.
18 Bursa Malaysia, Commodity murabahah in Deposit, at 11.
the Commodity Murabahah certificate is not tradable in the secondary market.\textsuperscript{19} The Commodity Murabahah Program (CMP) is of three types. The types are as follows:\textsuperscript{20}

3.2 Bank Negara Malaysia (BNM)/ Murabahah Tender

This is the Commodity Murabahah Tender which is commonly referred to as ‘Commodity Murabahah Programme.’ It is a part of the initiative of Bank Negara Malaysia to facilitate liquidity management in the Islamic financial institutions. It is a cash deposit that is based on the internationally acceptable contract. Its objective is to bridge the gap of the liquidity mismatch between the surplus and the deficit financial institutions. The CMP is designed to utilize ‘Crude Palm Oil’ (CPO) as its underlying asset.\textsuperscript{21}

The CMP under Bank Negara Malaysia (BNM) is auctioned through the Fully Automated System for Issuing/Tendering (FAST) as part of the Islamic interbank Money market. The institutions that participate in the Islamic interbank money market are the participants in the activities of the commodity Murabahah programme. Thus, the CMP projects Malaysia as the international Islamic financial centre.\textsuperscript{22}

3.3 Commodity Murabahah Deposit (CM Deposit-I)

The second type is the CMD-i. According to the agreement of the Commodity Murabahah Deposit, the commodity Murabahah deposit (CM Deposit-I) is a deposit system that operates in accordance with the principles of the Islamic law. That is, the contracts of al-Murabahah and al-Tawaruq. The mechanism of the system is that the customer of the bank will appoint and authorize the bank, and the bank will accept the authorization to act as its agent. The authorization of the agency agreement will include the purchase of commodities or other goods in the local market on its behalf. The agency contract includes the authorization of the bank to determine the price of the commodity.\textsuperscript{23}

However, the bank will buy the goods from the customer on deferred payment basis by cost plus the profit method. That is al-Murabahah contract. The commodity must be Shari’ah compliant. Thus, it cannot be alcohol, pork, narcotic, and it cannot be substances that are considered as currency, such as gold and silver. Therefore, since the only contention among the underlying contract is al-Tawaruq contract the following section is dedicated for its jurisprudential position.

\textsuperscript{20} FSTP, 43.
\textsuperscript{21} Commodity Murabahah Programme, see,<http://iimm.bnm.gov.my/view.php?id=72&dbIndex=0&website_id=14&ex=1216289403&md=%C3%88%E2%80%9Em>, (02/12/2012).
\textsuperscript{22} Commodity Murabahah Programme, see,<http://iimm.bnm.gov.my/view.php?id=72&dbIndex=0&website_id=14&ex=1216289403&md=%C3%88%E2%80%9Em>, (02/12/2012).
4. Contract of al-Tawaruq

‘al-Tawaruq’ is a legal terminology under Islamic law of transaction which is derived from the Arabic word ‘al-Wariq’ that is ‘silver coin’. Technically, it refers to the practice of mobilization of liquidity. That is, the seeking for cash for the purpose of financing of trade or other project. Thus, al-Tawaruq is the practice of obtaining cash or liquidity through the method of Shari’ah compliant sale contract as contrary to the practice of conventional interest based loans. It is a contract in which the al-Mustawriq, that is, the seeker of financing or liquidity, adopts to avoid dealing in interest while mobilizing the required fund for its project or trade. In another word, it is a ‘tripartite method of the purchasing of commodity on deferred payment basis from a seller, and its resale to a third party for cash.’ It is a contract in which when people are in need of cash, for instance, they will purchase commodity of the value of one hundred by one hundred and fifty. The contract is a lawful sale contract that is known as al-Tawaruq.

Moreover, al-Tawaruq is defined by the Islamic Fiqh Academy as the purchase of the commodity that is under the ownership and possession of a seller by a deferred payment, and its subsequent sale by the purchaser to a party that is not the seller on cash basis, for the purpose of obtaining cash, that is ‘wariq.’ However, al-Tawaruq can take various forms. One is the situation whereby a seeker of liquidity will purchase a commodity on credit and then sell it to another party on spot cash payment, without any prior arrangement or disclosure of intention. Another format is the situation whereby a seeker of liquidity will approach a trader for a loan, however, such trader will sell certain goods or commodity to him on credit instead of advancing the loan, and the fund seeker will at his option, sell the goods at any price that suits him to secure his required cash. Moreover, it can also be in the format of a situation whereby the fund provider will purchase a commodity and sells it to the fund seeker on credit basis with a price that is higher than the purchased price (market value) against the delay of payment. However, while the first two formats of al-Tawaruq are generally accepted, the permissibility of the third format remains a matter of divergence of opinions between the scholars of Islamic commercial jurisprudence.

In the same vein, the Shari’ah Advisory Council of Bank Negara Malaysia defines al-Tawaruq as a transaction with two stages of sales. At the first stage, the buyer will purchase an asset on credit from the original seller, and at the second stage, the buyer will

27 Resolution of the Islamic Fiqh Academy, an affiliate of OIC, on Bay’ al-Tawaruq, No. (4), in a session that was convene in Makkah on 11th of Rajab 1419AH/31st of Oct. 1998.
28 The International Fiqh Academy for Muslim World League; 15th session held in Makkah, 11-15 Rajab, 1419 H.A
29 Ibid.
then sell the asset on a cash basis to a third party.\textsuperscript{30} This definition is similar to the definition of the Ministry of Awqaf in Kuwait which states that, al-Tawaruq is ‘the purchasing of a commodity on credit and selling it to a person other than the initial seller for a lower price on cash. That is, ‘a sale by a seller to the customer on deferred payment, and after the ownership of the commodity is taken; the seller sells it to the customer on deferred payment at a specified negotiated price.’\textsuperscript{31} Thus, ‘if a person is in need of cash and he buys a commodity that is valued at 100, for 150, the practice is permissible. This is referred to as al-Tawaruq.’\textsuperscript{32} It is discussed by the scholars alongside the subject of al-Inah in the various schools of Islamic law.’\textsuperscript{33} However, having discussed the concept of al-Tawaruq from various viewpoints, we shall look into the juristic opinions on the permissibility of the contract as follows.

4.1 Shari’ah Ruling on al-Tawaruq

The scholars of Islamic jurisprudence are of two opposing opinions on the permissibility of al-Tawaruq. While the majority of scholars allow it, some scholars disallow it. The argument between the scholars is as follows:

4.1.1 The group that permit the contract of practice of al-Tawaruq

The scholars that allow the practice of al-Tawaruq includes both the classical and the contemporary scholars. The classical scholars are the scholars of the Hanafi, Shafi‘i and Hanbalî schools of law who hold the opinion that al-Tawaruq is permissible, while the contemporary scholars that permit al-Tawaruq are Shaikhsh Abdul Aziz Bin Baz, Muhammad Bin Salih al-Uthaymin, as well as scholars of institutions such as the Islamic Fiqh Academy, that is the classical al-Tawaruq in its 15th session in Makah where it issued a resolution in support of the practice of al-Tawaruq with the condition that the purchaser who is the fund seeker that purchases the commodity on deferred payment and resells it to a party other than the original seller with a price that is lower than the initial purchase price, in order to avoid dealing with interest ‘al-riba’. Other scholars that permit it are the scholars of the Shari’ah Advisory Council of the Bank Negara Malaysia and etc.

4.1.1.1 Proofs on the legality of al-Tawaruq

That the word ‘al-bay’ in the verse ‘Allah permits sale and prohibits usury,’\textsuperscript{34} which legalizes trade and prohibits dealing in al-riba, indicates the general permissibility of sale contracts without any restriction except that which is explicitly prohibited by textual revelation. Thus, al-Tawaruq is implicitly included in the general understanding

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\textsuperscript{30} Bank Negara Malaysia (Central Bank of Malaysia), Shariah Resolutions in Islamic Finance, 2\textsuperscript{nd} Ed., at 94.
\textsuperscript{32} Ibid.
\end{flushright}
of the permissible sale contracts since there is no any proof from the Qur’an or Sunnah that prohibits it.\textsuperscript{35}

\textbf{i.} The Hadith of Abu Hurairah and Abu Sa’id al-Khudiri (R.A), that the holy Prophet (S.A.W.) appointed a man for the management of the farmland in Khaybar. The man once came to the holy Prophet (SAW) and brought with him high quality ‘dates’. Then the Prophet (SAW) asked him that whether all the dates of Khaybar are of the same quality. The man replied that, they used to barter one sa’in\textsuperscript{36} of the high quality dates with two Sa’in of other low quality dates, or two Sa’in for three Sa’in. Then the holy Prophet (SAW) said; ‘do not do that. You can sell the low quality dates for cash and then use the cash to purchase a high quality dates.’\textsuperscript{37} Thus, it is argued that this Hadith indicates the permissibility of the adopting of a method that can lead to the avoidance of dealing in al-riba. Thus, given that, the practice of the person constitutes dealing in al-riba al-fadl ‘barter trade al-riba’. The Prophet (SAW) taught him a method of avoiding such prohibited al-riba by the adopting of sale method to arrive at the desired objective. More so, the intention is not considered. Thus, the mobilizing of liquidity through the practice of al-Tawaruq which is a sale contract that fulfills its condition is permissible.\textsuperscript{38}

\textbf{ii.} That the rule that guides commercial transactions is the ‘presumption of the permissibility of all transactions, except that which is explicitly forbidden’, ‘al-Asl fi al-Mu’amalat al-Ibahah.’ Therefore, since al-Tawaruq is among the contract upon which there is not any divine text from the Qur’an or Hadith which implicitly or explicitly prohibits it, it should be considered as a permissible contract. Thus, al-Tawaruq is permissible pursuant to the general rule of the ‘presumption of the permissibility of all transactions, except upon that which there is a text that explicitly prohibits it is.’\textsuperscript{39}

\textbf{iii.} The necessity of the availability of such contract in order to ensure the mobilization of fund without dealing in al-riba. Such necessity purports the legality of al-Tawaruq. More so, according to al-Kasani; ‘the transferring of the ownership of the sale object constitutes the exchange of the commodity.’\textsuperscript{40} This negates the claim of the practice on the basis of al-riba from some scholars.\textsuperscript{41}


\textsuperscript{36} According to the Hanafi School of law, 1 ÎÊÈ³° is equal to 3261 gram, while in the other schools of law, one ÎÊÈ³° is equal to 2172. See, Muhammad Rawwas al-Qal’aji and Hamid Sadiq Qunaibi, Mujam Lughat Fuqaha (Dictionary of Islamic Legal Terminology) Arabic-English with Index of Arabic English, (Bairut: Dar An-Nafaes, 1985), 270.

\textsuperscript{37} al-Bukhari, Sahih al-Bukhar, Hatith No. 2089 & Muslim, Sahih al-Muslim, Hadith No. 1593.


\textsuperscript{39} Muhammad al-Amin Shinqiti, Mudhakirah Usul al-Fiqh, (MAkkah: Dar al-‘Alam al-Fawaid, 1426), at 24.


4.1.2 The group that disallowed the contract of practice of al-Tawaruq

The groups that disallow al-Tawaruq are the scholars of Maliki School of law. Their argument is that the sale of a commodity by the price that is higher than the market price in such manner is a al-riba. This is also the contention of the scholars that frown at bayN al-Inah within the Maliki School of law. Other scholars that disallow it are Umar Bin Abdul Aziz and Muhammad Bin Hasan of the Hanafi School of law, as well as Shaikh Islam Ibn Taymiyah and his disciple Ibn Qayim al-Jaoziy. They all consider it as a way of circumventing al-riba and that it is similar to al-Inah. The scholars of the International Fiqh Academy also prohibit al-Tawaruq that is referred to as al-Tawaruq al-Munazam ‘organized Tawaruq’ which is practiced by the Islamic financial institutions. This is contained in the resolution of the Fiqh academy in its 17th Session. The proofs of the opponents of the contract are as follows:

4.1.2.1 Proofs on the prohibition of al-Tawaruq

i. Al-Hiyal al-Shara’iyah: That al-Tawaruq practice is similar to al-Inah, and that it amounts to the adoption of legal trick for the circumvention of the dealing with al-riba, while the intention is to generate increase or interest on a loan which is al-riba that is prohibited in the Qur’an. However, this argument is answered that according to the legal maxim of Shafi’i School of law that, ‘when the wording of a contract is explicit and is not in need of any further explanation, the intention of the parties is irrelevant, and that the verification of intention is only important where the wording is ambiguous.’ Therefore, the matter of the intention of the party whether it is a legal trick or not is not relevant here.

ii. Sad al-Dhari’ah: that since the purpose of al-Tawaruq is to obtain liquidity like that of al-‘Inah contract, precautionary measure should be taken against the practice because of its similarity of purpose with al-Inah and that, that is an indication that the rule of al-Inah is applicable to it. They also sighted the Hadith that prohibits al-Inah with a strong warning. Thus, pursuant to that, precautionary measure should be taken against the practice of al-Tawaruq. This is avoid to falling into the trap of the warning of the Hadith that prohibits al-Inah contract. However, this is answered that the invocation of Sad al-Dhari’ah ‘precautionary measure’ or ‘the principle of closing the means to the commission of the prohibition’ here, is not acceptable because such principle can only be invoked when there is a clear means to the commission of a prohibited act, which is not the case here. Thus, since al-Tawaruq falls under the general rule of the ‘presumption of the permissibility of transaction except where there is a clear prohibition’ it cannot be considered as a ‘means’ to the commission of the prohibited act. Therefore, the principle is irrelevant here, and al-Tawaruq remains permissible.

iii. Bay’ al-Mudtar: That is ‘sale under duress,’ and that Bay’ al-Mudtar is prohibited by the holy Prophet (S.A.W.). There should not be a compulsion for any person to enter a sale contract when he is looking for a loan. However, this is refuted that a sale under duress that is prohibited is either (1) when a person is compelled under threat to enter into a sale contract to sell his belongings or (2) when a natural need

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44 Ibid.
45 Abu Daud, Sunan Abi Daud, Hadith No. 3384.
compels him to enter into a sale contract to sell his belongings. This is not the case in al-Tawaruq. Thus, a seeker of fund under al-Tawaruq is none of these categories. Rather, he is usually in need of liquidity for business expansion or investment. Therefore, al-Tawaruq is permissible because it does not fall under the purview of Bay’ al-Mudtar.46

4.2 Types of al-Tawaruq

Al-Tawaruq is of various types. Some of such types are as follow:

4.2.1 Al-Tawaruq al-Fiqhi (the Classical Tawaruq)

Al-Tawaruq al-fiqhi which is otherwise known as classical Tawaruq is a process whereby a seeker of funds or liquidity ‘al-Mutawariq’ will approach a fund provider ‘al-Muwariq’ for loan. However, instead of advancing the loan, the fund provider will sell some commodity that is valued at the requested funds to the fund seeker on a deferred payment basis, in one hand. In the other hand, the fund seeker will sell the commodity, at his discretion, to a third party on a lower or higher price. The money that is secured from such sale transaction will then be utilized by the fund seeker for his objective. This will take place between the three parties without any prior agreement, and the first seller of the commodity is not concerned by the intent of the fund seeker while selling the commodity. Thus, except for the opinions of Sheikh Islam Ahmad Ibn Taymiyah and his disciple Ibn Qayum al-Jaozy, as earlier discussed, all the scholars of the notable schools of Islamic law, both classical and contemporary, agree that this type of sale transaction is permissible under Shari‘ah.47

This practice of al-Tawaruq is the earlier unsophisticated system of al-Tawaruq. This shows the practice of al-Tawaruq is not a new phenomenon. It had been widely practiced in the earlier times. However, the practice then was not as sophisticated as the contemporary practice. During the early times, the mechanism was that, a person will merely purchase commodities and make an agreement to pay on deferred payment basis. Then such person will sell the commodity to a third party for lower price and with cash spot payment. Then the fund seeker will use the money for his need, while being obliged to pay the original seller on deferred payment basis. Thus, al-Tawaruq is considered permissible by an overwhelming majority of scholars so far it fulfills the condition of sale contract.48 This slightly differed from the modern organized Tawaruq as discussed below.

