



How 'Islamic' is Islamic Banking?

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ABSTRACT

Islamic Banks hold well over US \$700 billion in assets and are growing at over 15% p.a. Islamic Banking and Finance (IBF) involves wider ethical and moral issues than simply 'interest-free' transactions. Its advocates argue that these make it more economically efficient than conventional banking and promote greater economic equity and justice. To what extent, then, do actual Islamic Banking practices live up to the ideal, and how different are they from conventional banking? A preliminary investigation shows that, three decades after its introduction, there remain substantial divergences between IBF's ideals and its practices, and much of IBF still remains functionally indistinguishable from conventional banking. This runs counter to claims by IBF advocates that it would rapidly differentiate itself from conventional banking. However, despite not providing an alternative to conventional banking and finance, IBF does strengthen a distinctly Islamic identity by providing the appropriate Islamic terminology for *de facto* conventional financial transactions.

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1. Introduction

1.1. Size and extent of Islamic Banking Worldwide

Commonly synonymous with 'interest-free' banking, Islamic Banking has become a growing force in global financial circles over the past three decades, with Islamic Banks found in over 70 countries worldwide (Warde, 2000, p. 1). In 2008 the value of the world's "Islamic assets" was about US \$700 billion (Economist, 2008) and in the 10 years preceding 2005, the growth rate of Islamic Banking assets had been ~15% p.a. (Benaissa et al., 2005, p. 1). In 1999 Dow Jones created 'Islamic Indexes' to offer *Shari'a*-compliant investment portfolios to cash-flush pious Muslims. Several major Western banks, e.g., Citibank, ABN Amro, Bank of America, HSBC, Standard Chartered, and the Union Bank of Switzerland, either have Islamic Banking subsidiaries or offer Islamic financial products to their customers. Clearly Islamic Banking and Finance (IBF) has transformed itself from an obscure financial experiment to a major factor in global finance.

By some (optimistic) estimates, Islamic Banks could account for 50% of all savings in the Muslim world by 2010 (Zaher and Hassan, 2001, p. 167). There is no doubt that Islamic Banking assets are growing rapidly: in Bahrain, the Muslim world's money center, between 1998 and 2005, Islamic Bank assets grew at 111% annually versus only a 6% average annual growth rate for conventional bank assets (Bahrain Monetary Agency, 2006). Unsurprisingly, the increase in crude oil prices in the last few years has increased the growth rate of Islamic Bank assets in the Middle East. Although still insignificant compared

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to conventional banking – the US's 10 largest banks alone hold over US \$4.3 trillion in assets (Mishkin, 2007, p. 262) – the growth of Islamic Banks demonstrates their importance to, and the growing financial clout of, the world's billion-plus Muslims.

1.2. Islamic economics: critics and defenders

Contemporary IBF practices have not been without their critics (e.g., El Gamal, 2006; Kuran, 2004; Zaman, 2002; see Nomani, 2006 for an excellent summary of the debate) who often charge that IBF is merely a change of terminology (e.g., substituting 'profit rate' or 'markup rate' for 'interest rate') in what is essentially a standard debt contract; this gives a *de jure* distinction that is without a *de facto* difference.

Kuran (2004, 1993), in his voluminous work¹ on the subject, has argued that in its 20th century incarnation IBF arose in colonial India and was part of a broader movement designed to replace Western (i.e., Christian) leadership and structures in all areas of Muslim life; the aim of Islamic economics was not to provide a viable alternative to conventional economics but to strengthen a threatened Islamic identity. This is what I term the Kuran Thesis. Thus "Islamic economics was primarily a vehicle for reasserting the primacy of Islam and secondarily a vehicle for radical economic change" (Kuran, 2004, p. 5), and "Islamic economics" would help counter the danger that "Westernization was weakening the control that religion [Islam] exerted on personal worldviews and interpersonal relationships" (Kuran, 2004, p. 88).

The current secured, interest-based debt contract that is the basis of conventional banking evolved over centuries of operation in an asymmetric information environment. Therefore Islamic Banks, which also operate in an asymmetric information environment, would inevitably be "sticking so closely to the techniques of conventional banking" that they would be indistinguishable from the latter (Kuran, 1993, p. 311). Since in this case form does follow function, there should be nothing surprising in Islamic Banking being virtually indistinguishable from conventional banking once one accounts for the completely different, Classical Arabic, terminology favored by IBF advocates.

A counter to the Kuran Thesis was offered by Ahmad (1993, p. 59), a leading IBF advocate, who argued that the apparent similarities between conventional and Islamic Banking was simply a phase in the transition away from conventional banking as IBF's clients had to be offered products they were immediately familiar with and that "evidence suggests that the significance of *murabaha* is declining in the overall financing operations of Islamic Banks."² Ahmad (1993) was writing a decade-plus after the establishment of major Islamic Banks in many parts of the world (e.g., United Arab Emirates 1975, Saudi Arabia 1978, Pakistan 1981, and Iran and Malaysia 1983) but many still viewed IBF as being a relatively new financial innovation.

A decade after Ahmad, IBF's advocates were still defending it from the same charges. Yousef (2004, pp. 63–64) while conceding the "predominance" of what he terms the "*murabaha* syndrome," i.e., Islamic Banks closely mimicking conventional banking practices, holds that this does not provide valid grounds for arguing against IBF as an alternative to conventional finance since this criticism has been severely overplayed and merely serves as a convenient tool to unfairly condemn all of IBF outright.

So which is it? Is the Kuran Thesis a valid criticism of Islamic Banking and Finance, or is Ahmad correct in arguing that Islamic Banks are transitioning away from mimicking conventional banks? A legitimate question to ask, therefore, is what are the *desired* characteristics of an Islamic Banking system and do *actual* IBF practices differ from their desired characteristics to the extent that contemporary IBF is functionally indistinguishable from conventional banking? This paper will attempt to answer this question by looking at both the ideal and the actual form that IBF takes.

As I shall show, three decades after IBF was first introduced as a major financial innovation, the Kuran Thesis is still a valid characterization of IBF, current IBF practice conforms in almost all key respects to the conventional banking norm, and IBF practice does not resemble what its advocates say IBF is supposed to be. Thus three decades after IBF's introduction, Ahmad's (1993) defense of IBF is increasingly untenable and unconvincing, and even some of IBF's staunchest advocates condemn how it is currently practiced. Consequently the "*murabaha* syndrome" is a valid charge to levy against IBF.

2. Why Islamic Banking and Finance?

2.1. General principles

The Qur'ān, Islam's Holy Book, and the *hadīth*³ lay down general guidelines for what are and are not Islamically permissible forms of economic activity. Over the centuries, the *ūlamā* (scholars of the various schools of Islamic law, *fiqh*) have concluded that, along with *ribā* (usually translated as 'interest' or 'usury' but having a literal meaning of 'excess' or 'increase,' see, e.g.,

¹ Kuran's work on Islamic Economics, Banking and Finance spans well-over two decades and dozens of books, articles, and chapters in edited volumes, far too many to list here but I include some representative works. A full bibliography is available from his webpage <http://econ.duke.edu/~tk43/>.

² A *murabāha* is a 'cost plus' contract between client and financier that essentially replicates a standard, interest-based debt-finance contract and is held to be, at best, weakly Islamic by most analysts and condemned by more conservative ones as being simply disguised interest. See Box 1 in Section 3.2 of this paper for more details.

³ The sayings and actions of the Prophet Muhammad; along with the Qur'ān these form the core of Islamic law (*fiqh*), the earthly representation of the *Sharī'a* (Divine Path) that all Muslims must follow.

Ayub, 2002, p. xxxi) which is banned outright in the Qur'ān,⁴ all practicing Muslims must also avoid financial transactions that involve excessive *gharār* (uncertainty; i.e., where the outcome is uncertain), *maysir* (outright gambling) and *harām* (religiously forbidden) products. Engaging in trade is encouraged but, ideally, profits must be the result of assuming a proportionate share of the risk involved in the transaction by taking an equity stake in it; profits must not be earned 'risk-free' by making a collateralized loan. This was summarized by a publication of the *Islamic Research and Training Institute of the Islamic Development Bank* as follows⁵:

The most important feature of Islamic Banking is that it promotes risk sharing between the provider of funds (investor) on the one hand and both the financial intermediary (the bank) and the user of funds (the entrepreneur) on the other hand. . . . In conventional banking, all this risk is borne in principle by the entrepreneur (Iqbal et al., 1998, pp. 15–16).

