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THE FUTURE OF ISLAMIC BANKING IN THE GLOBAL MARKET

ABDUL GHAFAR ISMAIL
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AT PERDANA LEADERSHIP FOUNDATION

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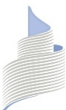
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PREFACE

The basic principles of the Islamic banking system is the presence of money. The differences in the concept of money between Islamic and conventional schools of thought have led to different implications on the relationships among several macroeconomic variables, namely money, interest, and credit. As a holistic religion, Islam has laid a wise foundation on the intricate relationship between these variables, from money to the real economy. Money is treated as a medium of exchange and capital. With this role, money becomes crucial to the Islamic banking system. Hence, the first part of this book will discuss how money will be channelled through the Islamic banking institutions. The result will be a different business model of Islamic banking.

In the next section, I argue that Islamic banking is established not only to comply with *Shari'ah* but also to achieve the objectives of *Shari'ah*. Hence, the focus on law origin and governance, institutional forms, value creation and stability is important, as they are the foundation of the Islamic banking system.

The business operations of Islamic banking do not stop here; the innovations that have been taking place are crucial for the development of Islamic financial intermediaries. Otherwise, Islamic banking would be considered a boring industry. This will be discussed in Part III.

Finally, this book notes that the Islamic banking industry is expected to expand to become an important banking system. In looking at the expansion, this book will look at the integration of the Islamic banking system with other players in the global markets. This integration is not without obstacles and challenges

May this book be considered my small effort to get the blessings of Allah. Allah knows best.

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INTRODUCTION

Introduction

Islamic society has witnessed vigorous economic activities since the Prophet (PBUH) first arrived in Medina. To the predominantly agrarian community was added a group of experienced traders from Mecca, even then a great centre of inter-regional trade. The next four to six centuries saw continuous expansion and increasing prosperity. Monetisation came early, and the ban on unequal exchanges of similar fungibles appeared to have facilitated the process. Muslims started using Byzantine gold dinars and Persian silver dirhams, but earlier on they began to mint their own coins. The state had a monopoly on coinage, and any tampering with their weight or purity was severely punished.

Trade and commerce over a vast expanse of the Islamic world, which included North Africa, Spain, and a large part of Asia, soon produced certain elementary financial instruments, such as the *sufitaja* (bill of exchange) and the *shekk* (cheque). Muslims used the customary contracts known in the Arabian Peninsula and other parts of the Islamic world. While some of these were found to violate one or more of the prohibitions and were thus rejected, others were modified to meet standards of fairness.

In line with this development, there are quite a number of scholars such as Abu Yusuf (d. 798), Abu Hamid al-Ghazali (d. 1111), Ibn Taimiyyah (d. 1328.), Ibn Qayyim (d. 1350), and a number of other Muslim scholars such as Ibn Hanbal (d. 855), al-Kindi (d. 873), al-Farabi (d. 950), Ibn Hazm (d. 1064), Alberuni (d. 1048), Kay Kaus (d. 1082), Nizam al-Mulk (d. 1092), Dimashqi (d. 1175), Nasir al-Din al-Tusi (d. 1274), and Dawwani (d. 1501). All these scholars help enlighten us on a number of economic concepts like market mechanism, demand, supply, prices and profits, money, counterfeiting and currency debasement, labour supply and population, and the role of the state as well as justice, peace and stability in economic development.

In the 13th and 14th century, several theologians, led notably by the Dominican St Thomas Aquinas, set down the dogma of the Catholic Church in the light of the resurrection of Greek philosophy at the hands of 12th Century Islamic scholars. These views were propagated and adopted through colonisation in several Muslim majority countries. For example, in Malaysia, the British-owned bank Standard Chartered was established in 1881.