4.2.2 Al-Tawaruq al-Munazam (Organized Tawaruq)

Al-Tawaruq al-munazam (Organized Tawaruq) is embodied in the practices of Islamic banks in the situation whereby a client who is in need of cash will approach the bank for loan. However, instead of loan application, the client will purchase a commodity from an Islamic bank on the basis of the sale contract of cost plus profit and deferred


payment. Thus, the client will delegate the bank as its agent to sell the said commodity to a third party on spot cash payment basis with lower price. The bank will then deposit the cash to the account of the client.49

In another word, al-Tawaruq as practiced by the Islamic bank is a procedure whereby a commodity which is neither gold nor silver, considering that both are considered as currency, will be purchased by the bank from the international market or local market and then be sold to the seeker of fund which is its client on a cost plus deferred payment basis. The bank will also act as the agent of the client to sell the commodity to another party with lesser price, on a cash spot payment basis. Then, the cash will be delivered to the client to fulfill his need. Thus, the practice of al-Tawaruq al-munazam (Organized Tawaruq) is more complicated than the classical Fiqhi Tawaruq. This is because the practice is not only between the buyer and seller. Rather, it includes the transfer of the ownership of the commodity by sale, regulation of the financial intermediaries which is the bank that intermediates between the purchaser and the seller and the method of the payment of the prices.50

4.2.2.1 Categories of the procedures of the Organized Tawaruq

a. International Market Procedure:

The Organized Tawaruq in the international commodity market is carried out in commodities such as crude palm oil, crude petroleum oil, flour, iron, sugar, copper etc. the mechanism of this practice of Tawaruq is that the bank which is the fund provider will purchase commodity from the international market, through its appointed broker in the market on a cash basis. After taking possession of the commodity, the bank will sell it to the fund seeker (al-Mutawariq) on the basis of al-Murabahah (cost plus profit) basis. Then the bank will act as the agent of the client and sell the commodity, through its broker again, to another party in the commodity market on spot cash basis and then deliver the proceeds of the sale to the account of the client. The client will pay the bank in instalments.51

b. Banking liquidity Procedure:

This is the procedure for the facilitating of liquidity to the banking institutions: The mechanism is that the bank will deposit money in a foreign account of a foreign bank. It will also appoint the oversea bank as its agent as well as entering into an agreement with the bank to purchase commodity from the international market on the basis of spot cash payment. The oversea bank will then sell the commodity to itself while still acting as the agent of the local bank on a deferred payment basis. The said overseas bank which now owns the commodity will sell the commodity in the international market on the spot cash

payment basis. It will then utilize the cash to cater for its liquidity needs. With this process the bank, that is, fund provider will earn increase on the money it deposited in the foreign bank on a legitimate sale contract basis, as opposed to the interest-based method, which is prohibited under Islamic law.

5. Conclusion

To sum up, the foregoing is an expositional study on the Malaysian Bursa Suq al-Sil’ah which is a globally acceptable Islamic commodity market for the management of liquidity. The underpinning contracts of the commodity transaction are -Murabahah, al-Tawaruq and al-Musawamah. However, the implementation of al-Tawaruq remain contentious. Nevertheless, it is agreed that even in the situation that it is utilized, its use must be premised on necessity and genuine need of liquidity, that is, in the situation where interest free loan is not obtainable. The opponent of the contract is likened it to al-Inah. However, it should be observed that both al-Inah and al-Tawaruq are only similar in the sense that they are both sale contracts whose purpose is to mobilize liquidity in order to avoid transaction on the basis of al-riba ‘interest, nevertheless the contracts defers in essence. Thus, while al-Inah involves two parties which are the buyer and the seller, al-Tawaruq involves three parties. This differentiates it from al-Inah. Al-Tawaruq involves the seller, the buyer, and the second buyer. This makes it more legitimate as opposed to the opinion of the scholars that view it as the same al-Inah which is alleged to be utilized as a legal trick to circumvent transaction on the basis of tal-riba. In short, the Malaysian Bursa Suq al-Sil’ah can be adopted as model for the emerging markets.

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Money Economy and Contemporary World
Economic Order: A Challenge of Identity
and Survival for Islamic World

By
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Abstract

The emergence of ‘money economy’ is awesome in the course of human
development. The inspiring corollary of this historic development is the
institutionalization of Banking and Finance as well as the jaundiced
‘interest’ economy and its consequences. It is argued that Banking and
Finance are rooted in Islamic jurisprudence and thus, not an invention of this
century's Islamic political movements. Ijtihad mechanism has thus become an
effective tool in finding rightful conceptual and practical frameworks
especially now that the world economy is being confronted with endless
crisis. Specialists and stakeholders are struggling to proffer solution; the
Muslim world is challenged by a world economic order that is beyond its
sway while its intellectuals are pre-occupied in disentangling the cob-web of
definitional point of ‘riba’. In a challenge of identity and survival what is
way forward?

Keywords: Money Economy, Theory of Banking and Finance, Polemics of
Interest Economy, Banking and Finance in Islamic Law and World Economic
Order

Introduction

The legal philosophy, upon which the concept of Islamic economy, banking and
finance is built, gives room for collaboration between things spiritual and things material
or physical. It is where Islamic law is the referee, and Islamic values the objective. It
does not separate the material from the spiritual or the secular from the theological with a
view to help the individual within his society to contribute to the eternal process of

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1 R.A., Al Tawhid: Its Implications for Thought and Life (Issues in Islamic Thought),
human-development and welfare.\textsuperscript{2} The concept of ‘modern’ Western money economy and banking system on the other hand, rests squarely on the well-known saying of Christ, ‘\textit{Render therefore unto Caesar the things which are Caesar’s}’.

Law of Banking and Finance has root in the Islamic historical antecedent. Thus, it is argued that it is not an invention of this century’s Islamic political movements but stems from injunctions found in the Qur’an and Sunnah\textsuperscript{3} which are the two primary sources of the Islamic Law, as well as the interpretations of these sources by successive scholars and legal experts.

\textbf{History of Islamic Money Economy}

At the dawn of Islam, various types of gold and silver were used as money, regardless of whether these were minted or not. Some historical accounts reveal that the Prophet of Islam (pbuh) did not mint money with specific and fixed features, rather the units of gold and silver were Roman and Persian coins – all these coins were in use widely during his lifetime. Payment of Zakat dues, settlement of debts, and fixture of prices of goods and services among other things, were determined according to the values of Dinars and Dirhams. That is to say, by evaluation of the weight of silver and gold.

Under what was known as the coin standard of the Caliph Umar Ibn al-Khattab, the weight of 10 Dirhams was equivalent to 7 Dinars (mithqals). The status quo remained until the caliphate of Abdul-Malik ibn Marwan, who particularly in the year 75 (695 CE) ordered Al-Hajjaj to mint the first Dirhams. By this singular step, he established officially the standard initiated during the time of Caliph Umar Ibn al-Khattab. In the next year he ordered the Dirhams to be minted in the entire Islamic jurisdiction. Apart from abrogating the old system of human and animals on the coins, he ordered that the coins be stamped with the sentence: "Allah is Unique, Allah is Eternal".

This monetary policy became the applicable rule throughout the historical development of the Islamic monetary economy. That explains why the basis of the monetary standard in Islam was gold and silver. Gold and silver coins remained official currency until the fall of the Caliphate. Since then, dozens of different paper currencies were made in each of the new postcolonial national states which were the remnants of dismemberment of Islamic nation-states following the decline of Islamic rule.

Analysts argue that there were underlined similarities between Islamic economics and leftist or socialist economic policies. However, Islamic jurists and authorities have maintained that privatization of resources of oil, gas, and other fire-producing fuels, animal pasture, and water is prohibited. The concept of public or joint-ownership has been drawn by Muslim jurists in the lights of Sunnah of the Prophet of Islam where he was quoted to have said (reported by Ibn Abbas) that: \textit{"All Muslims are partners in three things—in water, herbage (animal pasture) and fire."}\textsuperscript{4} Anas added to the above hadith, \textsuperscript{2}Abu Saud, M. \textit{Money, Interest and Qirad}, (Studies in Islamic Economics), International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah, (1976), p. 76.
\textsuperscript{4}As narrated in Abu Daud, and IbnMajah; see \textit{Fundamentals of Islamic Economic System}, ww.muslimtents.com/shaufi/b16/b16_19.htm (accessed 25\textsuperscript{th} April, 2013)
"Its price is Haram (forbidden)." Jurists have also applied the Qiyas mechanism to contend that the above restriction on privatization can be extended to all essential resources that benefit the community as a whole as long as there is no evidence to the contrary.

Apart from these supposed similarities between Islam and socialism, early forms of proto-capitalism and free markets were prevalent in the era of Caliphate. An early market economy and early form of merchant capitalism evolved particularly in the period between the 8th and 12th centuries. A vigorous monetary economy developed based on the wide circulation of a common currency (the dinar) and the integration of previously independent monetary areas. Business techniques and forms of business organization employed during this time included early contracts, bills of exchange, long-distance international trade, early forms of partnerships (mufawada) such as limited partnerships (mudaraba), and early forms of credit, debt, profit, loss, capital (al-mal), capital accumulation (nama al-mal), circulating capital, capital expenditure, revenue, cheques, promissory notes, trusts (waqf), savings accounts, transactional accounts, pawning, exchange rates, bankers, money changers, ledgers, deposits, assignments, the double-entry bookkeeping system, and lawsuits. Organizational enterprises similar to corporations independent from the state also existed in the medieval Islamic world. Many of these concepts were adopted and further advanced in medieval Europe from the 13th century onwards.

The concepts of welfare and pension were present in early Islamic law as forms of Zakat one of the fundamental pillars of Islam, since the time of the Caliph Umar in the 7th century. The taxes (including Zakat and Jizya) collected in the treasury (bayt al-mal) of an Islamic government were used to provide sustenance for the indigents, including the poor, the elderly, orphans, widows, and the physically challenged individuals. According to the Islamic jurist Al-Ghazali (Algazel, 1058–1111), the government was

9 Banaji, J., "Islam, the Mediterranean and the rise of capitalism", Historical Materialism 15 (1), Brill Publishers, (2007), pp. 47-74,
14 Banaji, J., "Islam, the Mediterranean and the rise of capitalism", Historical Materialism 15 (1), Brill Publishers, (2007), pp. 47-74,
also expected to preserve food supplies in every region in case of disaster or famine. The Caliphate was thus one of the earliest welfare states.\textsuperscript{15}

When Islam prohibited the hoarding of wealth, it specifically prohibited the hoarding of gold and silver despite the fact that wealth includes any property that can be owned. However, hoarding is reflected in money, not in the goods and services. Islam has linked gold and silver to a number of rules. For instance, Prophet Muhammad was reported by An-Nisai on the authority of Amru Ibn Hazm to have said: "The blood money for one soul would be 100 camels...and for those who deal in gold it would be 1000 dinars."Bukhari also reported on the authority of Aisha (ra) that the Messenger of Allah also said: "The hand is cut for the theft of one-quarter of Dinar and upward."

The fixing of certain rules by the Dinar, the Dirham and the Mithqal, would make the Dinar with its weight in gold, and the Dirham with its weight in silver, a monetary unit by which the values of goods and services are measured. When Islam imposed the diyyah (i.e. blood money), it specified a fixed amount of gold. Also, when it decreed the penalty for cutting the hand of the thief, it specified the minimum value of gold that is stolen which would entail the cutting of the hand. The fact that Islam has linked the Shari'ah rules to gold and silver by text, when these rules are related to money, serves as evidence that gold and silver are emphasised as money. This does not mean that other items cannot be money. However Islam requires gold to definitely be part of any legal tender for the Khilafah in a multi-metallic standard.

A Brief History of Money Economy in the West

In ancient Europe, merchants and traders used the barter system. At that early time, the acts of buying and selling were being carried out without money serving as medium.\textsuperscript{16} Rather, it was by exchange of goods. With the passage of time, they found the trade by barter system impractical especially, the merchants dealing in luxury goods such as silk.\textsuperscript{17} This category of merchants would only accept money in payment. Introduction of a common medium of exchange became inevitable. Thus, the culture of money economy (or economy based on money) emerged. This development led to a number of commercial consequences, including the establishment of the institution of banking. Merchants began to carry different currencies with different values. Money-changers (usually Jews or Italians) determined the value of the various currencies and exchanged one currency for another.\textsuperscript{18} In the same vein, they introduced procedures for transferring funds from one place to another, received deposits, and arranged loans, thus becoming the first bankers in Europe.\textsuperscript{19}


\textsuperscript{17} Ibid.

\textsuperscript{18} Ibid.

\textsuperscript{19} Ibid.
Goldsmith – The Emergence of Banking and Culture of Interest Economy

Modern banks perform more or less the same functions which money-lenders performed before the banking era.20 This query takes us back to the late Middle Ages when gold and silver coins were the main form of money. At that time, gold symbolized accumulation of wealth21 - disposable wealth which was usually held in the form of gold or silver bullion. For safety, such assets were kept in the safe of the local goldsmith, he usually being the only individual who had a vault on his premises.22

Since 16th century, Goldsmiths were known to be craftsmen, bullion merchants, money changers and money lenders.23 Tradesmen and business tycoons who had accumulated stockpile of gold entrusted their wealth to the Royal Mint of England for storage. However, in 1640 King Charles I seized the private gold stored in the mint as a forced loan (which was to be paid back over time). Consequently, merchants were inclined to storing their gold with the goldsmiths of London, who possessed private vaults, and charged a fee for that service. In exchange for each deposit of precious metal, the goldsmiths issued receipts authenticating the quantity and purity of the metal held under their trust. These receipts could not be assigned (only the original depositor could collect the stored goods).24 By passage of time, the goldsmiths became responsible for the function of the scriveners (or scribe which was a Middle English term for a person who could read and write) of relending on behalf of a depositor and along the line, modern banking practices evolved; promissory notes were issued for money deposited which by custom and/or law was a loan to the goldsmith.25 In other words, the depositor expressly allowed the goldsmith to use the money for any purpose including advances to his customers. The goldsmith charged no fee, or even paid interest on these deposits. Since the promissory notes were payable on demand, and the advances (loans) to the goldsmith's customers were repayable over a longer time period, this was an early form of fractional reserve banking. The promissory notes developed into an assignable instrument, which could circulate as a safe and convenient form of money backed by the goldsmith's promise to pay.26 Thus, goldsmiths could lend to customers in the form of gold money, or in the form of promissory notes, or in the form of checking accounts.27 Gold deposits were relatively stable, often remaining with the goldsmith for years on end, so there was little risk of default so long as public trust in the goldsmith's integrity and financial soundness was maintained. Thus, the goldsmiths of London became the forerunners of British banking and prominent creators of new money based on credit.28

21 Ibid.
22 Sandberg, N., Blueprint for a Prison Planet 1- A brief History of Banking, (the truth seeker. co. uk, (2008).
24 Ibid.
26 Richards, R.D., supra, note no. 38.
27 Ibid.
28 Ibid.
Experts argue that the world economic and financial crisis experienced in the contemporary time had its root in the culture of mediaeval precedents laid down in goldsmith’s procedure. In contrast to that, it is argued that the Islamic concept of economy and acquisition of wealth are based on ethical values as well as humanistic norms. That explains why the Vatican was unequivocal to declare recently that: “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.” The Vatican made this statement against the backdrop of recent economic meltdown that has posed challenge to the entire international community in general and western world in particular. It is not surprising that this declaration came from the Vatican. Casting our mind back to history, we discover that the Catholic Canonists did not disapprove of profits on commercial ventures, rent for the use of land or of the sale of the fruits of the land or other capital. They disapproved of money interest on money lent.

Interest within Theoretical Framework

The idea of interest had been a weak spot, and of course, a controversial issue in the Science of Economics and more seriously the question and determination of the rate of interest than any other economic theory. It must be noted that the “liberal interpretation” of ‘interest’ by some Muslim scholars who argue that Islam is a rational religion and thus, there is possibility of reconciling Islamic theory with modern concept of interest, is misleading and contrary to the tenets of Islamic Law. All sorts of interest which had been embedded and formed the tangible expression of the modern Western economic models is usury. It is what is technically referred to in Islamic Jurisprudence as “Riba Al-Nasi’ah which is categorically forbidden by the Qur’an and Sunnah.