Since "All income should be commensurate with work effort" and "money does not create a surplus value by itself," interest income is *harām* in Islam (Presley and Sessions, 1994, p. 586). Money is generally held to have zero opportunity cost (Ayub, 2002, p. 12) and thus does not require any compensation for use; however, when combined with other resources, money becomes capital and so deserves 'just' compensation. In short, "In Islam, one does not lend to make money, and one does not borrow to finance business" (El Gamal, 2000, p. 33).⁶

2.2. Basic guidelines

From a more practical perspective, El Hawary et al. (2004, p. 5) defines IBF as a system that adheres to the following four principles:

- (1) *risk-sharing*: the terms of financial transactions need to reflect a symmetrical risk/return distribution among each participant to the transaction,
- (2) *materiality*: all financial transaction must have "material finality," i.e., be directly linked to a real underlying economic transaction; thus options and most other derivatives are banned,
- (3) *no exploitation*: neither party to the transaction should be exploited,
- (4) *no financing of sinful activities*: transaction cannot be used to produce goods banned by the Qur'ān (e.g., alcohol, pork products, gambling, etc.).

Thus the current strict interpretation of the *hadīth* relating to trade and commercial transactions would ban not only speculative financial transactions such as options and futures but also, for example, hedging by forward sale, interest-rate swaps and any transaction involving items not physically in the possession of the seller (e.g., short sales) and all other forms of derivatives, i.e., financial securities that have no underlying 'real' transaction (see Venardos, 2005 and Usmani, 2002 for more details). Warde (2000, pp. 140–141) takes a more nuanced approach to derivatives and other financial instruments but generally considers them to be violating Islamic norms. Similarly, activities such as bill discounting and government debt issue with a fixed coupon rate (the basis of modern Open Market Operations by central banks and financing the national debt), inflation indexing, securitized debt obligations, and foreign exchange dealings would also be prohibited unless cumbersome intervening steps reminiscent of the medieval *contractum trinius* are undertaken.⁷

Thus it should be apparent that IBF is more than just the 'interest-free' banking that the common view holds it to be. However, since virtually all financial instruments involve the interest rate in some way or form, 'interest-free' operations have become the *sine qua non* for any bank calling itself 'Islamic.' How then is IBF actually carried out and how 'interest free' is its operations?

3. Islamic Banking in theory

3.1. Profit and loss sharing via direct equity participation

At its most basic, there are only two ways to finance any commercial venture if one's own resources are insufficient for the task: take on a partner or borrow money. The advocates of IBF contend that equity finance is preferable to interest-based debt finance because if the venture fails, the borrower does not bear the entire cost alone or lose the collateral. If the venture succeeds, the financial investor receives a larger return than a predetermined interest rate would allow (e.g., see Usmani, 2002, p. xiv). Thus profits and losses are shared in a pre-decided ratio. Equity finance, it is usually argued, would make more

⁴ Islam is, of course, not the only religion to ban interest. At various points in their history Judaism and Christianity also condemned interest or usury. See, e.g., Glaeser and Scheinkman (1998) for more on this.

⁵ The Institute is the best funded and probably the largest and most influential IBF 'think tank' in the world. It promotes a fairly restrictive version of IBF and is the research wing of the *Islamic Development Bank*, the regional multilateral development agency for the Muslim world, akin to the *Asian Development Bank* or the *InterAmerican Development Bank*.

⁶ See also Chapra (1992) (for a more sympathetic) and Kuran (2004) (for a more critical) presentation of the basic tenets of Islamic Economics.

⁷ The *contractum trinius* was a series of three separate transactions, all of which were permitted by canonical law, to evade the medieval Catholic Church's ban on usury (El Diwany, 2006; see also El Gamal, 2003).

financial resources available to small businesses, make it more difficult to accrue 'unearned' income, and generally promote an ethos of equity and justice in society since all deserving ventures would be financed, not just the ones with excellent collateral or well-established credit histories.

This line of reasoning is strongly argued by most advocates of IBF who hold that such a 'risk sharing' financial system would lead to greater equity, allocative efficiency, financial system stability, and GDP growth (see, e.g., Iqbal and Molyneux, 2005, pp. 31–34).⁸ For its most partisan advocates, an equity-participation based Islamic system, once fully implemented, would automatically give us a world where "no inflation, no unemployment, no exploitation and no poverty exist" (Ahmad El Nagar,⁹ quoted in Warde, 2000, p. 21). In a more sober vein, early IBF advocates envisaged "Islamic Banks as predominantly risk-taking institutions committed to long-term productive investment on a partnership or equity basis" (Mills and Presley, 1999, p. 51) since profit-and-loss-sharing (i.e., equity participation) "is at the core of Islamic Banking" (Zaher and Hassan, 2001, p. 161). Thus Islamic Banks are supposed to act as venture capital providers, investing in worthy firms and financing promising ideas in exchange for a share of the profits, rather than lending on the basis of cash-flow and collateral, and forcing firms into liquidation to recover loans that had gone bad through no fault of the borrower.

3.2. Non-participatory Islamic financing modes

However, equity participation is not the sole means of Islamic financing available. Islamic Banking may be done on the basis of something other than equity participation. There are actually two types of IBF: profit and loss sharing (PLS) and non-profit and loss sharing (non-PLS) (Sundarajan and Errico, 2002, p. 20). PLS, as the name suggests, is participatory (direct equity stake or a partnership), or the financier may choose to be non-participatory and not take an equity stake. Virtually every IBF advocate argues that equity participation is the desirable alternative and non-participatory finance, sometimes referred to as 'trade-based financing modes,' is acceptable only as an interim measure or for situations where participatory finance is clearly unsuitable, such as very small or personal consumption loans (Usmani, 2002, p. 42; see also Kuran, 2004; Ayub, 2002; Sundarajan and Errico, 2002; Zaher and Hassan, 2001, and especially Warde, 2000). So while non-PLS forms are "weak Islamic forms in contrast to the strong Islamic forms based on sharing of returns," Siddiqui (2002, p. 175), an extremely influential early IBF theorist, argues these "weak Islamic forms" are permissible as long as there is some sharing of risk between the two parties.¹⁰

Main participatory forms:

Mudāraba (a 'sleeping' partner contributes capital and another expertise/knowledge) and *mushāraka* (the financier takes a direct stake in the venture).

Main non-participatory (trade-based) forms:

Murabāha ('markup' or cost-plus sale), *ijāra* (lease), *bay' salam/istisna* (deferred delivery), *bai muajjal* (deferred payment), *jo'alah* (service fee), and *qard al hasana* (charity/beneficence loan).

Box 1 summarizes these major Islamic financing modes. While there are many other forms possible, these constitute the overwhelming majority of Islamic financing. In fact, four forms of financing effectively comprise IBF, as is shown by an analysis of the 1994–1996 financing patterns of the then 10 largest Islamic Banks: *ijāra*, *mudāraba*, *murabāha*, and *mushāraka* accounted for over 87% of all financing provided.¹¹

4. Islamic Banking in practice

4.1. Non-participatory financing as the norm

Given the extensive critique by IBF advocates of the debt-based/interest-based financing that constitutes the overwhelming majority of conventional finance, one would expect equity-participation/direct-investing to dominate Islamic financial transactions. Unsurprisingly, this is not the case. *Murabāha* and *ijāra* (leasing) operations predominate.

A typical *murabāha* banking transaction would be structured as follows. A firm in need of upgrading its existing machinery would approach an Islamic Bank to obtain the machinery on its behalf, with a concomitant agreement to purchase the machinery on a marked-up basis from the bank. If the bank's purchase price was \$100,000, it might resell the machinery to the firm for, say, \$110,000 payable in 12 equal monthly installments. The bank retains ownership until the last installment is paid and so the bank's position is fully secured. This is accepted as *Shari'a*-compliant by most authorities (e.g., Usmani, 2002, pp. 52–54 and Warde, 2000, p. 133) because the agreement is based on a real transaction and the rate of mark-up is

⁸ See also El Gamal (2006, p. 138), Kuran (2004), Usmani (2002), Iqbal et al. (1998), among others, for more details; see Mills and Presley (1999, Chapter 2) (the Islamic critique of interest) for an excellent summary of the Islamic critique of the conventional view of interest.