A number of interest-free savings and loan societies were reported to have been established in the Indian subcontinent during the 1940s, but efforts to arrange finance for business enterprises seem to have started later. There was one pioneering but short-lived experiment in MitGhamr in Egypt in 1963. The same year saw the establishment of Tabung Haji in Malaysia, which is still in business, profitably investing money being saved to meet the cost of the pilgrimage to Mecca. During the same period the Philippine Amanah Bank was also established to enable Muslims to meet some of their financial needs without involving interest. An interest-free bank in Karachi, Pakistan, was established around the same time but did not survive.

Dubai Islamic Bank was then established in 1975 under a special law allowing it to engage in business enterprise while accepting deposits into checking accounts that were guaranteed, as well as into investment accounts that were to receive a share in the profit accruing which was used for business by the bank. Within the next ten years, twenty-seven more banks were established in the same manner in the Gulf States, Egypt, Sudan, and elsewhere. Indeed, many more were to follow all over the Muslim world. By 1985, over fifty conventional banks, some of them located in money centres like London were offering Islamic financial products. Some of the major conventional banks subsequently established Islamic branches dealing exclusively in Islamic products. Citi-Islamic in Bahrain, Grindlays in Karachi, and the National Commercial Bank in Saudi Arabia established over fifty Islamic branches by the 1990s.

Islamic investment companies and Islamic insurance companies also appeared in the late 1970s, and their numbers have continued to increase. A number of Islamic mutual funds appeared in the 1990s, many of which were managed by reputable Western firms.

Based on the current information, there are over 300 Islamic financial institutions worldwide across 75 countries. According to the Asian Banker Research Group, the world's 100 largest Islamic banks have an annual asset growth rate of 26.7%¹ and the global Islamic finance industry is experiencing an average growth of 15-20% annually.²

Why did it emerge? How does it work? How does it evolve? And how could it be integrated with the global market? These are timely questions, given the increasing instability of the conventional system of money, banking, and finance which now experiences recurrent crises and which has failed to reduce the growing gap between the rich and the poor, within and among nations. Many hold the conventional system partly responsible for the growing inequality.

In this chapter, we propose an examination of the foundation of banking and finance in Islam, its concepts, precepts and laws, with some reference to its roots in early Islamic history.

We will then describe its recent development and spread. Lastly, we will discuss the future of Islamic banks in the global market.

The Prior Model of Islamic Finance

The earliest Islamic banking model was based on two-tier *mudharabah*, with profit-sharing replacing interest in the bank-depositor and bank-borrower relationships. Islamic banks would serve as financial intermediaries, like conventional banks, except that they would purge interest from their operations and rely instead on partnership and profit-sharing. They could operate demand deposits like their conventional counterparts, and like other banks they could offer other services against fees. Banks directly conducting business or entering the real estate market in order to profit for depositors and shareholders (partners) were not part of this model.

But practitioners in the Arab world did not see much scope in this model. Accepting deposits in investment accounts on a profit-sharing basis was acceptable, but their profitable employment required direct involvement in business. Investment

¹ McKinsey, The World Islamic Banking Competitiveness Report 2007–08, “Capturing The Trillion Dollar Opportunity”

² Ibid

banking was closer to the milieu with which *Shari'ah* scholars were familiar. They felt more at home with a model in which savings were mobilised on a profit-sharing basis, while their profitable use was based on familiar Islamic contracts of sale, purchase, leasing and so on.

Murabahah (cost-plus or mark-up financing) entered into the model of Islamic banking in the late 1970s. By this time, practice had revealed the difficulties of applying the *mudharabah* (profit-sharing) contract in dealing with business people in a legal environment that failed to provide any protection to the financier in such cases, unlike the protection provided to interest-based finance. Adverse selection in an environment dominated by interest-based institutions was another serious problem. Other Islamic contracts, such as *salam*, *istisna'*, and *wakalah*, were also explored. *Shari'ah* scholars, many of whom were formal advisors to Islamic financial institutions, made significant contributions in developing the model.