Interest (Riba) among Islamic Schools of Thought

In their efforts to find rulings on the question of Riba in the light of relevant texts of the basic sources, Muslim scholars have done extensive analysis of the subject. Generally, Scholars of Hanafi, Hanbali and Shi’a Schools have divided the six commodities mentioned in the above Hadith into two categories, namely, a) Commodities that are measured by weight such as gold and silver, and b) Commodities that are measured by volume such as wheat, barley, dates and salt. They ruled that riba applies

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33 Abu Saud, M., supra, note no. 10 at p. 78.
34 Ibid.
only to commodities that fall under these two categories and by analogy, they added other commodities that can be measured by weight or volume such as rice, beans, seeds, iron, raisins, copper, etc. They exempted from riba all other commodities that are not measured by weight or volume, such as bricks, eggs, cloth, swords, tools, etc.  

The Hanafi School excluded from riba the money that is made of materials other than gold and silver called (floos) and argued that "it is acceptable for example to exchange twenty piastres (or twenty dimes) with fifty half piastres (or fifty half nickels) to be paid on a later day." The Hanbali School exempted the money that is made of materials other than gold and silver (floos) from riba and argued that it is acceptable to buy thirty piastres for forty piastres (2 rials) to be paid on a later day as well as commodities such as rice, beans, and corn while exempting from riba all other commodities that are not food stable or noquood (or money). The Shafi’i School also argued that there is no riba in money made of materials other than gold and silver (floos), and thus, it is acceptable to sell twenty piastres for fifty half piastres to be paid after one month. The Maliki School maintained that the moneys made of metals other than gold and silver are like trade merchandise, and thus, there is no riba in them.

Abu Hanifa while drawing a distinction between batil and fasid contends that contracts of usury fell into the category of valid contract. According to him, the divine prohibition did not adhere to the nature or essence of the consideration (e.g. silver, or foodstuffs) but only to one of its qualities or attributes, namely its amount. Such contracts, then, were in Abu Hanifa’s view valid in essence and only vitiated in their usurious element: ownership of the basic commodity concerned duly passed, but the forbidden extra quantity was expunged. The Malikis and Shafi’is disagreed with him on the ground that the essential agreement which constituted the contract was only reached on the usurious basis: instead, with the Hanbalis, they held such contracts wholly void.

The Zahiri School held that riba applies only to the six listed commodities in the above Hadith, and should not be applied to other commodities. It can be deduced from the above analyses that money in Islam is meant to be from gold and silver as a tangible commodity that may be used as a measure or yard-stick for pricing other commodities and thus, it should be exchanged in equivalent measure, quality and weight in order to avoid tampering with the yard-stick, that is to say to keep and maintain the measuring standard intact.

Samer Madhar Kantakji notes that the Prophet also made mention of four other commodities that may be used as standard measures or yard-sticks. These commodities were the most common and most utilized at that time as money and stable foods.

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36 Ibid.
37 Ibid.
38 Al-Jaziri, A.R., ibid.
Therefore, it was not surprising that such commodities were used as means of payment at that period in time. It is to be noted that the Roman Empire paid soldiers’ salaries and wages by means of commodities such as salt. Indeed the word ‘salary’ itself was extracted from the word ‘salt’.41

**Interest (Riba) and Modern Banking and Finance and Muslim Jurists**

Controversy has been generated from a number of fatwa passed by modern Muslim jurists as to compatibility of the conventional banking and finance system with the Shari’ah. The controversy radiates essentially on ‘interest’ and related issues. The controversy has divided scholars into two camps, namely, the traditionalist and modernist scholars.

Modern banking is intricately connected with interest, which many modern Muslim thinkers characterize as *riba* – that is, lending at interest.42 The Qur’an clearly prohibits *riba*, which has similarity with the interest charged by the modern banks when lending money to their customers, thus, modern banking activities are considered “illicit”.43 As earlier noted, Muslim scholars generally agree that *riba* refers primarily to usury, i.e. “the lending of money with an exorbitant interest charged for its use.” However, a majority of the scholars including those in al-Azhar’s Research Council consider that *riba* also refers, in a secondary meaning, to “interest under all its forms”.44

**‘Interest’ Based Economy – One Crisis too Many (Disaster Galore)**

The recent world economic down-turn reenacts a continuation of series of crisis generated by the interest-based economy. It will be recalled that the British initially and then the Americans, through various methods including, colonialism, neo-colonialism and of course, globalization succeeded in imposing their legal tenders on the world ensuring international markets were priced in their currencies. This gave them an advantage over and above all other nations as their national currency was needed by the world to purchase international commodities, whilst the US can print the dollar and purchase the same goods.44 The implication of this scenario is that the entire world economy, banking and financial institutions, are tied strictly, to the apron of the so-called world economic powers. As a result, the entire world economy suffered the same fate. In other words, the collapse of their economy means the collapse of the entire world economy.

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43 Ibid.
44 Khan, A., The Economics of Money, (khalifah.com), (2008),
Solution (Ethical Dimension of the Crisis)

“Let us make no bones about it. This financial crisis is a major spiritual crisis. It is the crisis of a society that worships at the temples of consumption, and that has isolated and often abandoned millions of consumers now trapped on a treadmill of debt. It is the crisis of a society that values the capital gains of the rentier more highly than the rights of people to a home, or an education or health. It is the crisis of a society that idolizes money above love, community, well-being and the sustainability of our planet. And it is a crisis, in my view, for faith organizations that have effectively colluded in this idolatory, by tolerating the sin of usury.” Ann Pettifor

“The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.” Vatican

“Clearly as religious leaders we want to say that the root problem is human greed, which is not specific to any one nation or even to the governing class or any one religion. International group of Christian and Muslim leaders

Now the world has come to face the reality of negative tendencies of the age-long system of interest-based economy and has come to accept the fact that the “current financial crisis is a major spiritual crisis.”

It remains to see whether religion generally and Islam in particular and the moral values upon which it was based could provide pancea for this age-long crisis. Frankly speaking, it can. Ethical and religious law of Islam offer two levels of direction, namely, (i) Principles: Fairness, Honesty, Responsibility, Justice and Transparency; and (ii) Rules: Interest prohibition, Sale of debt, other specific regulation and of course, the Shari’ah provisions.

Brief History of Islamic Banking

The first experiment in interest-free banking was undertaken by Prof. Dr. Ahmad El-Naggar during the early sixties in the Nile Delta. This maiden attempt covered a large number of villages. Having succeeded in the Nile Delta project, he went further to Saudi Arabia where he campaigned for the establishment of Islamic banks throughout the Muslim World. His campaign appealed to Prince Muhammad and his illustrious father King Faisal who accepted the idea. His efforts were crowned with success when the Islamic Development Bank was established in Jeddah in 1975. Over the past few years, he has been instrumental in the establishment of no less than a dozen Islamic banks spread over the wider canvas of the Muslim world. Countries at present having one or more Islamic banks are Egypt, Sudan, Jordan, Kuwait, Dubai, Bahrain and Sharjah. Malaysia and Mauritania have also joined the league. The performance of these banks

45 “Face to Faith” The Guardian, October 11, 2008 as quoted by Asutay, M., ibid.
46 Bloomberg, “Vatican says Islamic Finance may help Western banks Crisis”, March 4, 2009, as quoted by Asutay, M., supra, note no. 93.
47 Middle East Online, October 16, 2008, as quoted by Asutay, M., supra, note no. 93.
48 Supra
49 Asutay, M., supra note no. 93.
50 www.islamic-world.net
51 Ibid.
has been quite satisfactory and it is hoped that they will be able to offer a much better service and reward to their clients than the competing Western banks.  

Some Distinctive Features of the Islamic Banking System

Despite the differences of opinion among Muslim scholars and jurists, Islamic banking system has become noted for a number of unique characteristics. Those characteristics mark it out from the conventional Western banking system. This is evident in the following:

1. The Islamic banking system is committed to efficient utilization of 'capital'. Savers being PLS holders force the banks to compete with each other and look for attractive investment opportunities. This leads to higher efficiency of capital.

2. Under an Islamic banking system a large majority of the saving depositors will switch over to PLS accounts, which will earn them better reward than is available under the Western banking system. This will also mean a better distribution of income.

3. The change from a traditional saver to an investor will reduce the propensity to consume and thereby contribute towards increasing the propensity to save/invest.

4. The shift from interest-bearing deposits to PLS will increase the share of the savers and reduce the 'unearned' income of the borrowers under the older system. This egalitarian character of 'investment management' will remove sharp income differentials between different income echelons.

Islamic Banking and Finance in the World Economic Order

Majority of the countries that make up the present-day Muslim world have emerged from a long night of colonial rule. Their politico-economic infrastructure was cast into its present molds during the colonial period. Thus, their centuries-old practice of finance in Islamic form was largely eclipsed. Even though, they have attained 'political freedom', they are still endeavoring to seek decolonization in the spheres of economy, technology, culture and social relationships.

The New International Economic Order (NIEO) was a set of proposals put forward during the 1970s by developing countries through the United Nations Conference on Trade and Development to promote their interests by improving their terms of trade, increasing development assistance, developed-country tariff reductions, and other means. It was meant to be a revision of the international economic system in favour of Third

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52 Ibid.
World countries, replacing the Bretton Woods system, which had benefited the leading states that had created it – especially the United States.\(^{56}\)

In the 1970s and 1980s, the developing countries pushed for NIEO and an accompanying set of documents to be adopted by the UN General Assembly. Subsequently, however, these norms became only of rhetorical and political value, except for some partly-viable mechanisms, such as the non-legal, non-binding Restrictive Business Practice Code adopted in 1980 and the Common Fund for Commodities which came in force in 1989.\(^{57}\)

This new International economic order produced a long train of hopes and expectations. After a while, the hopes were engulfed by disappointments and frustrations. The former Prime Minister of Malaysia, Dr. Mahathir Muhammad, once echoed the current feelings of a large number of scholars and statesmen when he says: ‘But we have to acknowledge now that the New International Economic Order was a non-starter. The developed countries turned it down flat.’\(^{58}\)

Although the NIEO Charter was never accepted by developing countries and is now dead, the political, economic, and social concerns that inspired it are still present. The Charter called for restitution for the economic and social costs of colonialism, racial discrimination, and foreign domination. It would have imposed a duty on all states to adjust the prices of exports to their imports. The realization of the New International Economic Order was an impetus for developing country support for the Tokyo Round of trade negotiations. Critics of the WTO continue to state that little of substance for developing countries came out of either the Tokyo or Uruguay Rounds.\(^{59}\)

The bitter truth is that, once British colonialism and American hegemony became established, it was inevitable that the two ‘powers’ would do everything possible to prolong their direct or indirect control\(^{60}\) of the world generally and Islamic Ummah in particular. Not only that, they would try to make sure that Islam could not again re-emerge as a political power in world affairs.\(^{61}\) This point is further reinforced by the emergence of a powerful global capitalist system which also controls the economies of the Muslim World. The economic theories of the West, including (the defunct) Communism, have also produced theories of poverty and development for the Third World countries.

As earlier stated, the British initially and then the Americans, through various methods including, colonialism, neo-colonialism and of course, globalization had succeeded in imposing their legal tenders on the world ensuring international markets were priced in their currencies. This gave them an advantage over and above all other nations as their national currency was needed by the world to purchase international


\(^{57}\) Ibid.


\(^{59}\) Matsushita et al.’s World Trade Organization (www. wikipedia.com)


\(^{61}\) Ibid.

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commodities, whilst the US can print the dollar and purchase the same goods. The implication of this is that the entire world economy, banking and financial inclusive, are tied strictly, to the apron of the so-called world economic powers.

The status quo has remained, the political, economic, and social concerns that inspired the New World Economic Order are still present. However, despite uncertainty and clear position of the Islamic jurists on the issue of riba in the midst of these hopelessness and frustrations the Islamic banking and finance had continued to exert its influence and impacts in the world economy.

In summary, the New International Economic Order (NIEO) will continue to be jettisoned and irrelevant, as long as the international political game remains perpetually in the hand of the contemporary Uni-polar world power. Consequently, attempt may be made in certain quarters to checkmate the resurgence of the Islamic Banking and Finance in both long and short runs.

Recommendations and Conclusion

(1) “Through our scientific genius we have made this world a neighborhood; now through our moral and spiritual development, we must make of it a brotherhood.” – Martin Luther King. The ethical perspectives in finance need to be revisited taking to account the endless crisis witnessed globally in the recent past. Islamic Banking and Finance System, it is argued is capable of providing solution to these crises in view of its ethical and moral background.

(2) Muslim jurist, writers, experts in Islamic economy, banking and finance should come out with a blue-print on clear and un-ambiguous position on the issue of riba with a view to harmonize different opinions on the issue particularly the question of definition of what amounts to riba.

(3) Time has come for taking practical steps towards the establishment of an International Islamic Central Bank which will adopt Dinar and Dirham as its currencies. I am not oblivious of the political implications of this point. However, I believe that it will go a long way in giving Islamic money its right value and place at both national and international levels. The end result will be, inter alia, serving as reference financial point, monetary uniformity in the Islamic Capital Markets as well as the Muslim communities around the world.

(4) A new International Economic Order that is based on a clear answer to four fundamental issues has to be developed. The issues include, the concept of nature and place of man in universe, the concept of property and ownership, the concept of justice and mechanism for its realization, and of course, the role of Government in the world economic order.

62 Khan, A., supra, note no. 97.
63 Ibid.
64 As quoted by Asutay, M. supra note no. 93.
65 Ibid.
State Bank of Pakistan – Fueling the Growth of Islamic Banking in Pakistan

By
Obaid Usmani

Abstract:
Pakistan, in recent years has showed strong inclination towards Islamic Banking. Islamic Banking share is more than 10% of the entire Banking Industry. Over the last decade, Islamic Banks have been successful in providing end to end alternatives to all conventional banking products. The support coming from the central bank of the country is one of the major factors of the rapid growth of Islamic Banking industry. With more than 1400+ Islamic Banking branches and a 20%+ growth in deposits, assets, financing and investments, the Pakistani Islamic Banking industry is set to become the hub of Islamic Banking of the region. In this paper, we review the steps taken by the central bank in Pakistan to promote the growth in Islamic finance and to reach standardization in the regulatory framework.

Keywords: Islamic Banking, Islamic Finance, SBP, AAOIFI

1. A Brief Overview about Islamic Banking in Pakistan

Pakistan, in recent years has showed strong inclination towards Islamic Banking. The first Commercial Islamic Bank in the country was established in the 2002, and within 13 years only, the Islamic Banking share is more than 10% of the entire Banking Industry. Over the last decade, Islamic Banks have been successful in providing end to end alternatives to all conventional banking products. The support coming from the central bank of the country is one of the major factors of the rapid growth of Islamic Banking industry. With more than 1400+ Islamic Banking branches and a 20%+ growth in deposits, assets, financing and investments, the Pakistani Islamic Banking industry is set to become the hub of Islamic Banking of the region.

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Coming to the core of Islamic Finance, Shariah compliance is the single most important aspect for the Islamic Banking & Finance industry. The credibility of Islamic Banking Institutions (IBIs) not only depends on the financial health of the institution but also on its adherence to the Shariah. Under the current strategy for promotion and development of Islamic Banking as a parallel, viable and compatible banking system, State Bank of Pakistan has taken a number of steps to ensure Shariah compliance by IBIs and for standardization of Shariah practices.

The State Bank of Pakistan has played a dominant role in enabling the Islamic Banking Industry to not only sustain but rapidly grow many folds. The mindset of the top executives including the Finance Minister of government of Pakistan have also taken important steps and showed its commitment towards Islamic Banking. The government went on to appoint a Deputy Governor at the State Bank of Pakistan especially to monitor and facilitate the Islamic Banking industry of Pakistan.

This article highlights the main steps taken by the government & State Bank of Pakistan including new initiatives which either directly contributes to, or indirectly augments the process of Standardization of Shariah practices in the Islamic banking industry of Pakistan both in the local as well as global context.

1.1 National Steering Committee for Promotion on Islamic Banking

The Steering Committee for the Promotion of Islamic banking was constituted by Ministry of Finance (MoF), Government of Pakistan in December 2013 comprising of leading Shariah scholars, bankers and officials from SBP. The main objective of the Committee is to carry out an objective review of the current paradigm of Islamic banking and to formulate a comprehensive policy framework for an Islamic financial system in the country including the review of the legal framework and suggest recommendations. Further, the Committee has also been given the task to review the existing taxation regime to remove the impediments of taking the industry to next level of growth and development by finding practical ways and means to participation based modes as modes of Islamic finance.