⁹ Although Warde does not contextualize the quotation, El Nagar founded Mit Ghamr Savings Bank, probably the first 'Islamic' bank in the world, in Egypt in 1963.

¹⁰ El Gamal (2000, p. 15) argues that there is no Qur'anic justification for preferring one permissible mode of financing over another; this comes from the personal inclinations of the observer.

¹¹ Calculated from 'Table 6: Financing by Modes, 1994–1996 averages' in Iqbal et al. (1998, p. 28).

Box 1: Major Islamic financing modes**Main forms of participatory (profit and loss sharing) Islamic finance**

Mudārabā: ‘Trustee finance contract’ or passive partnership; one party provides funds while the other provides expertise and management; profits accrued are shared on a pre-agreed basis; losses are borne only by capital provider.

Mushāraka: ‘Equity participation contract’ providing for profit/loss sharing in the joint business; the financier provides a portion of the total funds and all partners may participate in management; profits are distributed in pre-agreed ratios but losses are borne strictly in proportion to respective capital contributions. A ‘declining *Mushāraka*’ may be used for installment purchase of, e.g., a house with the buyer paying *pro rata* ‘rent’ to the financier.

sukūk: Islamic bonds, generally paying a ‘LIBOR + X%’ rate but may have a fixed rate if backed by *ijāra* or *murabāha* transactions; must be asset-backed and *Shari’a* compliant; sometimes also referred to as *Mushāraka Term Finance Certificates*, with a nominal equity component.

Direct Equity Investment: e.g., purchasing shares on the open market, etc.

Main forms of non-participatory (non-profit and loss sharing, or trade based) Islamic finance

Murabāha: Mark up sale, i.e., a sale on mutually agreed profit; client requests the bank to purchase an item for her; bank resells it to the client for a predetermined (‘marked up’) price usually paid in installments.

Ijāra/ijāra wal iqtina’: Lease or lease-purchase agreement.

Bay’ salam (including *istisnā’*): deferred delivery purchase; only items that can be fully specified in terms of quantity, quality, attributes, etc., are eligible; monetary instruments are specifically excluded.

Bai’ muajjal: Deferred payment/credit sale, also known as *Murabāha Muajjal*, where seller informs buyer of cost, selling price and the final payment date (may be installment or lump sum); spot price may be lower than deferred payment price.

Musawama: Normal market sale with no cost disclosure obligation.

Ji’āla: Service charge, consultancy fee, placement fee, etc.

Qard al Hasana: zero-interest loans; repaid when/if able; usually extended only to the needy or destitute.

Source: El Gamal (2000), Ayub (2002), Sundarajan and Errico (2002). See Ayub (2002) or Usmani (2002) for extensive discussion of these and other forms of Islamic finance.

(theoretically) not a function of the time taken to repay the bank (Mills and Presley, 1999, p. 17). A *murabāha* is permissible since the bank has had actual ownership of the machinery and so has borne some risk; a simple loan for \$100,000 at 10% interest, secured by the machinery, is not.

The *murabāha* can also be used for personal loans. For example, many Saudi banks keep a stock of gold or some other commodity on hand for personal loans (United Nations Conference on Trade and Development, 2006, p. 9). The bank ‘sells’ these to a customer for, say, 25,000 riyals with payment to be made monthly over one year; the customer then immediately ‘sells’ the gold back to the bank or to a dealer for, say, 23,000 riyals spot cash. This is a fully *Shari’a*-compliant transaction despite the 8.7% implicit annual interest rate. So even if explicitly interest-based transactions were not utilized, Islamic *fiqh* from the very beginning utilized such *hiyal* (singular *hila*) as legal stratagems “designed to achieve purposes fundamentally contrary to the spirit of the *Shari’a*” (Coulson, 1978/1964, p. 139).

Clearly if the time period, ‘purchase’ and ‘sale’ prices are known, calculating the implicit interest rate is trivial. This is why *murabāha*, *ijāra* and other non-PLS forms are viewed by most conservative *ūlamā* as, at best, weakly Islamic since the similarities to a standard bank debt-finance contract are immediately obvious. However, other analysts (e.g., El Gamal, 2006; Kuran, 2004) of contemporary Islamic Banking practices go further and, following Coulson (1978/1964), argue that *murabāha* and much of contemporary IBF is still merely Islamic legal sophistry: an Islamic version of the old medieval *contractum trinius*.

Murabāha and *ijāra* are the dominant mode of Islamic finance as globally “profit and loss sharing transactions . . . only account for about five per cent of the operations of Islamic financial institutions” (Warde, 2000, p. 240) and “In a typical Islamic Bank, [non-PLS forms] dominate the assets portfolio and can exceed 80%” (El Hawary et al., 2004, p. 15). A breakdown of the 1994–1996 financing pattern of the world’s 10 largest Islamic Banks confirms these observations: of the US \$8.56 billion of financing during this period, PLS accounted for less than 14% of the total, with *Murabāha* alone accounting for 65.66% (Iqbal et al., 1998, pp. 28 and 30).

This financing pattern holds true even for non-profit making, non-commercial multilateral development agencies. An analysis of the Islamic Development Bank’s asset portfolio for 1976–2004 showed that 91% of its financial transactions were non-PLS (calculated from Table 3.3, Islamic Development Bank, 2004, p. 111); by 2006–2007, this had changed somewhat as 11.3% of its current portfolio was now direct equity participation, but 92% of its income was still derived from non-PLS sources (calculated from Tables 6.1 and 6.3, Islamic Development Bank, 2007, pp. 101–102). Indeed, the Islamic Development Bank makes no bones about the importance of conventional market interest rates for its income generation as its 2006–2007 Annual Report makes clear:

The income from commodity placements increased by 107.6 percent over the previous year. This rise is attributable to the increased level of liquid funds placed in these assets as a result of proceeds from issuance of *sukūk* and Short-term

Murabaha with higher yields in an environment of rising LIBOR-linked rate of returns. (Islamic Development Bank, 2007, p. 102.)

“Commodity placements” (or ‘Commodity *murabāha*’) are themselves nothing other than the Islamic Development Bank placing surplus funds with other, usually conventional, financial institutions for their own use or to lend out to traders. This is mainly due to the “excess liquidity” problem inherent to all contemporary Islamic Banks (Ahmed, 2001) since they lack many clearly *Shari‘a*-compliant short-term investment opportunities available to conventional banks (e.g., Treasury Bills or commercial paper or even the overnight interbank market) to park their short-term excess funds.¹²

In 2004, 94% of the Islamic Development Bank’s placements were with non-Islamic Banks and both a minimum return and the principal were guaranteed by the borrowing bank; these “placements” accounted for almost 31% of the Bank’s operational assets (Islamic Development Bank, 2007, p. 5). Ostensibly the use of these funds is supposed to be restricted to *Shari‘a*-compliant purposes (i.e., financing trade in Islamically permissible commodities) but there is no effective check on how these funds are actually utilized as the user/borrower simply affirms that it will not use them for any non-Islamic purpose. It would be remarkable if non-Islamic Banks could find more *Shari‘a*-compliant investment opportunities than could Islamic ones. It is practices such as this that led Al Nasser (2008) to conclude that “the Shariah authorities demonstrate excessive confidence in their subjects when it comes to dealing with parties in the industry,” so regular, external *Shari‘a* audits (akin to independent external financial audits) are needed “to bring about transparency and ensure that they [IBF institutions] deliver what they have committed to their customers” and to “prevent the exploitation of religion for financial gain and [the] straying away from its regulations.” When external *Shari‘a* audits have been carried out, “many of these auditors frequently complain about the amount of violations that they witness and cannot discuss since they [the records] have been tampered with” (Al Nasser, 2008). Zaman (2008, p. 9) concurs with Al Nasser’s assessment and argues that this is often the only way for IBF’s to remain profitable.