One of the specific needs was financing for home purchase on acceptable terms. Three models of interest-free finance were developed. The first, which formed the basis of the House Building Finance Corporation of Pakistan (1980), was based on joint ownership and rent-sharing, eventually leading to the home dweller owning the home in full as he gradually purchased the government-owned part. The second model was a cooperative in which members pooled resources and were funded in turn, while the pooled resources were profitably invested in the meantime. The third model was based on *murabahah*, with the customer paying the higher deferred price in instalments. In practice, small variations were introduced to ensure *Shari'ah*-compatibility, as well as financial viability.

During the 1990s, the model was further developed and refined. The liabilities side saw frameworks put in place for handling the trust funds, venture capitals and financial papers based on *ijarah* (leasing), *salam* (forwards), and *murabahah* (mark up). Special techniques for launching *Shari'ah*-compatible mutual funds were also developed. This involved selecting companies that did not violate any *Shari'ah* norms and whose shares could therefore be traded. The first norm was that the products in which the company dealt with should not include prohibited items such as alcohol or pork. The second was that its finances should be free of interest-bearing loans and its revenue free of interest income. Since the condition concerning debt finance would eliminate almost all shares traded on the stock exchange, some scholars have allowed

leverage of 30% or less. There may be additional criteria, but these two norms were common to all existing Islamic funds. Once the filtering process was complete, managing a portfolio became a professional job. This is why the phenomenon of Islamic mutual funds, even though endorsed by a group of *Shari'ah* scholars, owes its existence to the initiative of professional players in the field. As the launch of the Dow Jones Islamic Index demonstrated, Islamic finance also requires modern tools designed to handle the complex web of financial transactions.

How this book is organised

It seems to us that the prior model of Islamic banking was too simple. The future of this industry must be explored especially in terms of its contribution in the following two aspects: as an alternative to current models of banking systems; and to produce a just banking system. The contribution can be realised by examining the following aspects, i.e., the foundation of Islamic banking and the integration with other players in the global markets.

Part I: Identify the Foundation of Islamic Banking

The contradiction on the concept of money between two competing economic schools of thought has led to major different implications on the relationships among several macroeconomic identities, namely interest, savings, and credit. As a holistic religion, Islam has beautifully laid a wise foundation on the intricate relationship between these entities, from money to interest, savings, and credit.

Since money is a medium of exchange, Islam claims that money does not have any intrinsic value (Al-Ghazali). Within this context, money on its own does not constitute wealth. Hence, money is not a production good or capital. Scholars consider money only as potential capital, as actual capital only exists when money, along with other resources, is invested in productive activities. Money becomes capital only when it is invested in business.

Therefore, with this role, money becomes crucial to the Islamic financial system. Hence, in this part, we will examine how money will be channelled through the Islamic financial institutions. At the same time, the Islamic financial system will

have to offer their financial services in the form of contracts. How do the contracts create a different relationship between financial institutions and customers?

Part II: How Islamic Banks Work in the Global Market

Great changes took place in the financial environment during the last few decades of the 20th century and in the early 21st century while Islamic banking and financial institutions were evolving. Some of the most significant changes were the decline in intermediation and the more active and aggressive management of investment, as well as the worldwide integration of financial markets in the wake of globalisation.

The first changes, symbolised by the repeal of the Glass-Steagall Act in the US, should be advantageous to Islamic finance insofar as financial intermediation was based on interest. In line with this development, many countries introduced universal banking in the early 2000s. Hence, the greater involvement of banks and other financial institutions in investment management is expected. It offers a wider scope for the use of Islamic financial techniques, such as profit sharing and mark-up financing.

The problem is that investment management in modern conditions boils down to risk management, which is quite underdeveloped in Islamic financial theory and practice. In the Islamic perspective, this area of conventional finance needs drastic reform. Thus, we face a dual challenge to develop Islamic techniques of risk management and to see that these new techniques are free of the ills associated with conventional methods. This is different from the challenge faced in the mid-20th century, which was to develop a method of financial intermediation free of interest.