2. Steps Taken for Promotion of Islamic Banking by SBP

- Establishment of a Shariah Board & a separate Islamic Banking Department at SBP to directly supervise & monitor the Islamic Banking industry.
- Instructions for Shariah Compliance in IBIs.
- 5 year Strategic Plan for Islamic Banking Institutions
- Introduction of Shariah Governance Framework
Adoptions of AAOIFI Standards.

伊斯兰出口再融资计划。

媒体活动推广伊斯兰银行业。

伊斯兰公开市场操作—流动性管理解决方案

最低资本要求

伊斯兰金融卓越中心

2.1 建立一个沙利赫委员会及独立伊斯兰银行业部门

沙利赫委员会为SBP提供建议，涉及到伊斯兰银行业务的程序、法律和规定，根据沙利赫原理。所有有关伊斯兰银行业务的指示/规定须在沙利赫委员会的批准后发布。

除了拥有一个沙利赫委员会，SBP还设置了一个独立的伊斯兰银行业部门，并由具有丰富经验的高素质专业人士组成，在政策制定和项目执行中推动伊斯兰银行业的发展。

2.2 沙利赫合规性指令

为了加强伊斯兰银行业务的沙利赫合规性机制，并确保所有相关的伊斯兰银行业务规定得到遵守，IBIs需要引入沙利赫合规性机制，作为其内部控制结构的一部分，根据SBP发布的沙利赫合规性框架。

沙利赫合规性框架涵盖了IBIs在执行其业务操作时的主要方面，如监测沙利赫合规性，审查单据，冲突解决，培训和内部沙利赫审计。

另一个重要方面是这些指令中的合适和胜任标准。每家伊斯兰银行机构（即伊斯兰银行和传统银行具有伊斯兰银行业务分支机构）需要根据SBP规定的合适和胜任标准聘请一位沙利赫顾问。沙利赫顾问的合适和胜任标准确保了他们具备足够的相关教育、知识和经验，这在推动沙利赫原理在不同伊斯兰银行机构中的和谐化中发挥着重要角色。

沙利赫顾问对银行负责，确保所有银行的产品和服务、运营和文件都符合沙利赫原则和规定。在推出任何新产品之前，银行需要获得沙利赫顾问的正式批准，确认该产品和相关文件符合沙利赫合规性。

SBP根据最近开发的伊斯兰银行机构沙利赫合规性检查手册对沙利赫检查进行审查。沙利赫检查有助于识别不同银行采用的不同程序。检查结果的决定也有助于实现沙利赫原理在伊斯兰银行业务中的标准化。
2.3 Five Year Strategic Plan for IBIs (2014-2018)

The Strategic Plan focuses on critical issues and includes necessary initiatives for improving public acceptance and promoting Islamic banking as a distinct and viable system for meeting the financial services need of the public in general and business community in particular. The strategy paper has chalked out a detailed plan with time bound objectives which will prove to be beneficial for the industry. The main structure of the strategy paper is given below:

A. Enabling Policy Environment
   • Enabling legal, regulatory, supervisory, liquidity management framework, taxation regime and financial accounting & reporting framework

B. Shariah Governance & Compliance
   • The focus in this area will remain on standardization and harmonization of Shariah practices, as well as on creating distinct Islamic banking products and services.

C. Awareness & Capacity Building
   • Efforts will be made for coordination and collaboration amongst internal and external stakeholders, enhancing awareness about Islamic finance, and building capacity of the stakeholders

D. Market Development
   • Initiatives will be undertaken for product diversification

3. Shariah Governance Framework

The State Bank of Pakistan has developed a comprehensive Shariah Governance Framework (SGF) for IBIs which cover points such as an effective mechanism for the BOD oversight of the IBI’s Shariah compliance environment, accountability of executive management in implementation of the framework, an independent and effective Shariah Board appointed as per Fit and Proper Criteria of SBP with one of its Shariah Scholar members working as Shariah Advisor to advise the bank on day to day and routine Shariah issues, a Shariah Compliance Department, a Shariah compliance review mechanism to assess the operative effectiveness of the Shariah governance and compliance framework introduced by the SB and BOD and an independent Internal Shariah Audit Unit.

3.1. Adoption of AAOIFI Shariah Standards

The introduction of international players in the Islamic banking industry has further necessitated the need to bring our industry at par with the global Shariah standards. Shariah Standards developed by Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) are an important and effective source available for bringing in the desired standardization in the Shariah practices.

In order to bring the industry at par with the international standards and also achieve standardization of Shariah practices locally, a mechanism for adoption/adaptation of these Shariah standards has been developed by SBP. According to this mechanism the meetings of Shariah Advisors of all IBIs are being held with a view to thoroughly study the AAOIFI Shariah Standards one by one, for their possible adoption / adaptation in the Pakistani market. Till now, SBP has adopted 6 AAOIFI Standards in Pakistan.
### Table 1: AAOIFI Shariah Standards Adopted by SBP

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<tr>
<th>No.</th>
<th>AAOIFI Shariah Standards Adopted by SBP</th>
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<tbody>
<tr>
<td>1.</td>
<td>Default in Payment by a Debtor</td>
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<td>2.</td>
<td>Murabaha to the Purchase Orderer</td>
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<td>3.</td>
<td>Ijarah &amp; Ijarah Muntahia Bittamleek</td>
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<td>4.</td>
<td>Mudaraba</td>
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<td>5.</td>
<td>Investment Sukuk</td>
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<td>6.</td>
<td>Sharika (Musharaka) &amp; Modern Corporations</td>
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#### 3.2 Islamic Export Refinance Scheme

The State Bank of Pakistan has been facilitating trade & commerce specially exports business through various schemes with concessional financing facilities. In this regard, Shariah compliant Export Refinance Scheme (EFS) is already in place. The IERS scheme is further being reviewed to better facilitate the businesses in the country through a Shariah compliant manner.

#### 3.3 Media Campaign for Promotion of Islamic Banking

One of the major steps the State Bank of Pakistan has taken to tackle the awareness challenge was the launch of mass media campaign for promotion of Islamic Banking supported by all players in the industry. Lack of awareness and understanding of Islamic finance and its business and operating model has been one of the key causes of confusion and misperception about Islamic finance. The plan thus gives extensive focus on intensifying the awareness efforts both at industry and individual intuitions level.

#### 4. Islamic Open Market Operations Solution for Liquidity Management

The biggest challenge faced by the Islamic Finance industry was the lack of availability on Rupee denomination sovereign Sukuk for deployment of excess funds of the Islamic Banks and the option of OMO for IBIs. The State Bank of Pakistan in collaboration with the industry developed an OMO alternative in form of Bai Muajjal, which is being used for the benefit of the industry on frequent basis.

#### 4.1 Minimum Capital Requirement for Islamic Banks

Some Islamic banks / windows in particular were facing difficulties in meeting the Minimum Capital Requirements of SBP. Therefore, SBP, taking a bold step, has revised the MCR for Islamic Banking Subsidiary from Rs. 10 billion to Rs. 6 billion in 2014. This will allow existing Islamic Banks to continue their operations without worrying much about the MCR and at the same time, this step will encourage conventional banks to establish Islamic Banking subsidiaries.

#### 5. Center of Excellence for Islamic Finance

The State Bank of Pakistan is working with leading academic institutions of Pakistan for establishing a world class Center of Excellence for Islamic Finance. The center will have a comprehensive set of education and training programs for various audience groups, state of the art research facilities, partnerships with the industry and buy-in of key stakeholders. The center will ensure output of quality human resources and capacity building, which will support to achieve the target growth of Islamic Banking & finance in the country in the time to come.
The Jurisprudential Principles in Managing the Risks Available in Certain Islamic Finance Contracts

By
Mahadi Ahmad and Ibrahim VambaFofana*

Abstract

It is a universal fact that in any financial transaction there are risks, which may be inherent or operational. This is more so in Islamic finance due to its distinct mode of operation - operations based on principles derived from divine laws which are enshrined in the Holy Quran and Hadith. With the fact that the Islamic financial institutions are responsible to Allah and then to their shareholders and depositors, their responsibilities became higher than their conventional counterparts. It is to this reason this paper aims at studying the jurisprudential principles of risks in certain Islamic finance contracts and how to manage same. The methodology of the paper is analytical in nature based on the contents of the Islamic jurisprudential literature and contemporary writers. The paper finds that the establishment of the jurisprudential principles in certain Islamic finance contract will enable to pave the way for Shariah compliant devices to carry out those contracts with a greater sense of mitigation of those risks.

Keywords: risks management, Shariah, Islamic finance contracts and jurisprudential principles.

Introduction

Due to the fact that Islamic finance is relatively new, the inherent risks available in the instruments used in financing are yet to be comprehensively understood. This is more so because risks faced by the traditional financial intermediaries and risks that are specific to Islamic finance due to their mandate to comply with the Shariah are different. In financing contracts, where an Islamic financial institution creates debt on the liability of the customer as in murabahah for example, the IFI is prone to credit risk and...
market risk due to the uncertainty in the customer’s ability to fulfill his own part of the contract. While in investment contracts like the *musharakah*, the Islamic financial institution is not transferring any risk but it is inside the risk together with its partners.² This situation needs a deep jurisprudential investigation for a Shariah compliant measures to be used to manage the risks associated with Islamic Finance.

Some of the risks associated with these products are market risk, credit risk, operational risk and liquidity risk. If risks are handled carefully and get pre-empted the financial situation of that financial institution may be very bad. This will cause a threat to properties. Scholars of *maqasid Shariah* hold that protection of wealth comes from two aspects; aspect of wealth generation and aspect of preserving the wealth against factors that militate against its existence.³ The need to manage risks falls under the latter aspect. But the challenge is heavy on the aspect of the Islamic Banks that deal with shareholders and depositors’ funds and manage these funds through retail banking activities, thus becoming liable to the two sides of the balance sheet; the asset side and the liability side.

It is against the above this paper sets to study the *fiqhi* principles on risk management and how to apply same in the contemporary Islamic Finance practices.

### Management of Credit Risk

Credit risk occurs when the net cash flow of an institution is volatile due to unexpected decline in its total cash because of default of the counterparty.⁴ To manage this type of risk the root cause of the risk needs to be investigated and thereafter the management mechanism could be propounded. Be that as it may, the preceding paragraph has mentioned the cause of this type of risk. To solve this problem therefore default payment in the Islamic financial institutions should be categorized into two; namely *default in consumption loan* and *default in commercial purpose*;

1. **Default in consumption loan.** The Muslim ummah needs to build a strong and efficient *baitulmal* system, capable of providing safety net to those indebted due to financing for their basic needs such as houses, car, children’s school, health and etc. The ability of *baitulmal* to serve as a strong solution depends on the successful administration of Islamic social funds like zakat, waqf, unclaimed money and etc. This opinion is based on the Islamic convention of running *baitulmal* for the safekeeping of revenues of Islamic State. The Prophet S.A.W said “anyone employed by us should get married, if has no maid he should get one, if has no house he should also get one.”⁵ The author of *Tuhfah al-Ashraf* reported two interpretations to this hadith as follows: 1- the state employee deserves the cost of maintaining his

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⁴ M. Umer ChapraAndTariqullah Khan, Regulation And Supervision of Islamic Banks, (Saudi Arabia: IRTI, 1421/2000), 52.
wife; he deserves a maid and a house so that he can perform his duty comfortably, and 2- it is permissible for him to procure all the things listed from the commission paid to him as consideration of his service. On the other hand al-Azim al-Abadi interpreted it as saying that, it is permissible for him to take the cost of dowry of a wife, her maintenance, and every basic need, without extravagancy and luxury from *bai al-mal*. If he takes more than his basic needs it is *haram*.

2. **Indebtedness Due to Commercial Purpose.** Usually, lack of capital is the driving force for applying for commercial loans. But with the existence of Islamic banks there are alternative financing to the conventional commercial loans without interest. It is to this effect Tahir Ibn Ashur said that Islam did not permit the wealthy people to enrich themselves through lending on *riba* basis, but through lawful contracts. The conventional banks are able to transfer some of their risks to their customers through *riba* bearing loans, whereas it is not permissible for the Islamic Banks to do same. Therefore, the Islamic financing Instruments must be used to finance on the basis of profit and loss sharing.

**Islamic Financing instruments and the Risk Involved**

The various financing instruments used by Islamic Banking, namely, *murabaha*, *Ijarah mudarabah*, *musharakah* and *Musharaka mutaqisah*, *Salam* and Parallel *Salam*, *Istisna* and Parallel *Istisna* etc. have their own risks associated with them, they may be credit risk, market risk and/or operational risks.

**Deposit mobilization instruments and their inherent risks**

The Islamic banks’ wadiah current account for example involves credit risk that may result from natural disaster. Going by the Shariah principles of wadiah, the bank is not liable for any loss of wadiah that was not attributable to misconduct or negligence of the bank. But it will be difficult for the customers to accept this. On the other hand, the mudharabah savings account is profit and loss sharing between the bank and the clients. The bank has already promised the client the percentage due for his account as profit of his mudharabah. With this the bank is faced with displaced commercial risk. According to Amr,

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7 Ibid.
8 Muhammad Tahir Ibn Ashur, *Tahir Ibn Ashur, Ta hrir Wa Tanwir*, (Tunisia: Dar Tunisiyay Li Nashr, 1984), v.4, at 88.
10 Kamal Ibn Humman Muhammad Ibn Abdul Wahid, Fat-hu Al-Qadir (Beirut: Dar Al-Fikr, n.d), v. 8, at 485; Wizarat Al-Awqaf Al-Kuwaitiyah Al-Mawsuat Al-Fiqhiyyah Al-Kuwaitiyat, (Kuwait: 1427), v.6, at 161.
Displaced commercial risk arises when the IIFS encourages their investment account holders by increasing the rate of return to keep the funds. Therefore the IIFS gives away a portion of their share of profit. The rate of return to the customer is smoothed at the expense of profit normally attributed to the IIFS' shareholders.11

There is nothing to prevent this type of risk management strategy from Shariah point of view. This is because from Shariah point of view it is not wrong for someone to withdraw from part of his rights. More importantly, this increase in the return of the shareholders is different from guarantee of loss which is prohibited.

Risks in Salam and Parallel Salam and the Shariah Responses

Researchers argue that the risk in salam arises from the following; shortage or non-existence of the object of salam at the mutually agreed time of delivery. The jurists unanimous agreed that existence of the object of salam contract at the agreed time of delivery is a condition of a valid sale of salam.12 However, the jurists disagreed on what to do in a situation where the object of salam becomes unavailable at the stipulated time for delivery. What will be the fate of the buyer who had already paid price in advance?13 This is one major risk in the contract of salam which researchers refer to as credit risk because it poses the risk of loss of credit to the buyer as he is not able to immediately get his money back as expected.

In response to this risk, Shafie, Abu Hanifah and Ibn Al-Qasim of the Maliki School held that the buyer is given the following options:1- either to request for refund of his money or to give waiting time till the next season of that produce. 2- On the other hand, some jurists maintain that the contract should be rescinded at cost, and 3-that the buyer has nothing other than the refund of his money.14 IbnRushd gave preference to the first opinion that gives option to the buyer.15

In a banking sector, it is assumed that the bank would prefer the option to recover its money instead of waiting till the following season whose fate remains unknown. But the bank is left with two challenges of how to settle the customer of the parallel salam and how to manage the credit risk that arises from the default of the first seller. It is indeed undisputed that non-performance of a contract obligation may be due to act of God16 and may be due to negligence of a party. Whichever the case may be,
bank is permitted to settle its counter party in parallel salam through procuring of another commodity similar to the one whose delivery failed as a result of the delivery failure from the seller in the original salam. This alternative is premised on the fiqhi matter resolved by the jurists, that validity of salam sale is not conditioned on the seller’s possession or production of the commodity.\(^{17}\) This is to say it is permissible for a party to enter into salam with the intention that he will purchase the required goods and deliver to the muslim (the vendor) on the mutually agreed date.