It was in keeping with the view of *murabāha* as simply ‘disguised interest’ that the Pakistani Federal *Shariat* Court and the *Shariat* Appellate Bench of the Supreme Court¹³ ruled against the existing system of Islamic Banking in 1991 and 1999 and mandated a conversion to full equity participation by the banking system; this was overturned on final appeal in 2002 and the case referred back to the lower courts for further study (Khan, 2008).

However, in response to these rulings, the State Bank of Pakistan bifurcated the Pakistani banking system. What had hitherto been termed ‘Islamic Banking’ was re-designated as ‘conventional banking’ (but care is usually taken to avoid using ‘interest rate’ and to use either ‘profit rate’ or ‘mark up rate’) and orders issued that only ‘Islamic Banks’ would be given new banking licenses. That is, all new banks would have to be truly Islamic and no new conventional banks would be allowed. Accordingly, a spate of new Islamic Banks (e.g., Meezan Bank and Al Baraka Islamic Bank) set up operation. The distinguishing characteristic of these banks is that their operations are now supposed to be completely *Shari‘a*-compliant and each bank has its own *Shari‘a*-board to ensure that its operations are indeed fully Islamic.

4.2. Historical practice of Islamic financing

The preoccupation with ensuring an ‘interest free’ banking environment for Muslims is mainly a current, i.e., post-WWII, phenomenon. Traditionally, in Islamic societies, financiers (and not just village moneylenders) operated on an explicitly interest-based basis and financial transactions were never characterized by the predominance of direct-equity participation. Jennings (1973, pp. 184 and 187), after analyzing 17th century Ottoman *Shari‘a* court records from the town of Kayseri, concludes that interest rates below 20% “were accepted by the entire religious community as in accordance with the *Shariah*” and offering collateral or third-party guarantees for loans was also common practice. Similarly, Gibb and Bowen (1960/1950, p. 301) in their study of 18th century Egypt find that trade between it and the Barbary States was normally financed at rates varying from 7% to 12% per annum and “that to take interest over 10% was regarded as usurious.” More recent research concurs in the assessment that it was not charging interest that was controversial but usury: in 16th century Ottoman Turkey it was only charging rates above the normal 10–20% that invited community censure and all the moneylenders in Aleppo, then a major trading center, were Muslim (Faroqhi, 1997, pp. 492–493). Indeed, Mehmet Ebusuud Efendi (1490–1574), the Ottoman Empire’s *Şeyhülislam* (the senior-most Islamic cleric of the Ottoman Empire), went so far as to issue a fatwa decreeing the permissibility, on purely pragmatic grounds, of interest-based lending for Islamic *auqaf* (charitable foundations) (Faroqhi, 1997, p. 492).

Interest-based lending continued unhindered in the Muslim Middle East for centuries after Mehmet Efendi’s ruling. In 1840 the cash-strapped Ottoman Empire began paying its bills half in cash and half in what were, in effect, treasury notes paying 12.5% annually; these proved so popular among the finance houses and the public that the Ottoman government was able to reduce the interest rate to 10% in 1843 and 6% in 1844 (Çizakça, 1996, pp. 187–189). Four decades later, the 1887

¹² Iqbal and Molyneux (2005, pp. 75–76) assert that “excess liquidity” is not a correct way of characterizing IBF institutions since they cannot turn to the interbank market or the central bank to borrow short-term funds in case of a temporary liquidity crunch as these are interest-based transactions; therefore, IBF institutions have to have greater liquidity than non-IBF ones; in any case, IBF institutions are only slightly more liquid than non-IBF ones from the same countries. However, this is contradicted by Iqbal’s earlier work (Iqbal et al., 1998, p. 77) where, of 60 IBF scholars surveyed, only 6 said that “excess liquidity” was “not a problem” for Islamic Banks and 28 of 60 felt it was a “serious problem” for some or all Islamic Banks.

¹³ Those parts of the Pakistani judicial system charged with ensuring that all laws and practices in the country are in strict conformity with the *Shari‘a*.

Table 1
Financing/Investment Breakdown for Islamic Banks.

	2006			2005		
	% PLS	% Non-PLS	% Other	% PLS	% Non-PLS	% Other
Large Islamic Banks						
Al Rajhi Bank	0	99.5 ^a	0.5	0	99.7 ^a	0.3
Kuwait Finance House ^b	20.1	78.4	1.5	22.7	75.1	2.2
Dubai Islamic Bank	14.4	85.6	0.0	25.3	74.7	0.0
Bank Islam Malaysia	0.7	99.0	0.3	0.79	98.8	0.4
Pakistani Islamic Banks						
Meezan Bank	5.0	95.0 ^c	0.0	7.0	93.0 ^c	0.0
Al Baraka Islamic Bank	7.0	93.0	0.0	10.0	99.0	0.0
Faysal Bank	10.0	90.0	0.0	11.0	89.0	0.0

Source: Calculated from Bank Annual Reports.

^a Includes 38.2% (2006) and 29.2% (2005) *Mutājara* trading.

^b 2005 and 2004 data.

^c 0.4% points lent interest free to bank employees.

Ottoman “murabaha ordinance” set the interest rate at 9% (Kuran, 1993, p. 310). Such an explicitly stated fixed interest rate would now be anathema for most present-day *ūlamā* and Islamic Bankers.

There remained, however, a tension between praxis and religious orthodoxy, and some pious Muslims shied away from such professions (even if on occasion they were clients) (Gibb and Bowen, 1960/1950, p. 301). Kinalizade Ali Efendi (1510–1572), an influential Ottoman political theorist and Islamic moralist (Uysal, 2007) and contemporary of Mehmet Ebusuud Efendi, in his trifold (noble, neutral, inferior) categorization of professions placed “usury and the entertainment professions” firmly in the “inferior” category but conceded that “for the good order of the world, all these professions are necessary” (İnalçık, 1995, pp. 44–45). However, after the 18th century, it appears that the main bankers/financiers in the Eastern Middle East were “Jewish and Christian bankers . . . Greeks also engaged in the money business [but] it was only in the Turkish period that they were joined by Armenians” (Gaudefroy-Demombynes, 1968/1950, p. 191).¹⁴ Even Ottoman officials issuing the treasury notes in the 1840s were concerned about their religious implication and fretted that they “have the perpetual harm of usury” (quoted in Çizakça, 1996, p. 189); these notes were eventually withdrawn in 1851, though probably for fiscal and not religious reasons.

In India, where Muslims constituted a (sometimes ruling) minority of the population, it appears that they were usually absent from most finance-related fields (i.e., mainly money-lending) until the 20th century. Tripathi, in his encyclopedic *Oxford History of Indian Business* (2004), mentions only three (relatively small) Muslim groups, Khoja, Bohra and Memon traders, as being involved in banking/finance, which was an overwhelmingly Hindu and British preserve. However, Tripathi adds, “they were converts from Hindu trading castes and still retained some of their pre-conversion customs and trading practices including usury” (2004, p. 21). Chandavarkar (2003, p. 56) concurs in the assessment that Khojas and Bohras, who were “mere converts and sometimes persecuted as heretics” by the orthodox Shī‘ah and Sunni *ūlamā*, “applied local usages regarding usury” rather than “the constraints [of] orthodox Islamic law” and flourished as traders and moneylenders.

Perhaps it is because Muslims were a (albeit large) minority in South Asia and Indian *ūlamā* felt that their religion was under constant threat from the British colonial rulers and the Hindu majority that explains both the rise of contemporary Islamic Economics there and Pal’s (2006, p. 86) observation that South Asian “*ūlamā* are ultra-traditionalist and much more conservative than the conservative *ūlamā* in the Middle East” and condemn unIslamic practices, e.g., *ribā*, even more vociferously and unqualifiedly than do their Middle Eastern counterparts. Accordingly, explicitly interest-based finance was probably less acceptable for South Asian Muslims than it was for many Muslims in the Middle East.