The scope of the financial market has expanded to cover the entire globe, introducing new kinds of risk. When Islamic laws were being written more than a thousand years ago, the nature and scope of risk and uncertainty were different. However, we can still learn something, which in combination with the modern experience should enable us to realise the *Shari'ah* objectives of justice, fairness, and efficiency.

The Prophet (PBUH) was reported to have prohibited the sale of an unborn calf, i.e., one still in its mother's womb. He was also reported to have prohibited the sale of fish still in the pond. In both cases, the reason was the uncertainty surrounding the quality and/or the quantity of the commodity being sold. The Prophet was reported to have permitted the sale of unripened fruit on the tree despite the uncertainty as to its quantity or quality. It was not possible to wait until the fruit was fully ripe and plucked and weighed or counted, for that would leave no time for marketing.

The Prophet (PBUH) was reported to have prohibited the sale of a non-existent commodity. But he did allow *salam*, the sale of agricultural crops months ahead of the harvest, provided the price was paid in advance at the time of contract. This was found to be advantageous to the farmer and to the grain trader, hence the uncertainty involved was tolerated for a purpose.

The message seems to be clear. As far as possible, transactions must be based on complete information in order to ensure that neither party is under any misapprehension. But given mutual consent, some uncertainty can be tolerated in order to secure greater advantages. As would be expected, the juristic discussion of *gharar* (hazard or uncertainty) or transactions in the absence of complete information is full of controversies.

The second changes are: the world financial markets are integrated as never before. Money moves across national boundaries costlessly and instantaneously. In principle, this change should be favourable to Islam which never cares much for national boundaries. In practice, however, it does pose problems for the Islamic financial movement, for two different reasons. Firstly, the home base of this new trend is in the Middle East as well as South and Southeast Asia, where the economies are small and the financial system are less sophisticated than in larger, developed countries. Secondly, Islamic financial institutions suffer from smallness in size, and very few of them operate in more than one country as the major players do. The situation has changed with the entry of some major conventional financial institutions into the field. But this has also made things more difficult for the older Islamic financial institutions, obliging them to consider mergers and consolidation.

Globalisation has increased the volatility of almost every financial variable, especially the exchange rates. It has also reduced the efficacy of national economic macro-management. Redress may only come through international agreements curbing speculation and regulating financial markets. In this regard, the insights of the Islamic financial movement concerning sharing modes of finance, commodity-linked financing such as *murabahah*, and reducing the role of debt have great potential. Therefore, in this part, we will identify the areas which need to be explored in order to ensure the future development of worldwide Islamic banking.

MONEY WITHOUT INTEREST

What Are Interest Rates?

Interest rates refer to the amount of money paid by the borrower to the lender, in addition to the original amount borrowed. For instance, a small company might borrow capital from a bank to buy new assets for their business. The lender receives a return for deferring the use of funds by lending it to the borrower. These serve as compensation and payment to the lender for providing the borrower with the opportunity to use the lender's funds temporarily. Without interest, lenders would not be willing to lend or temporarily give up the ability to spend, and savers would be less willing to defer spending.

Interest rates are classified into three types: nominal interest rate, periodic rate, and annual rate. Nominal interest rates refer to the quoted rate, while periodic rates are the amount charged in a particular period. The annual rate refers to the percentage of interest rates that are charged per year. For example, suppose a household deposits RM100 with a bank for 1 year and they receive interest of RM10. At the end of the year, their balance is RM110. In this case, the nominal interest rate is 10% per annum.

An interest rate can be considered flexible or fixed. A fixed interest rate means that the lender can only charge the same amount of interest per month throughout the life of the loan. Many borrowers prefer to find a lender who offers a fixed interest rate because the repayment terms are predictable and protected by a contract. Because the interest rate in a fixed loan cannot be adjusted, however, many lenders charge more for the loans or do not offer them in the first place. When buying a large item such as a home, a fixed interest rate is almost always preferable to a flexible one.