Accordingly, the bank, as a part profits risk management strategy, will liquidate its asset of the first salam, which is hitherto posing credit risk, price risk and even market risk. The management of these risks therefore would be for the bank to sell to a third party at cost price based on the opinion of Ibn Taymiyyah, or at a mutually agreed price based on the opinion of the Maliki School of thought, with the condition that the commodity is not food.\(^{18}\) From Ibn Taymiyyah’s opinion that suggests selling the yet-to-deliver objects of salam on cost price one can notice that he permits al-tawliyyah on salam commodity that is yet to be delivered. On this matter, Ibn Taymiyyah had vehemently refuted the argument of Ibn Qudamah who said that there is no juristic difference on prohibition of sale of salam to a third party prior to taking its delivery.\(^{19}\) Ibn Taymiyyah had refuted this assertion by citing the opinion of Ahmad Ibn Hambal and the opinion of the Maliki School of thought that makes sale of salam to a third party permissible prior to taking its delivery if the object of the salam contract is not food.\(^{20}\) The researcher suggests that in order to get a third party involved, the bank is permitted to issue sukuk salam of which delivery failed and when the delivery come by next year they will get their money back and the bank will use ‘displaced commercial risk to settle the sukuk holders so that they can realize some profits.

In the case of food like agricultural produce, since there is a unanimously agreed shariah ruling that prohibits sale of food before taking its delivery, the Maliki School of thought excludes food from their opinion that permits sale of object of salam to a third party prior to taking its delivery. Therefore, the Shariah compliant management of the risk would be to resort to sharikah (partnership). Some Ulema have allowed sharikah in food items before taking its delivery while others refused it. The following are their texts;

The Proofs of Permissibility of Sharikah in Food Prior to Taking its Delivery

1. Imam Malik (may the mercy of Allah be upon him) reported in his ‘Muwatta al-Imam Malik’ under the chapter of ‘bayN al-Ñariyyah’, that, sale of al-Ñariyyah (sale of date palm fruits that are yet to mature against dried dates that are being delivered instantly), is permissible if the estimate is made fairly against the equivalent dried dates. Imam Malik went further and said that,

\(^{17}\) Bukhari, V.4, at 431.  


\(^{19}\) Ibn Qudamah, al-Mughni, (Cairo: Maktabah al-Qahirah, 1968), v.4, p: 227.  

this ‘al-‘Nariyyah’ is permissible because it is put under the category of al-tawliyyah, (sale at cost price), al-iqalah (mutual contract rescission), and al-sharikah (partnership). He argued that if ‘al-‘Nariyyah’ was categorized under other types of sale contracts, the legal consequence therefore would be impermissibility of after-sale partnership in food stuff prior to taking its delivery; mutual rescission would have been impermissible on such food stuff and also sale at cost price would have been impermissible until he takes delivery.  

As the reader can observe the Imam rationalized the permissibility of after – sale partnership in food stuff prior to taking delivery. Though, he upheld the Shariah provision that prohibits selling food before taking its delivery, but excepted after-sale partnership prior to taking its delivery from this prohibition, and accordingly permits sharikah on food. This is a vibrant solution to the difficulty in the prohibition of sale of food before taking its delivery, particularly in salam sale between bank and agriculturist who might have been unable to perform his obligation to deliver the food stuff that is object of the salam sale. As instrument for risk management, partnership would be completed through sukuk sharikah in order to manage the credit risk posed by the original salam counter party’s delivery failure.

2. Also “Imam Malik ruled that anything purchased by you or your advanced payment in salam sale, if that commodity is not food or drink, but any other commodity by counting, measuring or weighing is permissible for you to sell it prior to taking its delivery and before the mutually agreed delivery date to a third party, at cost price, or below the cost price or above the cost price, but on cash basis.”

In this point the mafhum al-mukhalafah (understanding the opposite) is that sale of food prior to taking its delivery is not permissible except if it was done through after-sale sharikah.

The Evidence against Sharikah in Food Prior to Taking its Delivery

3. Al-Thauri said that partnership is a sale and so one should not have partner until he takes delivery of the food stuff.

4. Imam al-Baihaqi also reported from Iqrimah who said that Ibn Abbas said that, ‘iqalah (mutual rescission) is not a sale but mere rescission, therefore it is not permissible except at cost price, and Hasan, Muhammad Ibn Sirin and A‘au ibnAbi Rabah said that al-Tawliyyah (sale at cost price) is a sale, and he (al-Baihaqi) said also that al-sharikah in our view is a sale. Therefore these

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two (al-tawliyyah and sharikah) are not permissible in salam [prior to taking delivery].

Since this issue is muamalat, and the original presumption of any muamalat is permissibility and finding of ease to difficulty in transactions, the opinion of Imam Malik that permits insertion of sharikah in food already purchased but the delivery has not be taken should be given preference. Further, even though partnership is a sale but it is exempted from the general ruling of prohibiting sale of food before taking its delivery as it is categorized under al-ariyyah.

Managing the Inherent Risks in Musharakah and Musharaka mutanaqisah

Musharakah is a contract between an Islamic Financial Institution and a customer whereby the Bank contributes capital to an enterprise, either on a temporary or permanent basis and profits generated are shared according to agreement and losses are shared in proportion to each partner’s share of capital. While musharakah mutanaqisah is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner.

The salient features of partnership from Shariah point of view are that it is a non-binding contract. That is, either of the parties is free to dissociate his partnership without the permission of the other party. Also, any damage or loss incurred due to negligence is borne by the party that was responsible for the damage or loss. However no party is liable for damage or loss without his negligence. Furthermore, another major risk in musharakah is that it is not permissible for any of the party to guarantee loss of capital of the venture. This ruling is by unanimous agreement of the Ulema. The effect of this prohibition manifests more in sanadat al-Muqaradah when large a sukuk is issued and in order to enhance the credit, the issuer would want to undertake that he would guarantee loss of capital and a percentage of the profit. The OIC Fiqh Academy ruled against this practice. However, the suggested form of managing this risk is third party guarantee that is not part of the sukuk holders. The OIC Fiqh Academy permits this in its 1988 conference in Saudi Arabia.

On the aspect of musharakah mutanaqisah, the salient feature is that it operates on the basis of a unilateral promise from one of the party. And the contract to sell the share to the promised party must be separate from the partnership contract. The promised party is free to honor the promise and to refuse it. The inherent risks in musharakah are the non-binding nature of the contract as the dissociation of one party may cause an

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25 Al-Imam Malik Ibn Anas, Muwaïla al-Imam Malik, n. 22.
26 Amr Muhamed El Tiby, at 56.
28 Ibid.
30 Ibid.
31 Al-Saddiq Muhammad, Sanadat Al-Muqaradhah, in Majallat Majma’ Al-Fiqh Al-Islami, v.4, at 1411.
injury to the other. The dissociating party may have more capital in the project or enterprise, and so, due to his withdrawal the other party is not able to carry out the project, ultimately resulting in capital impairment risk.

It is said that the Islamic financial institutions are exposed to two types of credit risks in financing through musharakah: 1- capital impairment risk, where they lose their share capital invested in the project, and 2- credit risk with regards to the customer’s repayment capacity. The shariah response to this type of risk that has already occurred is mitigation. A shariah principle says that if it is not possible to remove harm completely it should be reduced. Accordingly, to reduce this type of risk is to reinvest the shares till another period of time when the shares will begin to re-appreciate.

In musharakah mutanaqisah the Islamic financial institutions are exposed to credit risk with regard to the ability and willingness of the partner to meet his commitment to purchase his shares. In addition the capital invested by the Islamic financial institutions is subject to capital impairment risk in case the value of the musharakah assets declines. To mitigate this risk the IIFS is permitted to sell its shares of the investment and recover its money.

Inherent Risk in Mudharabah

Mudharabah is a contract between capital owner and an entrepreneur, whereby the former provides the capital and the latter manages the venture based on agreed terms that do not violate the Shariah. The inherent risk arises as a result of moral hazard that is difficult to control due to the fact the rabalmal does not follow the mudharib in his place of business. Since the capital provider does not accompany the mudharib in managing the funds there is possibility of moral hazard. Nevertheless, the Shariah responds to this risk with set of fiqhi guiding principles. For example the mudharib is not allowed to travel with the funds or commodity beyond the place permitted by the Rab al Mal. Failure to heed to this amounts to breach of the terms of engagement as an entrepreneur. The Rab al-Mal also has the right to restrict him from certain transactions and certain types of customers.

In addition, the Maliki School held that the claim of loss or damage of funds by the mudharib is not accepted if there are circumstantial evidence to prove the contrary; and his claim of loss and lack of profit are not accepted except with following two conditions: if he took an oath to affirm his claim of losses in his transaction, and if there are no circumstantial evidence to prove the contrary. Also, it is permissible for the mudharabah sukuk holders to appoint some members among them to represent them in

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34 Amr Muhamed El Tiby, at 56-7.
protecting their interest in *mudharabah* contract. These are formidable measures for managing risk of moral hazard in *mudharabah*.

**The Inherent Risk of Murabaha and the Shariah Compliant Responses**

In banking practice, *murabahah* is predominantly practiced on the basis of order placed by a customer, who promises to buy after the bank has taken ownership. The inherent risk in *murabahah* is that the customer may not fulfill his promise to purchase or an unforeseen circumstance may befall him after the bank has already purchased the ordered item. And the item may not be needed by another customer as early as possible. This causes liquidity risk, price, and market risk to the bank as the cost price may fall before getting another buyer and the costs that are associated with the purchase, like cost of insurance, and other delivery expenses are liability on the bank. To manage these risks the bank normally takes earnest price (*urbun*) from the customer. Alternatively, the bank may enter into *musharakah* contract agreement with a car vendor for example, with little amount of money so that the relationship between both of them is now that of partnership and not seller-buyer’s relationship. With this partnership agreement, the bank would have minimized cost; it is not in need to commit any cost for *murabahah* for purchase orderer, rather it simply delivers from its jointly owned company without incurring any additional cost.

**Ijarah**

The inherent risks in *ijarah* contract vary from one type of *ijarah* to the other. There is operating *ijarah* which is not meant for transfer of ownership at the end of the contract, and there is Islamic hire purchase (*ijarah muntahia bi tamleek*) which is aimed at transferring of ownership to the lessee at the end of the term of the *ijarah* and there is *Ijarah mawsufah fi dhimmah* which is defined as forward sale of usufruct against cash payment. It is similar to sale of *salam* in all aspects, except that *salam* is a forward sale of commodity against cash payment. The risk in Operating *Ijara and Ijarah Muntahia Bi Tamleek* on operating *Ijara and Ijarah Muntahia Bi Tamleek*, is the lessee may be unable to service the rental as and when due. Therefore, to mitigate the potential credit risk the Islamic financial institution is able to repossess the asset thus mitigating the credit risk. El-Tiby added that the *Hamish jiddiyah* (earnest price) in addition with the repossession will mitigate the market risk. There is also an operational risk—which is different from inherent risk in *ijarah*. This risk may arise from mishandling of equipment by the lessee and consequently damaging it. To mitigate this risk it is imperative for the Islamic financial institution to appoint an agent to supervise the fairness of the lessee in using the machines. Also, he should take a comprehensive insurance policy for full coverage.

38 Majallat Majma’ Fiqh AL-Islami, (), v. 4, 1455.
39 Though it is contested by the earlier jurists, but permitted by the overwhelming population of the contemporary jurists, most notably, the OIC Fiqh Academy. See OIC Fiqh Academy, “Urbun”, resolution no. 72 of 1993.<http://www.fiqhacademy.org.sa/> (assessed 30th December, 2014).
41 Amr Muhamed El Tiby, at 52-3; Abdullah Haron and John Lee Hin Hock, Inherent Risk: Credit and Market Risks in Rifaaat Ahmad Abdel Karem and Simon Archer, *Islamic Finance, the Regulatory Challenge*, (Singapore: John Wille and Sons, 2007), at 96.
The risk in *ijarah mawsufah fi dhimmah* on the other hand ensues as the quality of service of the person may not meet expectation, hence operational risk will occur. This operational risk will also give rise to market risk in the receiving institution. For example, the *ijarah mawsufah fi dhimmah* was concluded to hire medical doctor who specializes in treatment of diabetes and related diseases but he turns out to be very good in diabetes only but poor in handling other related diseases. This will cost the institution additional expenses to hire additional medical doctor or a replacement that can cover the gap left by the first one. This has potential of causing market and credit risks to the receiving institution. To mitigate market risk in *ijarah mawsufah fi dhimmah*, the institution may make pre-agreement with his counterparty that in the event of dissatisfaction with any of the trainer he has to make immediate replacement.

**Istisna and Parallel Istisna**

In *istisna* contract IIFS is faced with the risk of the customer inability to discharge his payment obligation or progress billing when the work is already in progress. And in parallel *istisna* the IIFS is faced with completion risk; where advance payment has been made to the sub-manufacturer and he failed to deliver at the time mutually agreed upon and no replacement for the sub-contractor was available. Also the payment made to the subcontractor may not be recoverable. The researcher is of the view that to manage the credit risk in loss of payment made to the subcontractor is to stipulate placement of substitute in the event the first subcontractor default or died. This is because majority jurists held that *ijarah* does not terminate with the death of either of the contracting parties; rather the contract is inheritable by the deceased’s survivors. If *ijarah* does not terminate with death of a counterparty, analogically it should not terminate based on failure to deliver, but the manufacturer should be compelled to fulfill all conditions of the contract or bring a replacement to complete it at his own expenses without any additional cost from the IIFS.

**Conclusion**

Risk management is an integral organ of Islamic financial institution in order to actualize objective of the Shariah in the protection of wealth. The wealth of a nation is a collective wealth of its citizens, and so, it is compulsory to protect the individuals’ wealth for a robust economic wellbeing. In finance some risks are inherent and others are operational, but Islamic finance has more risks than the conventional finance. This is so because the former is guided by the Shariah principles some of which are prohibition of riba and *gharar*, while the latter does transfers some of these risks to the customers because there is no prohibition of riba and *gharar* applicable to its operational principles. A Shariah principle says that if harm cannot be removed completely it should be reduced. Therefore, management of inherent risks and prevention of operational risks are key to the success of Islamic finance. To achieve this aim, there is need to improve on banking

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42 Abdullah Haron and John Lee Hin Hock, Inherent Risk: Credit and Market Risks in Rifaat Ahmad Abdel Karem and Simon Archer, *Islamic Finance, the Regulatory Challenge*, (Singapore: John Wille and Sons, 2007), at 96.
43 Ibid.
44 This is in the recognition that the jurists other than the Hanafi School treat *istisna* and *ijarah* as one type of contract.
supervision and give more training to the staff so that they are better equipped with expertise for managing inherent and operational risk. The Takaful companies also should be strengthened to assist the banks in mitigating risks so that the economy can be balanced.

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An Empirical Assessment of the Displaced Commercial Risk in Malaysian Islamic Banking Institutions: Bank Profitability Model Evidence

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Abstract
Islamic banks are exposed to a unique risk - Displaced Commercial Risk (DCR). DCR arises from the assets managed on behalf of the investment account holders which may be borne by the Islamic bank’s own capital, when the Islamic banks forgo part or all of its share of profits on the investment account holders funds, in order to increase the return to the investment account holders. In a dual banking system, DCR could be a threat to the Islamic banks given the competition of fixed and higher return from the conventional banks. However, DCR would not be a threat to Islamic banks if their account holders choose Islamic banks due to religious obligatory factor. Pertaining to this issue, this paper aims to examine whether DCR is a threat to Islamic banks’ profitability in the case of Malaysia. For that purpose, a model is set up to estimate bank profitability. The model includes other bank specific characteristics and macroeconomic variables as control variables to avoid omitted variables bias. We find that DCR is one of the factor that affects bank profitability, at least in the case of Malaysian Islamic banks. This empirical evidence implies that Islamic banks operating in a dual banking system are affected by DCR. The risk of losing deposits happens when bank profitability is lower than that paid by the competing banks. Hence, analysis concluded that the relationship between bank profitability and DCR is shown to be significant and negative.

JEL classification: C23; E30; G21.

Keywords: Islamic Banks; Return On Assets; Displaced Commercial Risk; Bank Profitability; Investment Account Holders; Profit Sharing Investment Account.