4.3. Current reliance on non-participatory finance by Islamic Banks

The predominance of interest-based financing is still the norm in Islamic Banks, the main difference being that now it is no longer explicitly identified as interest-based finance and that the business is no longer dominated by non-Muslims. As Table 1 indicates, Al Rajhi Bank¹⁵ (the world’s largest Islamic Bank, operating almost exclusively in Saudi Arabia with a few branches in Kuwait), Kuwait Finance House (Kuwait’s largest Islamic Bank, operating mainly in Kuwait, Turkey and

¹⁴ See Kuran (2005) and Warde (2000, esp. pp. 48–50), for more details on the acceptance and prevalence of de facto interest-based transactions in Muslim societies and the various stratagems employed to disguise interest; Warde also details how some of these stratagems were used by medieval Europeans to get around the Catholic Church’s ban on usury.

¹⁵ Al Rajhi Bank has a large proportion of its net investments in what it terms *mutājara* trading. *Mutājara* is essentially a *murabāha*-type transaction used for short-term trade or other financing. *Mutājara* often resembles a repo trade in that it is a matched ‘sale and repurchase’ agreement, and a substantial portion of Al Rajhi’s *mutājara* investments are with the Saudi Arabian Monetary Agency, the country’s central bank. Al Rajhi does not give a detailed breakdown in its annual reports for its *mutājara* trading, reporting only gross aggregates. See Moody’s Investor Services ‘Credit Opinion: Al Rajhi Bank’ (2008) for more details.

the Persian Gulf region, with a small presence in Malaysia), the **Dubai Islamic Bank** (the largest Islamic Bank in the UAE, with a small presence in the rest of the Middle East and Pakistan), and the **Bank Islam Malaysia** (Malaysia's largest Islamic Bank, operating mainly in Malaysia with a small presence in the UK) and the three Pakistani now-completely Islamic Banks continue to rely overwhelmingly on non-PLS financing. The non-Pakistani Islamic Banks are among the largest Islamic Banks in the world and the older evidence cited earlier is not anomalous.

El Hawary et al. (2004, pp. 16–17) also gives another important divergence between Islamic Banking theory and actual practice. Although ostensibly accepting deposits on a PLS basis since no preset 'interest' rate is permissible, no Islamic Bank has ever written-down the value of its depositor's accounts when it has written-down the value of its non-performing assets. In other words, bad debts are not translated into "losses" for depositors. On the contrary, Islamic Banks have declared market-competitive returns for depositors (obviously to avoid deposit outflows and a loss of faith in Islamic Banking) even when running into financial difficulties themselves.

Many central banks also implicitly guarantee Islamic Bank deposits in a manner not consonant with Islamic risk-sharing principles. For example, a run on the Dubai Islamic Bank in 1998, following reports of a massive embezzlement scandal, resulted in the withdrawal of US \$138 million, 7% of its total deposits, in one day; such a large withdrawal would have caused the Bank's collapse if the Dubai Central Bank had not stepped in as the "lender of last resort" and effectively guaranteed all deposits (Warde, 2000, pp. 155–156). This was reinforced recently when the head of the Bahrain-based Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), one of the two international standards setting body for IBF institutions, was quoted as stating unequivocally that "If you let banks share losses right and left, the whole system will collapse in any downturn" (Wigglesworth, 2009).

5. Why is non-PLS the dominant mode of financing?

5.1. The prevalence of information asymmetry, moral hazard and adverse selection

There is a long-established consensus in conventional economics on how best to resolve the debt-finance versus equity-finance question in the presence of non-trivial information asymmetry and hence costly state verification: the standard debt contract is superior to equity financing.¹⁶ Therefore, Islamic Bankers' preference for non-PLS financing is an eminently rational response to the information asymmetry problems inherent in all financial transactions. Given information asymmetry, there is a risk of two types of problems.

The *ex ante* problem is adverse selection when loans/investments are made to/in a poor credit risk. The *ex post* problem is moral hazard when loaned/invested funds are misused and/or utilized in inappropriate ways. Naturally the degree of information asymmetry, and the resulting adverse selection and moral hazard problems, depends upon the amount and quality of information flows between lender or investor and borrower. Institutions such as credit rating bureaus improve the information flow and reduce the likelihood of adverse selection, while civil, criminal and possibly societal sanctions reduce the moral hazard dangers. However, in the absence of institutions to mitigate the information asymmetry issue, fully collateralized debt-finance would be the financing mode preferred by banks to minimize their risk.

Warde (2000, pp. 155–157) confirms this serious problem when he details a long list of "Islamic Moral Hazard" problems. These ranged from depositors demanding higher returns but a guaranteed principal amount, to borrowers challenging the permissibility of financial penalties and late fees, to Pakistani borrowers in a high inflation environment cheerfully repaying only the principal of the loan on the grounds that interest is forbidden. Given the relatively poor quality and quantity of financial information flows in most countries that have substantial IBF operations (El Hawary et al., 2004, p. 35), the resulting information asymmetry problems would make standard debt contracts secured by excellent collateral even more preferable and equity participation even less desirable. For example, Kemal (2007, p. 28) estimates the 2005 incidence of tax evasion in Pakistan as being between 5.7% and 6.5% of GDP and the size of the unofficial/underground economy as between 54.6% and 62.8% of GDP, among the world's highest. Tedd (2005, p. 17) found in that in Africa and the Middle East, 38% of firms surveyed did not report at least 30% of their sales to government tax authorities, while for OECD countries only 14% of firms indicated the same degree of sales underreporting. Jalali-Naini (2000, p. 11) reports "widespread tax evasion in both the formal and informal sectors" of the Middle East and North African (i.e., Arab) countries. Similarly, Transparency International's *Corruption Perception Index* rankings showed that the highest ranked Muslim country was only the 31st least corrupt country in the world (out of 163 surveyed) and that the majority of the world's Muslim countries were in the lower (more corrupt) half of the survey (Transparency International, 2006).

This gives an indication of the low quality of financial information available to IBF institutions in Muslim countries and the resulting severe moral hazard and adverse selection issues. Therefore, for credit providers, collateralized, conventional debt contracts are preferable to direct equity participation in firms characterized by severe information asymmetry issues. As indicated earlier, relatively early on Kuran (1993, p. 311) had predicted that the problems of moral hazard and adverse selection would force Islamic Banks to look very much like conventional ones. Similarly, El Gamal (2006, pp. 1–2) argued

¹⁶ See, e.g., Williamson (1987), Stiglitz and Weiss (1981) and Townsend (1979).

Table 2
Reliance on *Murabāha* and *Ijāra* (leasing) by Islamic Banks.

Large Islamic Banks	2006		2005	
	% <i>Murabāha</i>	% Leasing	% <i>Murabāha</i>	% Leasing
Al Rajhi Bank	42 ^b	57.5 ^c	40.5 ^b	59.2 ^c
Kuwait Finance House	62.7	13.7	57.5	15.6
Dubai Islamic Bank	55.6 ^b	14.9	53.1 ^b	16.5
Bank Islam Malaysia	89.7 ^{a,b}	3.1	95.4 ^{a,b}	3.5
Pakistani Islamic Banks				
Meezan Bank	56.2 ^a	21.1	56.0 ^a	23.9
Al Baraka Islamic Bank	69.6 ^a	16.0	85.0 ^a	13.7
Faysal Bank	75.0 ^a	14.3	76.0 ^a	13.6

Source: Calculated from Bank Annual Reports.

^a Includes other mark-up or cost-plus financing and bill discounting.

^b Includes *mutājara* and deferred payment sales.

^c Termed “installment sales” by bank.

that, like conventional financial markets, “Islamic financial markets . . . deal with the allocation of financial credit and risk” and consequently have no choice but to mimic conventional finance as closely as possible as this is a functional necessity. Thus Islamic financial rhetoric is a meaningless “distinction of form without substance” and it is forever doomed “to be an inefficient replication of conventional finance, always one step behind [conventional] developments” (El Gamal, 2006, p. 25).

Issues of adverse selection and moral hazard are, of course, not confined solely to Muslim or Third World countries. In even advanced financial systems with sophisticated credit rating systems and broad and deep financial markets, the information asymmetry problems are so severe that most financial transactions are debt-based and not equity-based (see Mishkin, 2007, especially Chapter 8). For example, the US market for venture capital and investment, among the largest and most sophisticated in the world, was only US \$59.9 billion in 2004 (Euromonitor International, 2005). In contrast, US bank loans as a source of corporate financing are worth several trillion dollars and most debt is collateralized (Mishkin, 2007, pp. 182–184). As the US sub-prime mortgage crisis shows, even ostensibly ‘fully collateralized’ AAA loans are not immune to information asymmetry problems.