In the case of a flexible interest rate, lenders often tie the loan's interest to the central lending rates, also known as the base lending rate.¹ This is the interest rate charged by the bank to the borrower. The base lending rate is regularly adjusted by the bank based on the decision taken by the central bank, which considers several

¹ Overnight policy rate (determined by central bank) plus margin = cost of funds. Then, cost of funds plus margin = Base lending rate.

economic factors such as inflation or high unemployment. Lenders can legally charge borrowers an interest rate which is a few points above the base lending rate at the time of the initial loan. If the rate changes, the interest on the loan may also be adjusted. A flexible interest rate may be beneficial when the economy is healthy but can seem more costly if the rates are suddenly raised.

The History of Interest Rates

A historical perspective of interest rate trends and lending practices spanning more than four millennia of economic history will be discussed in this section. It covers the following periods:

- Ancient Times: Mesopotamia, Greece, and Rome
- Medieval Times and Renaissance Europe: Italy, Spain, Germany, France, and more
- Modern Europe and North America to 1900: England, France, and other European countries, as well as the United States
- Other countries and regions in the 1800s

Ancient Times

During ancient times, people ventured into the money-lending business. Lending during these times may not have been like the way it is done today, but the process is similar. The implementation of interest rates can be traced back to ancient Mesopotamia. It has been said that during that time, laws concerning lending were enacted in order to protect both the lenders and the consumers or borrowers. Proof of the use of interest rates in the past can be seen in the writings of Hammurabi, a ruler of Babylon in 1750 BC. In his writings, more commonly known as the Code of Hammurabi, the ruler instituted laws regarding the payment of loans, often protecting the interests of the lenders.

The first interest rate caps for most loans, also instituted in ancient Mesopotamia, fell a little below the 33.3 percent mark. This is a big contrast to the interest rates instituted in ancient Greece, which fell between 6 percent and 12 percent

during 600 and 100 BC. The falling rates in ancient Greece were the first recorded instance of falling interest rates. This phenomenon was attributed to the economic and market situation during that time.

Medieval Times and Renaissance Europe

The Greek philosopher and thinker Aristotle were an enthusiastic opponent of interest. Part of what he wrote should attract the attention of a banker when applying for a loan: *“Of the two sorts of money-making one, as I have just said, is a part of household management, the other is retail trade: the former necessary and honorable, the latter a kind of exchange which is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural use of it. For money was intended to be used in exchange, but not to increase at interest. And this term usury, which means the birth of money from money, is applied to the breeding of money, because the off-spring resembles the parent. Wherefore of all modes of making money this is the most unnatural”*.¹

Aristotle’s thinking was that money is, by nature, incapable of bearing fruit. As such, the lender’s gain cannot come from the peculiar power of money and consequently, it can only come from a defrauding of the borrower. Interest is therefore a gain gotten through abuse and injustice. Things began to change somewhat under the Roman Empire when economic exchange and trading of goods reached such complexity that gratuitous credit began not to make sense any longer.

Accordingly, the Romans, perhaps in line with the theological credo of the time, put severe legal constraints to the amount of interest that could be charged. To canonize these limits which varied on a case-by-case basis, they were the first to publish a list of interest rates. This list grew more and more complicated with time, since the Senate thought that interest rates should be less for friendly countries and more for unfriendly countries, thereby instating the first international economic

¹ See Aristotle *The Politics* (1962). Penguin Group, Penguin Books Ltd, 80 Strand, London WC2R 0RL, England.

agreements among countries of the Mediterranean Basin. These economic agreements were unilateral, and examples were imposed by Rome on everyone else.

Things became progressively worse, however, following the break up of the Roman Empire and the advent of Christianity. In fact, in the sacred writings of the New Testament were found certain passages which, as usually interpreted, seem to contain a direct divine prohibition of the taking of interest. The powerful support for the spirit of the time, already hostile to interest, was thus found in the express utterance of divine authority. This gave it the power once more to draw legislation to its side. The Christian Church lent its arm. Step by step, it managed to introduce the prohibition into legislation. First, the taking of interest was forbidden by the Church but allowed to the clergy only. Then, it was forbidden to everyone, but the prohibition still only came from the Church. At last, even the temporal legislation capitulated to the Church's influence and gave its severe statutes the sanction of Roman law.