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1. Introduction

This study aims to examine the significance of displaced commercial risk to the Islamic banks in Malaysia. DCR refers to the risk arising from the assets managed on behalf of the investment account holders which is transferred to the Islamic banking institutions’ own capital where the Islamic banking institutions forgo part or all of their portion of profits on Profit Sharing Investments Accounts, in order to increase the rate of return that would otherwise be payable to the investment account holders. Technically, if customers choose Islamic banks purely on religious motivation, DCR should not be a concern since they would not withdraw their deposits from the Islamic banks due to lower return compared to the conventional banks.

However, the development of Islamic banking in Malaysia suggests the possibility of displaced commercial risk to exist within the Islamic banking system. Firstly, the Malaysian banking system is based on parallel or dual banking system, which allows interest-based and interest-free banking to coexist and compete for deposits and financing. As the Malaysians are multi-religious and multi-cultural, Islamic banking is therefore expected to deal with situations in which the demand for and supply of excess funds are no longer made on the basis of faith alone but also on factors such as return on deposits, cost of financing and convenience. The religious and non-religious elements in the market segment of Malaysian Islamic banking is likely to affect performance as changes in market interest rates are likely to affect Islamic bankers’ asset-liability management strategy, as well as depositors’ behaviour.

The Bank Negara Malaysia’s Annual Report 2012 exposed, between 2000 to 2012 (BNM, 2012), the Islamic banks have successfully expanded their operations by attracting more customers, the non-Muslims included. This implies that Islamic banks customers are no longer limited to those whose motivation is religious per se. This translates into the probability that these customers are highly profit oriented, hence there is also a high tendency for them to withdraw their deposits should the return from Islamic banks not be at par to the conventional ones. Given this situation, there is a higher probability of Islamic banks facing Displaced Commercial Risk (DCR).

Moreover, studies show that banks’ customers motivation for choosing a bank is not at all related to religious factor. For instance, Marimuthu et. al (2010) and Amin et. al (2011) conducted studies on the loyalty of Muslim and non-Muslim customers in the Malaysian Islamic banks. Both studies claim that, customers are concerned with three major attributes that ultimately affect their switching behaviours, which are, better service provided by bank competitors; higher profit provided by other banks; and the variety of products and services. In addition, Mulyani (1998) finds that in Indonesia, people choose Islamic banks not so much because of religious, instead profits hold an important role in bank selection process.

Another set of studies (Haron and Shanmugam, 1995; Haron and Ahmad, 2000; Mangkuto, 2004; Sukmana and Yusof, 2005; Yusof et. al, 2009; Leong at. El, 2009; Mohamad Zaid et. al, 2011; Abduh et. al, 2011; Zeitun, 2012) that examine the savings motive of Islamic banks customers, also observe the existence of profit motive among the Islamic bank’s customers. The existence of profit motive has many implications, one of which is the tendency of depositors to withdraw their fund and remove it to conventional bank if the latter offers higher return (interest rates).

More importantly, Zainol and Kasim (2010) and Bacha (2004) find that changes in Islamic banks’ total deposits depend on the level of conventional banks’ interest rate; and
there is a significant relationship between conventional banks’ interest rate and Islamic banks’ total deposits. This suggest the existence of deposit switching from Islamic banks to conventional banks when the conventional banks’ interest rate increases. The evidence is more direct in highlighting the possibility of DCR to be a threat to the Islamic banks since it proves that deposit transfer did exist when there is an increase in conventional banks’ interest rate.

Collectively, those findings suggest that Islamic banks in Malaysia possibly face the threat of DCR, which is the tendency of Islamic banks depositors to withdraw their fund and transfer the fund to conventional banks when the real return provided by the Islamic bank is lower than the interest rate of its conventional counterparts (and vice versa). However, to the best of our knowledge, studies on DCR and its significance to the Islamic banks are very limited. Hence, this study is undertaken to empirically examine to what extent the DCR affects Islamic banks in terms of its profitability.

The next section presents a detail explanation on the core concept, that is Displaced Commercial Risk. The research data and methodology is covered in Section 3. The empirical results and conclusion are presented in Sections 4 and 5, respectively.

2. Displaced Commercial Risk (DCR)

Displaced commercial risk is an unexpected loss that the bank is able to absorb to ensure that Investment Account Holders (IAH) are remunerated at a competitive rate (Toumi, 2010). Inspired by Rosly and Zaini (2008), Sundararajan (2008) and How et. al (2005), in detail, there are some causes that Islamic banks should consider in displaced commercial risk, where displaced commercial risk derives from competitive pressures on bank to attract and retain investors (fund providers). Islamic banks as mudaribs may forgo their rights to part or their entire mudarib share in profits in favor of Investment Account Holders (fund provider) and is a commercial decision.

Displaced commercial risk indicates that the Islamic bank may not be able to pay competitive rates of returns as compared to other competitors. In such situations, this risk arises when an Islamic bank underperforms during a period and is unable to generate adequate profits to pay its investors and depositors a rate of return higher than what should be payable under the actual terms of the investment contract (AAOIFI, 1999; Khan and Ahmed, 2001; Van Hennie and Iqbal, 2008). The reasons for this are quite clear in the Islamic bank environment. If bank do not provide rates similar to deposits, then investment account holders will move their funds to a bank (Islamic or otherwise) that does define displaced commercial risk. This is a legitimate concern and it relates to the mentality of investment account holders who may desire a stable low-risk return.

Therefore, in reality, most of Islamic banks decide to waive their profit portion to pay the investment account holders (IAHs) in order to prevent the withdrawal of the IAHs. An Islamic bank is strongly exposed to massive withdrawal risk due to lower rate of return on investments deposits, which explains the logic of increasing the profits distributed to IAHs (Khan and Ahmed, 2001; Ahmed, 2003; IFSB, 2005; El-Hawary et al., 2007). Once it occurs and cannot be handled properly, Islamic banks may go bankrupt or at least be taken over by government (banking authority). To prevent withdrawal from their depositors, the owners of the bank will need to apportion part of their own share in profits to the investment depositors. As a result, some Islamic banks give minimum guaranteed returns to depositors, although it is prohibited by the shariah principles (AAOIFI, 1999; Warde, 2000).
Thus, Archer and Karim (2006) argue that DCR is potentially an efficient and value creating means of sharing risks between two classes of investor with different risk diversification capabilities and preferences. Therefore, Islamic banks set up two standards of practices reserves with the intention of minimizing any need to forgo management fees. According to Greuning and Iqbal (2007), Islamic banks introduce Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR) to compete with conventional banking industry, it is a shield used by Islamic banks to protect DCR. Besides that, Central Bank of Malaysia (BNM, 2004) issued Framework of Rate of Return to aid Islamic banking sector to mitigate risk of income destruction by sustaining comparable rates of return for fund depositors.

It means that DCR is related to the fact that Islamic banks may find themselves under pressure to smooth the rate of return of the Profit Sharing Investments Accounts (PSIA) in order to remain competitive and not lose customers. In addition, the actual return of PSIA would be subsidized by shareholders’ profits (Christos & Alexandros, 2009).

Further, the issues of DCR which arise as a result of the risk characteristics of profit-sharing investment accounts (PSIA). The disclosure of PSIA should be consider in particular the implication of PSIA for DCR can provide strong incentive for effective and transparent risk sharing and associated product innovations. The characteristics of PSIA in Islamic banks could vary among banks and jurisdictions, from being deposit-like products (fixed return, capital certain, all risks borne by shareholders) in some, to being investment-like products (variable return, bearing the risk of losses in underlying investments) in others. These depend on the extent of the balance sheet risks is transfer from investment account holders to shareholders through various techniques available to Islamic banks’ management. Such as, in Islamic banks, the tenor of unrestricted PSIA may be shorter than that of Islamic financing assets. These market pressures have the effect of displacing onto shareholders’ investment risks on IAH funds which, from a purely shariah point of view, would be borne entirely by the IAH. In other words, these pressures give rise to DCR.

In Islamic banks, the target market is likely to be sensitive to market based price measures, particularly if these banks operate in competitive contractual environments with other Islamic and conventional banks and deposit taking institutions. As a result, Islamic banks may be pressured in varying degrees to provide distributions similar to other institutions or risk losing their depositor base. This risk has been termed displaced commercial risk. It essentially refers to the risk that investors will withdraw their funds in droves, thereby subjecting the bank to failure, if the returns paid demonstrate a trend contrary to the investors’ expectations of deposits of a similar nature.

Particularly, the research will provide specific information on DCR which is applicable to countries that have the same Islamic banking industry. In addition, the output of the research will fill a gap in knowledge and understanding with regard to examine DCR through Islamic banks’ profitability side in the case of Malaysia. Next section provides a step practical procedure for the estimation of DCR.

3. **Data and Methodology**

This research will use a sample of 17 full-fledged Islamic banks in Malaysia. The study periods spans from 1994 to 2012, using a balanced panel data of 323 observations.
Our calculations are based on individual bank data drawn from the available annual report database.

### 3.1 Bank Profitability Models

The bank profitability model includes other bank specific characteristics and macroeconomic variables as control variables to avoid omitted variables bias. The equation (1) will be estimating the impact of DCR on bank profitability with the bank characteristic included the macroeconomic factors as the control variables.

\[
BP_{it} = \gamma_0 + \gamma_1 S_{it} + \gamma_2 AST_{it} + \gamma_3 OWN_{it} + \gamma_4 LOAST_{it} + \gamma_5 LPLO_{it} + \gamma_6 DIV_{it} + \gamma_7 COST_{it} + \\
+ \gamma_8 EXCH_{it} + \gamma_9 INFL_{it} + \gamma_{10} GDP_{it} + \gamma_{11} INT_{it} + \gamma_{12} DCR_{it} + \gamma_{13} HERFIN_{it} + \mu_{it}
\]  

(1)

Where;

- \(BP\) = Bank profitability.
- \(S\) = Bank stability.
- \(AST\) = Total assets of a bank.
- \(OWN\) = The ownership.
- \(LOAST\) = Loans to total assets.
- \(LPLO\) = Loan loss provisions to total loans.
- \(DIV\) = The Income Diversity.
- \(COST\) = Cost to income ratios.
- \(EXCH\) = The exchange rates.
- \(INFL\) = The inflation rate.
- \(GDP\) = Gross domestic product.
- \(INT\) = The interest rate ratios.
- \(DCR\) = Displaced commercial risk.
- \(HERFIN\) = The Herfindahl index.
- \(\mu\) = Error term.

### 3.2 Estimating Equations

\(BP\) stand for bank profitability. In this study, we use the return on asset (ROA) as a measurement of bank profitability. The return on assets noted by ROA, measured by the ratio of net income to total assets.

\(S\) as a proxy of bank stability. Bank stability is measured using Z-score. This measure is calculated as the sum of a bank’s average ROA and average Capitalization Ratio divided by standard deviation of ROA (the volatility of ROA). Based on the previous study that larger banks will be less riskier (e.g., Boyd and Runkle (1993), Boyd, De Nicolo, and Jalal (2006), Laeven and Levine (2009), Houston, Lin, and Ma (2010), Beltratti and Stulz (2012)), due to the increased ability to diversify their income streams, in all spectrums including geographic, customer and industry (De Young and Roland 2001).

\(AST\) is total assets of a bank; The \(AST\) variable is the value of total asset included in the regression models as a proxy of size to capture for the possible cost advantages associated with size (economies of scale). We include the log of total assets to control for changes in the bank’s size since Bannier and Hansel (2008) as well as Martin-Oliver and Saurina (2007) provide empirical evidence that the banking institution’s size is a strong determinant of profitability effects. Pasiouras and Kosmidou (2007) find a positive and significant relationship between the size and the profitability of a bank.

\(OWN\) is the ownership as a proxy of dummy variable. Assume the value of (1) if the bank is a local Islamic bank and (0) is a foreign Islamic bank in Malaysia. For example, if local Islamic banks are relatively weaker than foreign Islamic banks, the
dummy variable would have a negative sign in the regression explaining bank profitability.

**LOAST** is ratio of loans to total assets. The **LOAST** is used as a measure of liquidity. Higher figures denote lower liquidity. Without the required liquidity and funding to meet obligations, a bank may fail. Among the previous studies that report a direct relationship between the relative percentage of loans in bank assets (LOAST) and profitability or, similarly, an inverse relationship between liquidity and profitability are Barros et al. (2007), Chiorazzo et al. (2008), DeYoung and Rice (2004), Goddard et al. (2004) and Iannotta et al. (2007).

**LPLO** is the ratio of loan loss provisions to total loans as a proxy of credit risk (Delis and Kouretas, 2011). The coefficient of the LPLO variable is expected to enter the regression models with a negative sign. In this vein, Miller and Noulas (1997) point out that the greater the exposure of banks to high risk loans, the higher would be the accumulation of unpaid loans and profitability would be lower. Miller and Noulas (1997) suggest that decline in loan loss provisions are in many instances the primary catalyst for increases in profit margins. Furthermore, Thakor (1987) also suggests that the level of loan loss provisions is an indication of the bank’s asset quality and signals changes in future performance.

**DIV** is the Income Diversity proxies by a measure of diversification across different sources of income. We control for Income Diversification since a number of banking studies find that diversification influences risk. Income diversity is calculated as:

\[
1 - \frac{\text{Net interest income} - \text{Other operating income}}{\text{Total operating income}}
\]

Greater income diversity tends to increase profitability large Islamic banks, suggesting that a move from lending-based operation to other sources of income might improve profitability in those banks.

**COST** is cost to income ratios as a proxy of cost efficiency. Cost to income ratio and bank profitability is expected to be positive. The previous studies evaluates the impact of COST on bank profitability and find that a positive and highly significant (Garcia-Herrero et al., 2009). This would imply that operational efficiency is a prerequisite for improving the profitability of the banking system, with the most profitable banks having the lowest efficiency ratios. Therefore, a positive relationship between profitability and **COST** is possible.

**DCR** is displaced commercial risk. Another determinant of bank profitability is the risk a bank is facing. In the case of **DCR**, the decreasing ability of Islamic banks to collect deposit from customers would explain a large proportion of the fall in profitability. Bourke (1989) and Molyneux and Thornton (1992), among others, find a negative and significant relationship between the level of risk and profitability. This result might be explained for example by taking into account that financial institutions that are exposed to high risk loans also have a higher accumulation of unpaid loans. These loan losses lower the returns of the affected banks.

**HERFIN** is the Herfindahl index as a proxy of market power. The Herfindahl index is define as the sum of squared market shares (in terms of total assets) of all Islamic banks in the Malaysia. We expect a positive sign for the interaction of the **HERFIN** and the bank’s profitability would indicate that a higher share of Islamic banks rise bank
profitability (Uhde and Heimeshoff, 2009; Beck et al., 2006; Schaeck et al., 2006; De Nicolo et al., 2003).

*EXCH* is the exchange rates as the proxy of market risk. According to the existing literature (Shahid and Abbas, 2012; Shayegani and Arani, 2012) on the banks that the increase in the *EXCH* or positive change in the exchange rate affects financial profitability in a positive manner and this study has confirmed this finding. The exchange rate increase has given a higher degree of profitability to the banks. It is also found that the capital of previous period as a variable has reverse relationship with the financial profitability of banking. This relationship is statistically valid.

*INFL* is the inflation rate. Why we are using the *INFL* variable also because of to capture the effects of macroeconomic shocks on banks’ balance sheets. *INFL* has been used in previous studies of banking to proxy for macroeconomic mismanagement, which has been found to adversely affect the financial system and real economy (Lown and Morgan, 2006; Buch et al, 2010). The findings of the relationship between inflation and profitability are mixed. Staikouras and Wood (2003) points out that inflation may have direct effects i.e. increase in the price of labour and indirect effects i.e. changes in interest rates and asset prices on the profitability of banks. However, the study of Abreu and Mendes (2000) and Demirguc-Kunt and Huizinga (1999), reports a negative coefficient for the inflation variable with profitability. It notice that banks in developing countries tend to be less profitable in inflationary environments, particularly when they have a high capital ratio. In these countries, bank costs actually increase faster than bank revenues.

*GDP* Gross domestic product is used as macroeconomic indicator to measure total economic activity within an economy. The *GDP* is utilized as a control variable since the banks’ investment opportunities may be correlated with macroeconomic cycles and its impact on the level of bank risk (Laeven and Majoni 2003; Cihak and Hesse 2008). The inclusion of this variable is based on the view that economic increases indicate improving conditions for banks and therefore reduce the likelihood of bank insolvency, whereas a recession will have the opposite effect. Hence, banks' operating under a higher level of *GDP* to be more profit is predicted. It is mean that, we expect a positive sign of the coefficient of real *GDP* growth with bank profitability if investment opportunities rise under economic booms.