5.2. Other explanations for the similarities between conventional and Islamic Banking

In addition to the moral hazard issues involved in financial activities in asymmetric information environments, El Gamal argues that the Islamic product has to be functionally identical to the conventional financial product since otherwise it would not be approved by banking regulators in both Islamic and non-Islamic countries (El Gamal, 2006, pp. 20–21). However, this reason does not explain why Islamic Banks in Pakistan, Sudan and Iran, whose governments favor Islamic Banking over conventional, all rely on non-PLS financing forms.

Some IBF advocates have proffered other rationalizations for Islamic Bankers’ preferences for products, especially *murabāha*, that closely mimic standard banking transactions. This is due, they argue, to their being Islamically permissible as long as the bank has ownership for any length of time (Henry and Wilson, 2004, pp. 3–4; i.e., no justification is actually necessary), or the weak property rights and high expropriation-risk levels found in most Muslim countries (Yousef, 2004, p. 73), or they being a “hangover” from the conventional banking industry (where most Islamic Bankers originally started their careers) which sees banks as liquidity/credit providers rather than investment vehicles (Ahmed, 2002, p. 28), or due to the higher “due diligence” costs associated with taking a venture stake in an enterprise (Iqbal et al., 1998, p. 50), or the tax advantages of debt financing over equity stakes (Iqbal et al., 1998, p. 51), or simply being an initial necessary step in the “early stages of the development of Islamic Banks” as they seek to establish themselves as viable competitors to conventional ones (Ahmad, 1993, p. 59). As Table 2 indicates, Ahmad’s (1993, p. 59) confident prediction about the declining role of *murabāha* in IBF was premature and overly optimistic. *Murabāha* and other non-PLS financing forms (mainly leasing) overwhelmingly dominate current IBF practices.

Sometimes the IBF institutions simply lie in their accounting and report conventional banking/finance transactions as being wholly Islamic. For example, the President of Faisal Islamic Bank of Egypt, the sixth largest Islamic Bank in the world (Iqbal and Molyneux, 2005, p. 81), revealed that the bank was buying conventional government bonds and reporting the income as “religiously legal operations” (Soliman, 2004, p. 281). Sometimes they do not lie in their financial statements but simply do not highlight their conventional activities. An examination of the Annual Report of Al Baraka Islamic Bank of Pakistan shows that 12.75% and 19.65% of its 2006 and 2005 *Gross Financings* were in the form of conventional (i.e., explicitly interest-based) export finance.¹⁷

¹⁷ Calculated from Note 11 of Al Baraka Islamic Bank’s 2006 Annual Report; see the next section for more details on how Export Refinance works in Pakistan.

Table 3Example of payment schedule for a home-loan under *Mushāraka*.

Month	Rent (\$)	Extra payment (\$)	Total fixed payments (\$)	Bank's ownership (\$)
Opening				120,000
1	800	347	1147	119,653
2	798	349	1147	119,304
176	37	1110	1147	4439
177	30	1117	1147	3322
178	22	1125	1147	2197
179	15	1132	1147	1065
180	7	1065	1072	0

6. How participatory is 'participatory?'

6.1. Avoiding true equity participation in home purchases

Clearly a *mudāraba* is PLS financing: one partner contributes capital and another contributes expertise/managerial skill. *Mushāraka* financing should also be PLS since there is supposed to be a direct equity stake taken by the financier, but this is frequently simply misleading terminology. Often when an Islamic Bank seemingly has taken a direct equity stake, it has actually done nothing of the sort.

For example, one common way of structuring an Islamic residential mortgage is as a 'declining *mushāraka*.' In this arrangement, the financier purchases the house on behalf of the eventual owner (with or without a down payment) and then rents it out to her on a 'rent to own' basis. The monthly payment contains two distinct components: 'rental' for the financier's 'share' of the house and a 'buyout' component for its 'purchase' (El Gamal, 2000, p. 16). The contract ends when the entire financier portion of the house has been purchased. As El Gamal (2000, p. 16) notes, the entire process is

very much like a conventional mortgage schedule [and] it is trivial to calculate the equivalent interest rate which would make the conventional mortgage payments identical with the diminishing partnership payments.

In theory, the 'rent' charged should be based on comparable homes in the area but, in practice, the 'rental rate' invariably varies according to the prevailing mortgage interest rate (e.g., see Islamic Bank of Britain, 2007, p. 13). Preliminary indications are that the implicit mortgage rate charged Islamic borrowers in the US is at least 25 basis points higher than that of comparable conventional mortgages (Healy, 2005), e.g., an extra \$6271 over the life of a 30 years, \$150,000 mortgage. However, Islamic mortgages often entail additional closing costs for the buyer so total costs are often far higher than a conventional mortgage's (Healy, 2005). One anonymous mortgage broker in the US cynically justified this as: "The price for getting into heaven is about 50 basis points [above a conventional mortgage]" (quoted in Morais, 2007, p. 132).

Rammal (2004) gives a detailed example of a diminishing *mushāraka*. A financier purchases a home worth \$150,000; the financier's share is \$120,000 (80%) and the homeowner contributes \$30,000 (20%). A fair rental price for the home is \$1000 and so the initial imputed rent accruing to the financier is 80% of \$1000 or \$800; a monthly 'extra payment' is made for purchasing the financier's share of the house. Table 3 (adapted from Rammal, 2004; ignoring insurance, taxes, etc.) gives the payment schedule for a 15 years (180 months) purchase plan.

Contrast this with Table 4, a conventional amortization schedule for 15 years, \$120,000 mortgage at 8% interest (ignoring all taxes and insurance). As is readily apparent, the differences between the two are trivial. Thus the differences between even 'participatory' Islamic Banking practices and conventional debt-finance with an interest rate charge are often minimal at best.

Some ostensibly Islamic Banks do not even make a pretense of attempting to disguise the role of market interest rates in a 'Diminishing *Mushāraka*' and how the 'rental' rate is directly derived from conventional interest rates and not from any imputed 'fair market rent.' For example, the Islamic Bank of Britain, proudly calling itself "the UK's first fully *Sharia* compliant bank" offers home mortgages on a Declining *Mushāraka* basis and states in its official consumer's guide to home finance that

Table 4

Amortization Table for a 15-year US \$150,000 conventional mortgage at 8% p.a. and a 20% down payment.

Month	Interest paid (\$)	Principal paid (\$)	Mortgage payment (\$)	Balance (\$)
Opening				120,000
1	800	347	1147	119,653
2	798	349	1147	119,304
176	37	1109	1147	4439
177	30	1117	1147	3395
178	23	1124	1147	2271
179	15	1132	1147	1139
180	8	1139	1147	0

The monthly installment of Rent will be calculated by reference to the relative ownership shares. . . . In this example, the rent was calculated by the Bank at a rate equivalent to 6% p.a. (Islamic Bank of Britain, 2007, p. 7).

The brochure goes on to state that the Islamic Bank of Britain's "rental rates" are "benchmarked" to commercial rates "such as LIBOR plus a further profit margin" and so the rental amount will vary but that Islamic scholars "have permitted Islamic finance providers to refer to an interest rate benchmark for determining Rent" (Islamic Bank of Britain, 2007, p. 13). Currently the UK is the only European country to offer Islamic mortgages and the market there is fairly small, under 5 billion pounds, although it is growing at about 40% annually (Oakley, 2007); Islamic mortgages are also available in the US and Canada but are still relatively uncommon outside of Muslim countries.

6.2. Further examples of 'non-participatory participation'

Another example of non-participatory participation is the State (i.e., central) Bank of Pakistan's *Islamic Export Refinance Scheme*, designed to promote exports by making subsidized credit available to firms which secure export orders. In the conventional *Export Refinance Scheme*, in 2005 banks borrowed from the State Bank at 6.5% and lent to firms at 8%, i.e., the bank's margin was statutorily set at 1.5% (State Bank of Pakistan, 2005). These predetermined interest rates are clearly unIslamic. Therefore, since the country also has dedicated Islamic Banks, the State Bank of Pakistan has established an *Islamic Export Refinance Scheme* on a *Mushāraka* pool basis where the firm seeking export credit is to be charged the financing bank's average profit rate based on the rate earned on financing offered to 10 "blue chip" bank corporate clients.