The status quo remained cast into stone for the following fifteen centuries, until the advent of Mercantilism and the Industrial Revolution. At that time, the contemporary monarchies, most notably the Crown of England, decided to back private entrepreneurs with their own money. They chose to do so to gain a political and strategic edge over other monarchies and other states. To encourage their own citizens not only to work manually but also to think, they cheerfully invested large sums in the development of their inventions, some archaic but others of practical application. In doing so, however, the monarchies wanted to gain also an economic profit by introducing the modern concept of interest.

Also, St. Thomas Aquinas, the leading theologian of the Catholic Church, had argued that the charging of interest is wrong because it amounts to double charging, charging for both the thing and the use of the thing. The church regarded this as a sin of usury; nevertheless, this rule was never strictly obeyed and eroded gradually until it disappeared during the industrial revolution. Usury has always been viewed negatively by the Roman Catholic Church. The Second Lateran Council condemned any repayment of a debt with more money than was originally loaned, while the Council of Vienna explicitly prohibited usury and declared any legislation tolerant of usury to be heretical and the first scholastics reproved the charging of interest. In the medieval economy, loans were entirely a consequence of necessity and, under those conditions, it was considered morally reproachable to charge interest.

Interest has often been looked down upon in Islamic civilization as well, and most scholars agree that the *Qur'an* explicitly forbids the practice. This is exactly what Imam Al-Ghazali had pointed out nine hundred years ago. The evil results of such an unnatural trade were further explained by him in another context as follows: *Riba (interest) is prohibited because it prevents people from undertaking real economic activities. This is because when a person having money is allowed to earn more money on the basis of interest, either in spot or in deferred transactions, it becomes easy for him to earn without bothering himself to take pains in real economic activities. This leads to hampering the real interests of the humanity, because the interests of the humanity cannot be safeguarded without real trade skills, industry and construction.*

It seems that Imam Al-Ghazali had, in that earlier age, pointed out the phenomenon of monetary factors prevailing on production, creating a wide gap between the supply of money and the supply of real goods which has emerged as the major cause of inflation with almost the same terrible consequence of trading in money.

The relevant fact at this point is that money, being a medium of exchange and a measure of value, cannot be taken as a production good which yields profit on daily basis, as is presumed by the theories of interest. As a mediator, it should be left to play this exclusive role. To make it an object of profitable trade would disturb the whole monetary system and bring a surplus of economic and moral hazards to the whole society.

Medieval jurists had, therefore, developed several financial instruments to encourage responsible lending. These instruments sometimes closely resemble interest, leading some to wonder whether they truly satisfy both the letter and spirit of the rule. During the Renaissance era, greater mobility of people facilitated an increase in commerce and the appearance of appropriate conditions for entrepreneurs to start new, lucrative businesses. Given that borrowed money was no longer strictly for consumption but for production as well, it could not be viewed in the same manner. The School of Salamanca was the renaissance of thought in diverse intellectual areas by Spanish theologians, elaborating various reasons that justified the charging of interest. The person who received a loan benefited and one could consider interest as a premium paid for the risk taken by the loaning party. There was also the question of

Synopsis

There are many challenges ahead for the Islamic banking industry that require the industry to change. One of the main challenges is integrating Islamic banking with the global market. This book will explore several important aspects of that challenge, among them: the competing worldviews on Islamic banking principles; differing *Shari'ah* rulings that influence legal origin and governance, indicators of financial stability, and risk sharing. In trying to integrate with the global market, Islamic banks need to innovate aggressively. This means offering new products and services which, of course, will carry with them new risks. In addition, new challenges are also emerging related to the harmonisation of *Shari'ah* rulings, regulatory and security issues as well as market discipline.

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