*INT* is the interest rate ratios. Islamic banks are influenced by *INT* because they are subjected to negative fund gap. It will be happened because the Islamic banks suffer from over-dependency on fixed rate asset financing (such as al-bay’ bithaman ajil and Murubahah contracts), funds gap will always be negative where all Islamic liabilities are interest-sensitive. In case of increase in *INT*, the demand for Islamic loans also increases because of relatively reduced cost compared to the conventional bank loans. Islamic banks have to maximize the profitability rates in the deposits in order to meet this demand. Hence, we expect a negative sign for the interaction of the *INT* and the bank’s profitability.

### 3.3 DCR: VaR Approach

To quantify DCR for Islamic banking institutions in Malaysia where banks operate in a dual banking system, we are using the Value at Risk (VaR) approach. A variety of approaches exist for estimating VaR. In this study, we are using the Variance-Covariance Approach called Parametric VaR because one of its fundamental assumptions is that the
return distribution belongs to a kind of parametric distributions such as the normal or the 
lognormal distributions. VaR can simply be expressed as:

\[ \text{VaR}_{1-\alpha} = -x_{\alpha} \times P \]  

(1)

Where:

- \( \text{VaR}_{\alpha} \) is the estimated VaR at the confidence level \( 100 \times (1-\alpha) \)%.
- \( x_{\alpha} \) is the left-tail \( \alpha \) percentile of a normal distribution \( N(\mu, \sigma^2) \). \( x_{\alpha} \) is described in the expression \( P[R < x_{\alpha}] = \alpha \) where \( R \) is the expected return. In order for \( \text{VaR} \) to be meaningful, generally set the confidence level of 95% which yields a 1.65 factor assuming a normal distribution or 99%, which yields a 2.33 factor assuming a normal distribution. \( x_{\alpha} \) is generally negative.
- \( P \) is the marked-to-market value of the portfolio.

In order to determine the DCR, assuming a normal probability distribution, and using the standard deviations of rate of return on equity (ROE), the equations can be shown through estimation model proposed by IFSB (2011) as follows:

\[ \text{DCR} = \text{UL}_1 - \text{UL}_0 \]  

(2)

Where; \( \text{UL}_0 \) is a multiple of the standard deviation of \( \text{ROE}_0 \) (Unexpected loss to shareholders when PSIA are treated as pure investment products) and \( \text{UL}_1 \) is a multiple of the standard deviation of \( \text{ROE}_1 \) (Unexpected loss to shareholders when PSIA are treated as being in between pure investment and deposit like products). The corresponding unexpected loss to shareholders under the two scenarios of PSIA can be calculated as the rate of return to equity is expressed as follows:

\[ \text{ROE}_0 = \text{RA} - \text{PA} \]  

(3)

\[ \text{ROE}_1 = \frac{\left(\text{RA} - \text{PA}\right) + \text{DI}}{K \text{w} \left(\text{RA} - \text{PA} - \text{R}_m\right)} \]  

(4)

Where; \( \text{RA} \) is the gross rate of return on assets; \( \text{PA} \) is the provision as a percentage of assets; \( \text{DI} \) is PSIA funds; \( K \) is shareholders’ funds; \( R_m \) is mudarabah income; and \( w \) is the weight attached market benchmarks in the decision on payouts to IAH.

To assess the DCR based on \( \text{VaR} \), we want to know the bank equity amount necessary to absorb the displaced commercial risk. In spite of the existing reserve level, the return on investment can fall below the benchmark level. The equity level uncovered by the reserve amount will be obtained by the \( \text{VaR} \) for a given probability level \( \alpha \). The estimation \( \text{DCR} \) equation from equation (2) will become (5) after implementing \( \text{VaR} \) method. If the investment and benchmark profit follow the standard normal law and isolating the \( \text{VaR} \) it comes:

\[ \text{DCR}_{\text{VaR}} = Z_{\alpha} \sigma \left( \overline{r}_I - \overline{r}_B \right) + E + \left( E(\overline{r}_I) - E(\overline{r}_B) \right) \]  

(5)

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This model adapted from Toumi et.al (2011), where; $Z_\alpha$ is a quantile of the standard normal law for the level of probability $\alpha$. $r_i$ is the return on the investment account. $E$ is the part of accumulated amount of reserve attributed to Investment Account Holders and $r_b$ is a return on benchmark.

Now, this study do it value of $VaR$ in the percentage amount in $DI$. It is making easier to interpret $VaR$ value. By developing the standard deviation (volatility) of the difference between the investment and benchmark profit, the $VaR$ is using by the capital asset pricing model (CAPM) model. In the simplest case were the benchmark portfolio is the risk free asset and the invested portfolio is equal to the market portfolio, the $VaR$ becomes:

$$\frac{DCR_{VaR}}{DI} = f \left[ Z_\alpha \sigma_R \left( R_m - R_f \right) \right] + E + (f - 1) R_f$$

(6)

4. Empirical Results

4.1 DCR output

Based on the sample above, we present empirical results of DCR model between 1994 to 2012. Figure 1 (In Appendix) detail the trend of capital required by Islamic Banks in Malaysia to cover the displaced commercial risk ratio at 99% confidence level.

The figure expresses DCR performance between 1994 to 2012. Overall, since 1994 to 2008, there is a sharp increase DCR for each Islamic bank. This situation is faced by banks since pressures from regulators on each Islamic bank to pay market related returns and avoid any loss of principal, in order to prevent possible risks that might arise from customer withdrawals from banks that offer below market returns. The crisis also revealed a structural weakness in Islamic banking operations particularly under a volatile economic environment. In Malaysia, 90% of Islamic financing are negotiated on fixed-rate terms. Comparatively, the return from financing under Islamic banking would decline under this environment and contribute to lower deposit rates to depositors. In essence, Islamic banking could not react swiftly under the current interest rate environment due to the absence of a floating rate option.

Generally, starting in 1999, all banks need the huge capital to cover the displaced commercial risk, which is the average capital required by this year to cover the displaced commercial risk ($DCR_{VaR}$) being 0.13 of the total of investment account. It happened since the impact of interest rate changes on Islamic bank performance in the dual system. The Islamic banks are exposed to interest rate risks and the cause of this phenomenon is the overdependence of Islamic banks on Islamic financing where the profit rate (financing rate) is fixed. When interest rates are rising, the base lending rate (BLR) and rates of return on deposits of the conventional bank would change accordingly to changes in the market interest rate. The Islamic bank’s depositors who were driven by profit motive take their fund from the Islamic bank and move it to the conventional banks. The substitution effect comes into play where depositors prefer the conventional banks. Further, as the level of Islamic deposit decreased when the interest rate increased. As a consequence, Islamic deposits give lower returns.

However, demand for Islamic banks’ financing will also increase when market interest rates increase, as their prices are normally lower as compared to the credit
interest rate of the conventional banks. Hence, as the market interest rate swings, no matter whether it increases or decreases, Islamic banks are exposed to a certain degree of risk, which possibly comes from the movement of either their depositors or users of funds. Thus, the higher the volatility of market interest rate, the bigger the displaced commercial risks faced by Islamic banks such that the banks need to increase their deposit rate or to decrease their financing rate or operate at a lower margin.

In 2002, the average amount of $D_C R_{VaR}$ climbed gradually to just over 0.50. This risk amount has fluctuated between 2002 to 2008, before ending at a peak of average 7.64 in 2008. Such a phenomenon of economic recession and loss of competitiveness is one of the reasons why the banks are exposed to higher DCR.

There was a steep fall in capital to cover the DCR by the end of the year 2009. The result shows that the performance of Islamic banking in Malaysia is strengthened during the period. With Malaysia’s goal of becoming the most significant Islamic finance hub in the world, it is therefore very important to Islamic banks to improve the asset quality and maintain a proportion of IAH in reserve within the IAH equity, with the purpose of smoothing returns to IAH. Therefore, at the end 2012, the average amount of the capital required by each Malaysian Islamic banks to cover the DCR is 4.26 of the total of investment accounts with 99% confidence. We find that, where based on the data used in this regression, an additional year of DCR, insofar as the effect of DCR is still small. However, the equity of Islamic banks is still needed to protect DCR.

4.2 Bank Profitability output

Descriptive analysis was conducted to observe the statistical properties of the data used as variables, such as the mean, median, standard deviation and normality of the data. Table 1 illustrates the summary of basic descriptive statistics of the variables involved in the model developed, based on two main indicators, namely the indication of bank specification and macroeconomic factors.

According to Table 1, we can see that a higher average HERFIN value of 7.52. Throughout this study, Malaysian Islamic banking proves its market power and strength. Islamic banks also should be looking at the DCR problem. The result shows that the average value of the capital required by Islamic banks to cover the DCR is 2.41% of the total of investment account with 99% confidence.

In terms of macroeconomics, growth of the Gross Domestic Product (GDP) averaged 9.34 and the exchange rates (EXCH) during 1994 to 2011 at 6.61. The level of average Z score remained stable at 0.67. While the ratio of loans to total assets (LOAST) variables is 0.36%. We believe that from this figure, the impact of liquidity in Islamic banks to hold liquid assets is 0.36%.

Next, standard deviation is used in determining the variation of the data. COST variables have the highest standard deviation value of 3.91. We use the COST which measures overhead costs relative to gross revenues. This figure shows that the Islamic banks have significantly higher overhead costs with the standard deviation at 3.91%. Small data dispersion exists for the gain (ROA) variable. For the macroeconomic variables, the highest data dispersion is the interest rate ratios (INT) variable with a value of 1.81, while the lowest dispersion value is growth of Gross Domestic Product (GDP) with a standard deviation of 0.07.
In measuring skewness, it is found that the bank characteristic variables, which consist of cost to income ratios (COST) and the Herfindahl index (HERFIN), have a negative scattered data. In contrast, the ratio of loan loss provisions to total loans (LPLO), total assets of a bank (AST) and displaced commercial risk (DCR) were positively scattered. Next, macroeconomic variable such as growth of Gross Domestic Product (GDP) recorded negative scattered data, while the data on the exchange rates (EXCH), inflation rate (INFL) and the interest rate ratios (INT) variables are positively scattered.

Next, kurtosis tests were carried out to observe the normality of the data distribution. The inflation rate (INFL), Income Diversity (DIV) and the Herfindahl index (HERFIN) kurtosis’ values are approaching two, meeting the criteria for a normally distributed data.

Jarque-Bera test is then used to confirm the extent of the data normality distribution. From this test, results in Table 1 demonstrate that all variables are significant. This shows that all data are not normally distributed. Therefore, ordinary least square (OLS) estimation is not compatible with the research data. Hence, the Generalized Least Square (GLS) method is more appropriate and expected to yield a much better result.

Table 2 shows the correlation matrix for the independent variables. This table provides a very interesting result. First, Most of the variables are correlated but not beyond the critical threshold of multicollinearity. All correlation results are below 0.6 for each pair of variables, which indicates that multicollinearity is not a potential problem. Second, the relationship between profitability and DCR is shown to be significant and negative. With correlation coefficient of 0.42 this result explain that for each unit increase in DCR, it will lead to a 0.42 decrease in profit. This finding is the empirical evidence which has been supported by Bessis (2002). Bessis (2002) find that DCR has adverse impacts on profitability. This is a logical relationship which suggests that as DCR increase, bank profitability would decrease. Third, the relationship between loans in bank assets (LOAST) and profitability is also negative and significant. This suggests that if a bank needs to increase risk to have a higher loan to asset ratio, then profit may decrease.

We are using the three Generalized Least Square (GLS) models: None effects, Fixed effects, and Random effects to select the best bank profitability model (See Table 3). The fixed effect model examines how heterogeneity from each group and/or time affects individual intercepts, while a random effect model hypothesizes error variance structures affected by group and/or time.

The Chow test conducted the F-test to compare between fixed effect with GLS none effect models. At the same time, the Hausman specification test compares between the fixed with random effect models. Whereas, the Breusch Pagan LM test to detect the heteroskedasticity problem. For this study, we subdivide Islamic banks into three groups: All, Large and Small categories because each category of banks have a difference performance by expanding the resources within existing business lines. In Malaysia, about 30 percent of the Islamic banks fall into the small bank category and around 70 percent of the Islamic banks fall into the large bank category.

Table 3 also shows that the p-value reported for the Chow test statistic is less than 0.0001. A low p-value suggests that we are able to reject the null hypothesis. Therefore,
we choose the fixed effect model. However, the best model is selected based on the Hausman test is to choose between fixed effects or random effects model. The output is reported to be chi-square with 2 degrees of freedom and a p-value of 0.0001. Based on these results we would reject the null hypothesis and a fixed effect approach will be preferred.

The statistical output also shows the result heteroskedasticity problem. When we use the Breusch-Pagan test, the null hypothesis is a constant variance. The output shows the p-value is 0.1946, then we failed to reject the null and there is no problem of heteroskedasticity. Based on the output, our results show that fixed effect model is better than GLS none effect and random effect model.

5. Conclusion

We can conclude that, basically the Displaced Commercial Risk problem should not occur in the Islamic banking system if their account holders choose Islamic banks due to religious obligatory factor. However, the empirical data proves the existing of DCR in Islamic banking system in Malaysia because of customers are profit motivated or often referred to as a floating client.

This study also examines the Islamic banks profitability from bank specific characteristics and macroeconomic variables by focusing on Malaysia scenario. The findings of the study show that variables that have been identified as the significant factors towards profitability for Islamic banks were stability (Z-score), cost income ratio, loans to total assets ratio, loan loss provisions to total loans ratio, displaced commercial risk, total assets, Herfindahl Index, exchange rates, interest rate, and inflation.

We find that DCR is the one factor that effect Malaysian Islamic bank profitability. DCR is applicable to the Islamic banks given the competition of fixed and higher return from the conventional banks. We recommends that the government, the shariah supervisory councils, Islamic banks and other relevant authorities to further promote to customer who deposit their funds in Islamic banks should be governed by shariah motive rather than profit motive.

References


Appendix

Figure 1: The Capital Required by Banks to Protect DCR

Table 1: Descriptive Statistic variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Skewness</th>
<th>Kurtosis</th>
<th>Jarque-Bera</th>
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Note: * Significant at 1%, ** 5% and *** 10%.
Table 2: Pearson’s Correlations

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Note: *** Correlation is significant at the 0.01 level (2-tailed).
** Correlation is significant at the 0.05 level (2-tailed).
* Correlation is significant at the 0.1 level (2-tailed).
### Table 3: None, Fixed and Random Effects Estimation Result

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Note: Figures in parentheses denote ‘Standard Error’ values of the regressions coefficients.

*** Significant at 1 percent level.
** Significant at 5 percent level.
* Significant at 10 percent level.
Executive Speak Opinion

Too little, too late

Sirajuddin Aziz*

I have learnt from a press report that the government has decided to bestow the ‘Sitara-e-Imtiaz’ on Agha Hasan Abedi almost 20 years after this legendary figure has passed away. The news item was carried rather surreptitiously and sheepishly.

Abedi’s status cannot be captured in any discussion, no matter how articulate. Words fall short to reflect his true persona. Agha Sahib was a true patriot – a Pakistani who gave so much to this country. He was possessed by the spirit of patriotism. Just hear from the father of nuclear technology Abdul Qadeer Khan about how highly he regards Abedi, especially his contribution on arranging funds for the laboratory. Abedi has to his credit the establishment and running of the third largest bank of the country in addition to the international bank that scaled new heights in the global arena.

Zulfikar Ali Bhutto stole Agha Sahib’s bank, due to the era of nationalisation yet Abedi was the most vehement supporter of ZAB when Ziaul Haq gave the orders for ZAB to be hanged. Abedi pleaded for clemency for him through the courtesy of the then ruler of the UAE. He was a kind and forgiving man.

His bank lent $100 million to support the balance of payments deficit for the country against a security of ungrown paddy stack – a security that had not yet sprouted out of the ground. Such was his immense trust in the country and its potential. His instructions to senior management were to never turn down any request from Islamabad.