The State Bank has issued 13 pages of detailed instructions on how this *Mushāraka* pool is to be established and what criteria is to be used to determine "blue chip" status. This is, however, all irrelevant since

The Islamic Commercial banks shall have to ensure that the effective cost of funds to the exporters does not exceed the rate declared by the State Bank under its Export Finance Scheme, besides ensuring that there is no negative spread on their portfolio under the Scheme (State Bank of Pakistan, n.d., p. 2).

That is, the State Bank of Pakistan sets the rate charged by Islamic Banks so the "Mushāraka pool" and "setting profit rates" is simply rigmarole designed to give a semblance of Islamic risk-sharing on what is effectively a straight interest-based, conventional finance transaction since the "pool" has to be structured in such a way that the "profit rate" has to equal the refinance lending rate set by the State Bank of Pakistan.

7. Islamic bonds

7.1. Basics of Islamic bonds and the size of the market

A *sukuk* (plural *sukūk*) is a generic term for an Islamic financial certificate,¹⁸ an 'Islamic bonds.' Most *sukūk* are corporate or public debt instruments, usually with a variable rate of return tied to a commonly accepted market indicator rate (usually EURIBOR or LIBOR) and must have an underlying 'real' transaction basis to be *Shari'a*-compliant. The Bahrain-based Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has issued *Shari'a*-compliance standards for the issuance of 14 different types of *sukūk* (Gassner, 2005). Thus the typical *sukuk* is, in effect, a 'floater' bond type of Asset Backed Security with some restrictions as to what it may be used to fund (no activity forbidden by Islam).

In November 2008, Maulana Justice M. Taqi Usmani, formerly of the Pakistan Supreme Court's *Shariat* Appellate Bench and now head of the AAOIFI's *Shari'a* advisory board, issued a ruling that shook the *sukūk* market when he decreed that most *sukuk* transactions mimicked conventional bonds too closely and so were unIslamic. This affected roughly four-fifths of the US \$80 billion outstanding *sukuk* issue but the ruling was not to be applied retroactively (See Oakley, 2008 for more details).

The most common type of Islamic bond now, and one not affected by Usmani's ruling, is the *sukuk al ijāra*, essentially a lease-revenue bond. Here the borrower's tangible asset is 'sold' to the financiers and then 'leased' back to the borrowers, who make regular payments to the financiers from the income stream generated by the asset; this tangibility and its related income-stream is what makes the transaction 'Islamic.' General revenue bonds issued by governments or corporations are not Islamically permissible since they are not Asset Backed Securities (there is no direct connection between the security and the income stream accruing to the financiers) and are backed by nothing more than faith in the government's/corporation's credibility and ability to service its debt.

A typical *sukuk al ijāra*, the most common type of *sukuk* offering, transaction might be structured as follows. A Special Purpose Vehicle (SPV) is created by X-Co, which 'sells' to it some of X-Co's physical assets (e.g., manufacturing plant) for, say, US \$500 million, with a concomitant agreement to lease the assets from the SPV for a specific time period, say five years, and a specific lease payment, say LIBOR + 0.5%. X-Co also agrees to buy back the assets from the SPV at the specified sale price (after which the SPV is dissolved). The SPV, in turn, sells shares of itself to investors, who are assured a (pro rata) share of the lease payment, and uses the proceeds from this sale to pay X-Co. The lease payment may include an amortization component, or X-Co may set up a separate sinking fund for the buyback from the SPV.

¹⁸ Common usage in finance is to refer to *sukūk* for both the singular and the plural; some writers make *sukūks* the plural.

While there is no doubt some implicit connection between overall market interest rates (as an indicator of economic conditions) and corporate sector profitability, there is unlikely to be a direct short-term link between, say, LIBOR and the profitability of an off-shore oil platform in Bahrain.

Islamic capital markets have been relatively underdeveloped until very recently but, while growing extremely rapidly, are still insignificant compared to regular bond issues. Gassner (2005) estimated the entire 2004 *sukk* volume to be under US \$7 billion. However, by 2006, *sukk* issuance was \$10.8 billion, was worth 44% of the new market debt issue in the Persian Gulf and the outstanding worldwide market had grown to approximately US \$22 billion (Fitch Ratings, 2007, p. 4). The phenomenal *sukk* market growth rate ensured that, by end 2008, the worldwide market had grown to US \$80 billion (Oakley, 2008). A January 2006 US \$3.5 billion offering by Dubai Ports Corporation (the largest *sukk* offering to-date) was 325% oversubscribed and news reports indicated that several Persian Gulf countries were considering massive (US \$50–\$65 billion) petroleum projects financed by *sukk* issue because of the extremely attractive (for the borrower) rates resulting from the high demand for them as almost all *sukk* “offerings are hugely oversubscribed” (AMEinfo, 2006). This popularity led to some offerings being listed on the London Stock Exchange in 2006 and assigned credit ratings by Standard and Poors (AMEinfo, 2006), as well as the creation of the Dow Jones Citigroup *Sukūk* Index to track *sukk* issues and serve as a benchmark performance index for “*Shari‘a*-compliant fixed-income investments” (Parker, 2006).

7.2. Ownership or merely a secured loan?

Fitch Ratings, along with Standard and Poor’s and Moody’s, one of the three original financial ratings agencies recognized by the US Securities and Exchange Commission, has indicated its concerns about the degree to which the asset sale underlying most *sukk* issues have been “validly transferred. . . [so that] in the event of an insolvency of the originator. . . the underlying collateral must remain completely separate from the originator/parent company” and “Fitch has not reviewed any transaction to date which would satisfy these requirements” (Fitch Ratings, 2007, p. 3). Therefore it is Fitch’s policy to not rate individual *sukk* issues separately but to assign them the same Issuer Default Rating as the originator. Moody’s concurs with this assessment as an exhaustive analysis by it of the Persian Gulf’s *sukk* market indicated that “The *sukk* investors would have no first-lien or prior ranking or security above any other unsecured creditor” (Howladar, 2009).

The validity of these concerns was underscored by the Chapter 11 bankruptcy of East Cameron Partners LP in 2008. East Cameron had originated a US \$165.67 million *sukk* in 2006 but in bankruptcy court its US lawyers argued that the *sukk* was not a true sale but merely a secured loan and so the *sukk*’s assets belonged to East Cameron and not to the *sukk* holders; the case is pending (Howladar, 2009).

Asset securitization is constrained by the fact that not all Islamic scholars are in agreement about what constitutes a *Shari‘a*-compliant financial instrument. For example, Malaysian *ulamā*, adherents of the relatively more progressive *Shāfi‘ī* school, have *Shari‘a*-certified securitizing *Islamic Private Debt Securities* (IPDS), i.e. corporate accounts receivable. However, scholars in Pakistan, India and the cash-flush Persian Gulf have held that IPDS are not *Shari‘a*-compliant since the underlying transaction is a sale of debt and not a tangible asset. This is, according to their interpretation of the *hadīth*, *ribā*. Therefore, the largest national Islamic corporate debt market, approximately US \$24.5 billion in beginning-2005, is not ‘Islamic’ enough for investors in most of the Muslim world (Malaysian details from Parker, 2006). Nevertheless, both the Islamic Development Bank and the Abu Dhabi Islamic Bank, in contravention of general *Shari‘a* rulings, have ‘sold’ assets, i.e., securitized prior ‘real’ financings, as repos in order to generate funds and service fees (Fitch Ratings, 2007, p. 3).

8. Islamic derivatives?

A derivative is, of course, an instrument which derives its worth (price) from that of an underlying financial asset. Derivatives are invaluable in risk hedging for firms (e.g., foreign currency options to hedge exchange-rate transactions for importers/exporters) but are now used mainly for speculating on the direction of future price movements since the notional value of derivative contracts is many multiples of the actual underlying economic transaction. Thus derivatives fail both the “materiality” and “no speculation” test for IBF and almost all conservative *Shari‘a* scholars have ruled that “when applied to modern financial contracts, the prohibition of *gharār* eliminates futures, options, and some life assurance contracts” (Mills and Presley, 1999, p. 5; see also Ayub, 2002, p. 35). However, some argue that if there is an underlying economic transaction being hedged (e.g., in a forward contract), then some derivatives may be legal (Ayub, 2002, p. 35; Warde, 2000, pp. 139–141).

