

ISLAMIC FINANCE: AN OLD SKELETON IN A MODERN DRESS

By DR. ASYRAF WAJDI DATO' DUSUKI

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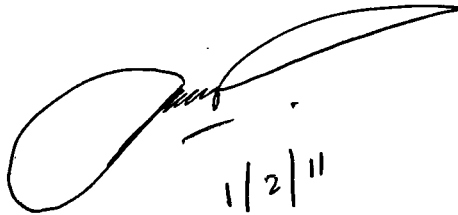
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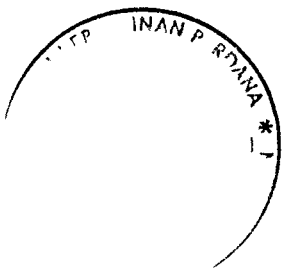
ISLAMIC FINANCE: AN OLD SKELETON IN A MODERN DRESS

DR. ASYRAF WAJDI DATO' DUSUKI

*Dear Tun,
Special Dedication to
'The Father of Islamic Finance'*



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FOREWORD

In consonance with the challenges that we face today, in an era of increased globalized interdependencies, operating within a stable, yet profitable financial system is of prime importance. The financial debacles that we have and are currently going through testify to the fact that the world is in need of a financial system that encompasses the need to generate a livelihood while at the same time, ensures justice, fairness, equity and other facets of a civilization that transcends political, racial, ethnic and religious differences.

In this respect and within this web of inextricable interconnectedness between nations, the articles in this series invite the readers to continue to look beyond traditional occidental thinking and financial praxis, and readily embrace Islamic financial concepts and practices that are not only relevant but needed in this era of everchanging global atmosphere, with its intricacies and multitudinous issues; this is more productive rather than just waiting for the turbulent financial waters to recede to one of calm and serenity. With regard to this, although Islamic and Western civilizations may appear to have polar financial views and approaches, it does not mean that in order for one to win, the other must lose, which is the hallmark of the zero sum game philosophy.

From its humble beginnings as just another alternative to the current conventional financial system, which is not in compliance with the precepts and rulings of the Shari'ah, Islamic finance has grown by leaps and bounds to emerge as an integral component of the global financial landscape, as more and more parties are looking to it as an enabler of progress while at the same time, creating more pipelines for trade and capital flows and solidifying a world characterized by balanced global growth and greater shared prosperity.

With the host of issues that we, the members of the global financial arena are facing, ISRA hopes to elucidate some of the said issues, through the ISRA Series in Contemporary Islamic Finance, which focuses on the Islamic financial system. This series explores various aspects of Islamic finance, from the role of maqasid as-Shari'ah in driving the Islamic financial sector to specific Shari'ah injunctions that govern the provision of products and services.

With increasing demands from all stakeholders for new and more innovative Islamic financial products and services, this series also aims to play a meaningful role in fulfilling that need, which of course cannot be achieved without the necessary knowledge, whether theoretical or applied knowledge. The internalization of the culture of continuously seeking knowledge is in line with verses 3 to 5 of Surah Al-'Alaq:

"Read, and your Lord is the most gracious, who imparted knowledge by means of the pen. He taught man what he did not know."

However, the readings presented in this series is just the tip of the iceberg of the volume of Islamic finance related knowledge and literature that exists within the totality of financial knowledge. Hence, this is a compelling testimony of the expansion of Islamic finance as a body of knowledge that continues to be relevant and definitely timely, in the face of complex economic changes.

It is our hope that this series will serve as a guide to those who are interested to know more about Islamic finance, its models, mechanisms and uniqueness, and the challenges and the possible solutions and opportunities that present itself to the players of the Islamic finance value chain.

To move forward with the resolve of continuously improving ourselves, ISRA welcomes any observations on the contents of this series, as continuous improvement is a reflection of one of Saidina Ali bin Abi Talib's insights that stems from his powerful faith in the path of Islam:

“He who busies himself with things other than the improvement of his own self, becomes perplexed in darkness and entangled in ruin. His evil spirits immerse him deep in vices and make his bad actions seem handsome.”

We sincerely hope that the publication of this series will be the bridge and catalyst for intellectual discourses among the financial community, with the purpose of addressing the many challenges inherent in the development of Islamic finance and propelling collaboration to higher planes, as well as realizing the end goal of achieving falah (success) in this world and in the hereafter.