* Author: Sirajuddin Aziz is a senior banker. Email: cirajuddinaziz@gmail.com
He gave maximum opportunities to young bankers in international as well as domestic markets.

He trained a great generation of bankers and some of them are doing very well in their careers, and even heading financial institutions across the length and breadth of the country. Of course there were some who paid only lip service to the high ideals of Abedi from the lot, but that is not due to any fault of Agha Sahib’s.

When East Pakistan fell apart, the refugees who poured into West Pakistan, as ex-employees of UBL, were all reemployed by Agha Sahib. He reinstated them all at their original packages and even offered them rehabilitation bonuses.

His social contribution to Pakistan and the global village with charitable organisations in the UK, Bangladesh, Zimbabwe and India has been significant. He established Infaq Foundation whose major beneficiaries have been SIUT, National Institute of Cardiovascular Diseases. There are also Lady Dufferin Hospital, Sir Syed University of Science and Technology and GIK in Topi.

Abedi was a man who wore many hats. He was a master, an articulator of new management concepts, which in that era was equivalent to heresy to much of the commercial world. Abedi addressed many issues outside the confines of banking and business. He exhibited the depth of his soul by speaking on compassion, empathy, humility interdependence, tolerance, forbearance and interfusion. He was a living example of people management.

He took the role of a great leader, and also played the part of a mentor for his staff and was a source of inspiration for the entire financial sector. He possessed inexhaustible energy. He was always smiling. Under his leadership, improvements in processes were rewarded and appreciated in the work culture he fostered. The motivation level of employees was incredibly high and was a key factor anchoring employees to the institution. A young banker once wrote a letter to Abedi thanking the management that he had been given a new purpose in life through his institution.

It is my firm belief that had his health not declined he would have rescued the bank from closure. He was a personal and private banker to the high and mighty just like a former banker-prime minister, only that he was better than the latter. The only issue with his bank’s setup was that it was an Arab-owned bank managed by Pakistanis in 73 countries with 450 offices globally.

Abedi was a man of peace. He rubbed shoulders with Jimmy Carter, James Callaghan and Deng Xiao Ping. Consequently he found himself on the international radar, and being from a Third World country he paid a heavy price for it.

A few years ago the government of Pakistan bestowed on Yusuf Khan, aka Dilip Kumar, an actor of great talent, the ‘Nishan-e-Pakistan’. Although I am a great fan of Dilip Kumar and his movies, but bestowing the ‘Sitara-e-Imtiaz’ on Agha Sahib, a ceaselessly true patriot, leaves me feeling extremely disappointed. Is that all he deserves?
Book Review

“Islamic & Sustainable Development by Odeh Al-Jayyousi”

By

Salman Ahmed Shaikh

The world today represents stark realities about material progress. On one hand, there are billions of people in abject poverty whereas; a small minority has majority ownership over resources. Value neutral economic pursuits devoid of ethical considerations lack a guiding mechanism to nurture the good virtues among human beings. Hence, it is no surprise that famine, death from hunger and debt enslavement is the fact of life for the three quarters of the people not because that overall, the societies have scarce resources, but because the distribution of resources is inequitable.

In mainstream economic literature, the development discourse has taken several steps in the right direction from an exclusive focus on economic growth, belief in social utility of greed and trickledown theory to now embracing humans as means as well as ends of development. While the concept of human capital development and sustainable development are richer than the exclusive focus on economic growth, the focus in twenty first century should also now lift from a human centric focus of development to an ecological balance now and in the future.

During the last 30 years, a lot of challenges have sprung up which require a renewed focus on environmental resource conservation, equitable income distribution, intergenerational equity and enhancing social infrastructure. Is rapid growth accompanied by equally rapid depletion of environmental resources and high fiscal deficit and public debt burden a truly admirable growth model? Just at the right time, the concept of sustainable development has come to the shore. It is realized that for growth to be sustainable, the growth shall provide widespread benefits and must not come at the expense of worsening income distribution and environment quality.

In Islam and Sustainable Development, Odeh Al-Jayyousi addresses the social, human and economic dimensions of sustainability from an Islamic perspective. The proposed framework for sustainability in the book consists of four components: good governance (adl), excellence (ihsan), social capital (arham) and integrity without corruption (fasad). The author argues that any deviation from the natural state (fitra) is a fasad. Hence, climate change from an Islamic perspective is a form of fasad. The author argues that the notion of natural state (fitra) implies that everything on earth is in balance. There is sufficient food and resources, if distributional equity and justice exist.

1 Book Review by Salman Ahmed Shaikh, PhD scholar in Economics. He can be contacted at: islamiceconomicsproject@gmail.com
The author highlights that consumerism culture has challenged the planetary boundaries. People in developed countries comprise around 25% of global population. But, they consume 15 times as much paper, 10 times as much steel and 12 times as much energy as the remaining 75% of the people in developing countries. There is a great need for restraint, but the capitalist system does not have sufficient mechanisms to restrain people from wasteful consumption. The author contends that banks, media, multinational corporations and governments in a capitalistic economy all have a vested interest in encouraging consumption so that a high level of investment is sustained.

The author highlights the importance of biodiversity and how it is put at risk by overconsumption beyond regenerative capacity of reproduction and also by industrial pollution. Diversity promotes sustainability since more diverse the organisms in an ecosystem, the more types of resources are available to deal with challenges. On the other hand, Islam does not approve the waste of even lifeless things like water.

The author writes that in the absence of a moral dimension, material possessions become an end in itself. Conspicuous consumption creates only temporary satisfaction. The author goes on to comment that without any meaning and purpose of life; fashions and models only exchange one kind of emptiness for another. The author also criticizes how the credit culture fuels consumerism and wasteful consumption.

The author argues that Islamic worldview expands the responsibility of humans to society, future generations, and other living species on the planet with afterlife accountability for every intentional act done by every human being. Islamic worldview regards humans as trustees of Allah for whatever material resources and mental faculties they come to possess in this world.

In the end, the author cautions that economic crisis can eventually be reversible, but the loss of biodiversity which represents our natural capital and life-support systems may be irreversible. All in all, the book introduces the moral dimension of the sustainability crisis and challenges and explains the potential of Islamic worldview and ethical institutions to help in creating and promoting a culture of conservation, care, responsibility and cooperation.
Book Review

“Takaful Investment Portfolios: A Study of the Composition of Takaful Funds in the GCC and Malaysia by Mehmet Asutay”

By Camille Paldi

Takaful Investment Portfolios: A Study of the Composition of Takaful Funds in the GCC and Malaysia provides an explanation and analysis of the investments of takaful funds in the GCC and Malaysia between 2002 and 2005 and explores the rationale behind such decisions. In addition, the author discusses and analyzes takaful investment trends and developments and depicts the findings through charts, figures, and tables. This book contains some useful information and statistics regarding three classes of takaful fund investments in the GCC and Malaysia including equities, sukuk, and real estate over a set period of several years in the early twenty first century. However, I had to sift through a thick maze of academic prose in a prose pajama party and suffer through pages of jargon in order to get to the heart of the useful information contained in the book. Although this information is slightly outdated for industry use, it provides an insightful guide to past trends, which may or may not be indicative of the performance of takaful investments at present or in the future. This book may be highly useful and relevant for University students and academics and those practitioners wishing to get a glimpse of past industry trends.

I have to admit I enjoyed the academic and scholarly discussion of the takaful concept in Chapter Two: Insurance and Islamic Law: An Introduction to Takaful. There are some interesting references to the Qu’ran and Sunnah as well as to the scholars of the past. However, in a book, I prefer to see more of the author’s original opinion rather than heavy reliance on other authors. Furthermore, I want to see an explanation of the cited statement as the author is relying on another author to relay his point. For example, in Chapter Two, the author writes: “Moreover, it is also claimed that commercial insurance leads to negligence (Moghaizel, 1991), murder (Al-Sayed, 1986; Hassan, 1979), and is exploitative of people’s needs (Mawlawi, 1996), and that the control of government may fall to powerful insurance companies (Abdu, 1987)” I would like to see some kind of original and authentic explanation of this statement from the viewpoint of the author. For instance, how does commercial insurance lead to negligence, murder, and exploitation and provide some examples. Furthermore, why and how would control of government

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1 Book Review by Camille Paldi, MD, ilovetheuae.com FZLLE, CEO, FAAIF Limited and Events JLT, studying for a MA in Islamic Finance at Ustinov College, Durham University, (UK)
fall into the hands of powerful insurance companies and what then would these insurance companies do with the government under their reigns? In addition, it is always an interesting scenario to witness secular trained academics incorporating religion into their work. The religious references are presented in quite a secular and neutral manner, which makes the book quite easy to understand and digest by religious, non-religious, and atheist alike.

Chapter Three contains a comprehensive academic explanation of the various takaful models. In addition, in this chapter, the author explains the differences between takaful, commercial, and mutual insurance and trends and developments in the takaful industry. The entirety of Chapter 4 discusses research methodology, which is geared for academic institutions and academics rather than the industry and practitioners.

Chapter Five on Exploring Investment Behaviors and Investment Portfolios of Takaful Operating Companies in the GCC and Malaysia is where I finally found the hidden treasure. The chapter is full of interesting factoids and figures, analysis, and comparisons regarding the investment of takaful funds in equities, sukuk, and real estate in the years 2002 – 2005. However, this information may or may not be indicative of present and/or future trends as we are now in 2015, ten years past the period of this study. It is, however, interesting information and may be used in the realm of academics or to see the results of takaful investments in three asset classes in the years 2002-2005. This book may also provide a rough idea on how to perform a feasibility study at the inception of a takaful company in a particular jurisdiction or area of the world or serve as a guide in conducting another similar academic study regarding takaful fund investments.

Although Chapter Six: Locating the Differences Between Actual and Desired Investment Portfolios contains some interesting discussion about the actual and desired investment portfolios of the GCC and Malaysia, I found that much of this chapter could be skim read and probably should have been deleted from the book. In Chapter Seven: Contextualizing the Findings, the only pertinent information includes the discussion on how takaful funds manage their liquidity and the figures for return on investment for the GCC and Malaysian Takaful Funds for the period 2002-2005. I felt like I spotted an oasis after traversing for days through a wild desert sandstorm of verbiage when approaching Chapter Eight: Conclusions and Recommendations.

Chapter Eight: Conclusions and Recommendations provides recommendations for regulatory authorities, takaful operating companies, and Islamic banks/windows. Actually, I found the conclusions and recommendations quite interesting and highly useful especially in regards to whom should be making the investment decisions and the need for more legislation and regulation of the takaful industry in the UAE and globally. Aside from recommendations, the author also explains the research limitations in conducting this study. The author states that focusing the research only on the initial period of the takaful industry during the years 2002-2005 could perhaps be considered a shortcoming. Furthermore, the author explains that another limitation may lie in the sample size that was chosen. The author says that the sample is so small – less than 30 companies – that the parametric statistical tests could not be used in this study. Second, even for use of nonparametric statistical tests, the small number of takaful companies operating in Malaysia limited the author to performing a comparison between the GCC and Malaysia. This can be seen where the author tried to study the differences between
levels of actual and desired investment portfolios between the GCC and Malaysia. The author was not able to adopt the Wilcoxon Signed-Rank Test for Malaysian companies.

Despite these and other limitations, overall, the book contains some valuable information, however, is it worth traversing through the pages of academic verbiage to find the hidden treasure? I felt like I was in the TV program Lost while reading this book, sailing on an ocean of words, which just kept taking me around in a circular whirlpool of lost time and space to the same place. If you have a preference for the lengthy, verbose academic presentation style, are skilled in pinpointing a needle in a haystack, have a lot of time on your hands, and are seeking the results of a study conducted from 2002-2005 examining the results of takaful fund investments in real estate, equities, and sukuk in the GCC and Malaysia, I recommend this book for you. The study may also reveal gaps in the asset classes for the takaful industry. After conducting a thorough analysis of the investments of takaful funds of the GCC and Malaysia from 2002-2005, the author concludes that the study shows that convergence is expected in the investment behaviors of takaful companies in the GCC and Malaysia once the primary and secondary markets for sukuk develop in the GCC and an international regulatory framework is practiced. This book is quite useful for University students and academics in the field of insurance, finance, Islamic finance, and Islamic insurance or takaful as it is a comprehensive, analytic, and comparative academic study of takaful investment portfolios in the GCC and Malaysia from 2002-2005 complete with a chapter on literature review and the questionnaire and interview used to conduct the study.
Country Model: Nigeria

Islamic banking was introduced in Nigeria in 1991 through Banks and Other Financial Institutions Act (BOFIA), which allowed provision of non-interest banking in the country. Up to 2009, the regulatory framework was not sufficient for Islamic finance to prosper. Real efforts for promoting Islamic banking in the country started in 2009 when Nigeria became a member of Islamic Development Bank (IDB). In the following year (2010) the regulatory frame work of Islamic banking was released by the Central Bank of Nigeria and the first Islamic bank started operations in the country in 2012. The introduction of Islamic banking was part of a drive by the Central Bank of Nigeria, CBN, to promote financial inclusion by introducing alternative products. Despite introduction of Islamic banking since 2012, Islamic banking penetration in Nigeria has yet to reach one percent even though Muslim population of the country is over 50 percent.

In terms of institutions offering Islamic financial services in Nigeria, presently three banks i.e. Jaiz Bank Plc, Stanbic IBTC and Sterling Bank Plc are operational in Nigeria. Amongst these, two banks i.e. Jaiz Bank Plc and Stanbic IBTC are full fledged Islamic banks while Sterling Bank Plc is offering Islamic banking facilities as a window. Apart from banking institutions three Islamic fund management companies and three Takaful companies are also offering Islamic financial services in Nigeria.

Historical Development of Islamic Banking and Finance in Nigeria

In 2009 Nigeria became a member of Islamic Development Bank (IDB). Following Nigeria’s membership in IDB, a Technical Assistance program was initiated to build capacity and create awareness on Islamic banking in the country. In the same year Nigeria joined Islamic Financial Services Board (IFSB).

The Central Bank established a non interest banking unit in the Financial Policy and Regulation Department of the bank in January 2010. For improving regulatory framework in the country Central Bank of Nigeria issued, “Guidelines on Shariah Governance for Non-interest Financial Institutions in Nigeria” (The Guidelines) and the “Framework for the Regulation and Supervision of Institutions Offering Non-interest Financial Services in Nigeria” (The Framework) in December 2010 and January 2011, respectively. The Framework provided detailed information on the type of institutions that can be created, licensing requirements and the Islamic instruments that an Islamic bank can transact in. Further, information was also provided with regards to subsidiaries and branches. The Guidelines provided details on the fit and proper criteria for scholars on boards which are to be set up for every Islamic Financial institution.

In September 2010, the Nigeria Deposit Insurance Scheme (NDIC) released its draft framework for a non-interest Deposit Insurance Scheme. Nigerian Stock Exchange (NSE) opened an Islamic window on its trading floor in August 2012 and in the same year Nigeria’s first Shariah compliant index, the NSE Lotus Islamic Index, was launched as collaboration between the Nigeria Stock Exchange and Islamic investment management firm, Lotus Capital.

* Source: State Bank of Pakistan, Quarterly Islamic Banking Bulletin
In 2013, the Securities and Exchange Commission of Nigeria (SEC Nigeria) set new rules on Sukuk issuance and in the last quarter of the year, country’s first Sukuk was issued. In the same year, the National Insurance Commission (NAICOM) issued guidelines for micro insurance and Takaful to help regulate the sector.

The Securities and Exchange Commission (SEC) released a 10-year master plan (2015-2025) in the last quarter of 2014, providing numerous plans for the non-interest finance industry. The overall goal of the master plan was to contribute at least 25% of the overall capital market capitalization in the next 10 years.

Future Outlook
According to industry sources, one or two more banks are expected to get an Islamic banking license in 2015 and by 2020 at least half of Nigerian banks will have either an Islamic banking window or stand-alone subsidiary. The government and other corporate entities also have plans for issuing Sukuk in the coming years. With an increased focus of Islamic banking and finance in the country complemented with a large Muslim population Nigeria can create an important place for itself in the African Islamic banking and financial industry.

Sources:
- Global Islamic Finance Report (various editions), Edbiz Consulting Limited, UK
- Central Bank of Nigeria website http://www.cenbank.org/
- www.islamicfinancenews.com
Note to contributors

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