Dr. Mohamad Akram Laldin

Executive Director

29 October 2008

INTRODUCTION

The last few decades have witnessed the rapid growth and development of Islamic finance. Consequently, Islamic finance has emerged as one of the fastest growing industries. It has expanded to all corners of the globe and received wide acceptance by both Muslims and non-Muslims alike. The rapid evolution of Islamic finance has resulted in the dramatic transformation of the industry, from being focused on conventional financial practices, based primarily on interest and excessive risk-taking activities to having promulgated Islamic standards that are free from riba and other unethical financial dealings.

Islamic finance refers to methods of undertaking banking and financial transactions that are in conformity with the precepts of Islamic law, also known as Shari'ah. Based on the Shari'ah, Islam has formulated comprehensive principles and ethics governing how businesses and economies should be run and how banking and finance is to be operated. Thus, Islamic banking and finance differ significantly from conventional finance, not only in terms of the business practices, but above all, the values which guide the whole operations and outlook of Islamic banking and finance. The values which are expressed are not only concerned with the minutiae of its transactions but also in the breadth of its role in realizing the objectives of the Shari'ah (also popularly known as Maqasid as-Shari'ah).

Although some of the mechanics of contemporary banking and finance may be perceived as alien to Islam, the Shari'ah principles outlining Islamic economics and financial transactions are not new at all. These principles were mandated in the Holy Quran and the Hadith of the Prophet (peace be upon him) in the seventh century. These principles define what is true, fair and just, the nature of business and corporate responsibilities and the priorities that should be given to society. Hence, a deep understanding of Shari'ah principles and objectives will drive an intense commitment of every individual and organization to justice,

brotherhood and social welfare. This will inevitably lead to a society where every member will cooperate with each other and even compete constructively, as success in life is to obtain the ultimate happiness in the hereafter.

So far, Islamic finance has remained resilient, despite the current challenging global financial environment. Initial reports show that in the aftermath of the financial meltdown observed on Wall Street and the overall global financial crisis, the future looks bright for Islamic finance. According to the figures from the Dow Jones Islamic Market Financial Index, which measures the performance of around 70 Shari'ah-compliant stock markets around the world, the index lost just 2.74% in September 2008 – a month where conventional stock markets saw a fifth of their value chopped off, as Wall Street went into meltdown and the credit squeeze claimed a number of high profile victims. Triggered by the subprime mortgage crisis in the US, beginning around July 2007, the meltdown has taken down financial giants one by one – Bear Stearns, Lehman Brothers, Freddie Mac and Fannie Mae, Merrill Lynch, AIG and Washington Mutual. And the list keeps on growing. Some observers relate the ability of Islamic banking of escaping the crisis partly to its heavy reliance on property investments and private equity.

However, the true strengths of Islamic finance are derived from the Islamic law or Shari'ah principles. In fact, these principles are the key pillars of Islamic finance that have contributed towards its overall stability and resilience. Islamic financial institutions all over the world are largely untouched by the current crisis, mainly due to the nature of Shari'ah-compliant finance, which prohibits them from engaging in debt trading activities (*bay' al-dayn*) and speculative financial transactions that are undertaken by conventional banks.

Furthermore, the Shari'ah injunctions require that the financial transactions be accompanied by an underlying productive activity, thus giving rise to a close link between financial and productive flows. In other words, the entire Islamic financial system is based on asset financing, since Islamic financial institutions are not allowed to make profit out

of lending money; rather invest in the assets required. This is one of the main reasons why Islamic finance and Shari'ah-compliant stock markets are likely to be in a stronger position to weather the effects of the credit squeeze. Even during the Asian financial crisis of 1997, the Islamic financial system performed better than its conventional counterpart.

The message of Islamic finance is therefore very clear. Yes, you can earn money, but money is to be earned in a manner that conforms to the principles of fairness and justice, as deeply inscribed in the Shari'ah. Unlike capitalism, Islamic finance places emphasis on overall social and economic good, and not greed and individualism. Against this backdrop, there is a need to further promote Islamic finance as an acceptable alternative to conventional finance. The present problem of capitalism and the increasingly uncertain global environment calls for a paradigm shift in the way the current financial system operates. While advocating a market style economic order, the new paradigm requires a high content of ethical spirit in financial behavior and this is undoubtedly offered by the Islamic financial system. In the coming years, the greater global participation in the Islamic financial development process would enhance the potential role that Islamic finance would have in contributing towards greater global financial stability in the international financial system.

This book is a collection of my personal articles that brings together previously published papers on the topic of Islamic finance. Most of the articles of this book are taken from my research articles that were written and published in various international academic refereed journals. Altogether, 10 articles are included, covering diverse issues and areas in Islamic banking and finance. It is hoped that the writings would contribute to create greater awareness and comprehension about the philosophy and practice of Islamic finance.

There is an endless list of persons to whom I am greatly indebted, without whom this book would not have been written. While indicating them here is scant recognition for their contributions, to acknowledge each more fully would burst the limit of an already long book. My loving

appreciation is dedicated mainly to my father, Dato' Dusuki Ahmad who has been inspiring and encouraging me to write and publish my articles. I will always remember his words, "A scholar without a publication is futile". Above all, I must thank my wife, Dr. Irwani for her love, patience, sacrifice, inspiration, understanding and constant help and encouragement during the composition of these articles; only she knows the depth of my indebtedness. Finally, I am indebted to all my family members and friends, which have in their very own ways inspired me to complete my task. This book would not have been possible without your support.

I wish to express my thankfulness and gratitude to the International Shari`ah Research Academy for Islamic Finance (ISRA) for the publication of this book. Finally, this written work is accomplished only by the Grace of God and He knows best what is true and right. All gratitude and praise be only to Him.

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Head, Research Affairs

International Shari`ah Research Academy for Islamic Finance (ISRA)
Kuala Lumpur

Friday, 24th Syawal, 1429

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A CRITICAL APPRAISAL ON THE CHALLENGES OF REALIZING *MAQASID AL-SHARI`AH* IN ISLAMIC BANKING AND FINANCE*

INTRODUCTION

Twentieth century spawned a movement committed to developing an Islamic variant of economics. After a long period of colonial domination on Muslim countries by Western imperialists, the movement for Islamization in all spheres of Muslims lives has started to gain momentum of support and acceptance. These movements started in the Middle East and had influenced neighbouring continents to promote what was claimed as a turning back to the actual and complete practice of Islamic way of life. The economic Islamisation campaign had enjoyed at least tacit support of politicians and intellectuals of many Muslim countries like Malaysia, Iran, Pakistan and Sudan.¹

Consequently, Islamic banking and finance has emerged as one of the fastest growing industries. It has spread to all corners of the globe and received wide acceptance by both Muslims and non-Muslims alike.² Extant literature proclaims that Islamic banking differ significantly from conventional banking, not only in the ways they practice their businesses, but above all the values which guide Islamic banking whole operation and outlook. The values which are prevailed within the ambit of *Shari`ah*, are expressed not only in the minutiae of its transactions but in the breadth of its role in realizing the *maqasid al-shari`ah* (objectives of *Shari`ah*).

Indeed, *maqasid al-shari`ah* reflects the holistic view of Islam which has to be looked at as a whole not in parts, as Islam is a complete and integrated code of life and its goals encompasses the whole life, individual and society; in this world and the hereafter. Hence, a deep understanding of *maqasid al-shari`ah* entails intense commitment of

every individuals and organisations to justice, brotherhood and social welfare. This will inevitably lead to a society whereby every member will cooperate with each other and even compete constructively, as success in life is to obtain the ultimate happiness (*falah*). Thus, mere maximisation of profits cannot, therefore, be sufficient goal of a Muslim society. Maximisation of output must be accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness and justice and fair play at all levels of human interaction. Only development of this kind would be in conformity with the *maqasid al-shari'ah*.³

Hence, the restricted view of understanding *Shari'ah*, by only focusing on the legal forms of a contract need to be changed. Instead, the substance that has greater implications to the realisation of *maqasid al-shari'ah* should be equally looked into especially when structuring a financial product. Otherwise, Islamic banks are just appeared as an exercise of semantics; their functions and operations are really no different from conventional banks, except in their use of euphemisms to disguise interest and circumvent the many *Shari'ah* prohibitions.

This paper aims at analysing the challenges of realising *maqasid al-Shari'ah* in the contemporary economic transactions particularly with respect to the development and operation of Islamic banking and finance. These challenges stem from the improper handling and sometimes misleading application of various tools of Islamic jurisprudence including *maqasid al-shari'ah* and *maslahah*. The concept of *maqasid al-shari'ah* will be delineated in details so as to shed light on its application to the modern day's practice of *mu'amalah*. The examples of various forms of controversial products implemented will be discussed to illustrate the problems of misunderstood application of *maqasid* and *maslahah* in legitimising contracts that substantially go against the spirit of *maqasid al-shari'ah* itself.

Following this brief introduction, sections will, in order, illustrate the divergence of Islamic banking and finance practices from its idealized version proposed by many Muslim economists; the fundamental principles of *Shari'ah*; evaluation of the application of the *maqasid al-shari'ah* and *maslahah* in Islamic banking and finance; and finally provide summary and conclusion.

OLD SKELETON IN A MODERN DRESS

Islamic banks made their first appearance in the 1970s. Since its first inception, massive efforts have been made to portray them as analogous to an ancient financial organization based on profit-loss-sharing (PLS) mechanism, particularly *musharakah* and *mudarabah*. Muslim economists including Sadr, Siddiqi, Chapra, Ziauddin Ahmad, Ahmad, Siddiqui, Haron, Ahmad, Rosly and Bakar, Haron and Hisham, Naqvi⁴ and others favour equity-based instruments and place greater social welfare responsibilities and religious commitments upon Islamic banks, in order to realize the *maqasid al-shari`ah* with respect to economic and financial transactions, including social justice, equitable distribution of income and wealth and promoting economic development and growth.⁵

These writers even go further to argue that equity-based financing is the only principle representing the true spirit of Islamic banking system which departs significantly from the interest-based system. Although they do not fully negate the use of other *Shari`ah*-approved debt-based contracts alongside equity-based contracts, they do assert that the socio economic objectives including social justice, economic growth, efficiency and stability which the Islamic economics seeks to achieve is better served by resorting to primarily equity-based contracts.

These writers almost consistently affirm that Islamic banking model should predominantly be based on equity to be congruent with the spirit of *Shari`ah* and overall Islamic worldview. In their opinion for Islamic banks to be different from conventional banks, they must aim at promoting Islamic norms and values as well as protecting the needs of Islamic society as a whole without undermining its commercial viability.

For example, the replacement of interest-based financial intermediation by PLS modes of financing inevitably promote small and medium entrepreneurship or micro entrepreneurs. Unlike conventional banks with their collateral-based lending and creditworthiness paradigm, favouring more established businesses and corporate clients,

Islamic banks on the other hand, with their emphasis on PLS instruments are compatible with the needs of micro-entrepreneurs. Hence, small entrepreneurs with viable projects that are normally shunned by conventional banks due to insufficient collateral might be perceived otherwise by Islamic banks.⁶ Therefore, according to Haron⁷, the Islamic banking system will become an efficient model in mobilizing and allocating resources in the economy, as a result of interest elimination and profit-sharing concepts. Entrepreneurs, for example, by associating themselves with Islamic banks will become more ethical in conducting their business in such a way that funds will be used properly and the sense of selfishness is reduced considerably⁸.

Ideal versus Reality

Despite the strong tendency in the literature to emphasize theoretical superiority of Islamic banking based on PLS over conventional banking, the practices of Islamic banks are found to diverge in important ways from the intellectual doctrines underpinning their role in the economy. Almost all Islamic banks across the globe today resort to the second line fixed return techniques or debt-based instruments. Observers point out that the use of PLS instruments, namely *mudarabah* and *musharakah* financing have declined to almost negligible proportion.⁹

In many Islamic banks' asset portfolios, short-term financing, notably *murabahah* and other debt-based contracts account for the great bulk of their investments. Yousef refers to the strong and consistent tendency of Islamic banks to utilize debt-like instruments in the provision of external finance as '*murabahah syndrome*'. Many Muslim economists now acknowledge that Islamic banks are avoiding risky investments. Ahmad al-Naggar, an Egyptian whom Islamic economists credit with founding the first Islamic bank (Mit Ghamr, Egypt), characterizes the existing Islamic banks as terrible failures. Their operations differ only cosmetically, he says, from those of conventional banks. Indeed, only a minuscule portion – generally well under 5 percent – of the assets of Islamic banks consist of loans based on genuine profit-loss-sharing.¹⁰



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