Until quite recently most scholars had held that a short-sale was strictly forbidden since it violates the materiality and no-speculation provision. However, some *Shari‘a*-compliant hedge funds have created an Islamic-short sale that is *Shari‘a*-certified if the shorter puts a “down-payment” towards the shorted stock to establish ownership of the item being sold (Morais, 2007, p. 131). Since short-selling in the US, for example, requires that a substantial margin be put up by the seller, an Islamic short sale is functionally equivalent to a conventional one. El Gamal (quoted in Morais, 2007, p. 131) characterizes the substantially higher fees charged by these Islamic funds as preying on “the gullible who don’t really understand the structure” since “both the sophisticated investors and the ultrapuritans will see through this.”

El Gamal (2006, Chapters 5 and 7) outlines several ways that IBF institutions have now “synthesized” Islamic versions of short and long sales as well as put and call options. For example, call options (i.e., where the buyer has the right but not the obligation to buy in the future at a preset price) are known as an ‘*urbūn* (down payment or earnest money) sale where

the buyer has the right to cancel the sale by forfeiting her down-payment (El Gamal, 2006, p. 181). The down-payment here obviously serves the same function as the premium on a conventional call option and the preset price functions as the strike price.

So a typical Islamic *'urbūn* call option might be structured thus: A writes (sells) B a call option on one share of X-Co stock for \$105, to be exercised by B within 6 months, with \$5 as the *'urbūn* payment. If B exercises the option, he will pay A the remaining \$100; if he decides not to, A keeps the \$5 payment (see El Gamal, 2006, p. 92–94 for details.) As with a normal call option, the higher the potential profit, the higher would be the premium or down-payment be. The similarities with a standard call option are obvious and, except for terminology, minor.

Since most options are not settled by the actual delivery of physical commodities, it is only a minority of *ūlamā* that consider them Islamic. Options dealing with financial instruments would be considered un-Islamic as they would fail the materiality test.

9. How Islamic is Islamic Banking and Finance?

9.1. Performance on El Hawary fourfold taxonomy

El Hawary et al. (2004, p. 5) gave the four defining characteristics of IBF as (a) *risk-sharing*, (b) *materiality*, (c) *no exploitation*, and (d) *no financing of sinful activities*. How well has contemporary IBF practice lived up to this?

- a. Given the overwhelming use of non-PLS financing modes, IBF cannot be said to be risk-sharing in any meaningful sense. IBF transactions mimic conventional, collateralized debt contracts very closely, often right down to actually using current market interest rates as pricing benchmarks.
- b. As shown by the Saudi gold sale, Malaysian *Islamic Private Debt Securities* and the Islamic short-sale example, contemporary IBF often has no meaningful underlying material transaction. Similarly, the sale and lease-back of existing physical assets, common in many *sukk* transactions, is a fictional materiality in that either no new asset is being financed or that there is no actual title transfer; this is a convenient vehicle to circumvent the fact that general revenue bonds are not *Sharī'a*-compliant.
- c. In so far as the higher fees associated with Islamic mortgages and investment funds for doing nothing more substantial than mimicking conventional banking/finance products are exploitative, IBF institutions fail on this criteria as well. Given that IBF institutions try to convince dutiful Muslims that they are truly *ribā*-free, they are also guilty of exploiting the pious here.
- d. Here as well IBF institutions are sometimes guilty of not being *Sharī'a*-compliant as the Faisal Islamic Bank of Egypt and Al Baraka Islamic Bank of Pakistan examples have shown. Furthermore, commodity placements usually rely on the simple word of the borrowing bank/firm that the funds will not be used for 'sinful' activities and rarely are *Sharī'a*-audits performed to ensure this. This is the IBF equivalent of 'don't ask, don't tell.' It cannot, therefore, be unequivocally said that there is no financing of 'sin.' There is no way of knowing how many other IBF institutions are similarly fudging their reporting.

Thus it seems clear that Islamic Banking and Finance is virtually indistinguishable from conventional banking and finance. What makes it Islamic is "*Sharī'a* arbitrage," which consists of "finding an appropriate [classical] Arabic name for the Islamic analog product" and insisting on using it so as to "justify and lend credibility to the Islamic brand name" (El Gamal, 2006, p. 20). Zaman (2008, p. 10) concurs in this assessment: "It appears that no matter how the transactions are structured by the [Islamic Bank], as long as these are made into "contract" documents, these are termed as Islamic."

9.2. Rent seeking by Islamic scholars

Each IBF institution has a '*Sharī'a* board,' usually comprised of between one and three respected Islamic scholars (*ūlamā*) who certify that the IBF institution's financial products are *Sharī'a*-compliant. How then can these institutions certify that these practices are "Islamic" when they do nothing more than replicate, using Islamic terminology, standard, interest-based banking products?

There are two possible answers to this. The first is the Kuran Thesis of IBF's origins and so there is nothing surprising in the fact that it looks very similar to conventional banking. The *Sharī'a* scholars are satisfied if the IBF institutions convince their customers that they are partaking in something exclusively Islamic, something that reinforces the borrower's "Islamic identity," rather than in ensuring that the financial products on offer are truly different.

A second possible explanation for why the *Sharī'a* boards regularly certify these IBF financial offerings as *Sharī'a*-compliant is that accommodating scholars are sought after by multinational and national financial institutions eager to gain the imprimatur of *Sharī'a* certification. And these firms are willing to pay top dollar. For example, Morais (2007, p. 122) reports that there are only 20 or so "rock star" *Sharī'a* scholars worldwide who have the necessary stature to certify something as *Sharī'a* compliant; these scholars sit on 40–50 *Sharī'a* boards each and earn between US \$20,000 and \$30,000 per board annually. Other reports are that some scholars have earned \$150,000–\$500,000 to *Sharī'a*-certify large transactions, sometimes by

serving as simple translators in that technical financial terms in complex Western financial instruments are simply given a Classical Arabic equivalent and then certified as being “*Sharia* compliant.”¹⁹

Malaysia, in response to the common perception of *Shari’ah* boards being mere rubber-stamps, has prohibited scholars from serving on more than one *Shari’ah* board at a time; in contrast, the Persian Gulf countries are virtually unregulated and some *Shari’ah* scholars have strongly resisted any attempt at regulating their activities (Asiamoney, 2006). Naturally the more accommodating the scholar, the more business he will get; ones known to be particularly strict in their interpretation are not likely to be much in demand. There is a clear conflict of interest here, analogous to the charges levied against Moody’s, Standard and Poor’s and Fitch in the US subprime mortgage crisis.

Conclusion

Consequently a vicious cycle is set up. Pious Muslims try to avoid *ribā* by avoiding the standard debt-contract, but this is not possible in most situations. Major banks wish to cash in on this desire but cannot provide truly *Shari’ah*-compliant vehicles. Therefore they look for scholars willing to certify *de facto* conventional instruments as *Shari’ah*-compliant. Conservative *ūlamā* regularly denounce much of contemporary IBF as being un-Islamic and even the industry’s own standards-setting body, the AAOIFI, has ruled against the *Shari’ah*-compatibility of some extremely lucrative IBF products.

Thus, as this paper has shown, El Hawary et al.’s (2004) fourfold taxonomy of IBF is systematically violated by contemporary IBF practices. Ahmad’s (1993) and Yousef’s (2004) (and other IBF advocates’) argument that IBF offers a radically different alternative to conventional finance is unsupported by the evidence and the Kuran Thesis still holds true. Therefore, as it is currently practiced, IBF simply replaces conventional banking terminology with terms from Classical Arabic and offers near-identical services to its clients but at a higher cost.

Given IBF’s explosive growth over the last two decades plus, it is clear that there is a large pool of financial resources in the Muslim world that observant Muslims are reluctant to place with conventional banks. While IBF does greatly increase the resource mobilization (and presumably economic development) potential of the Muslim world, it does so by duping observant Muslims in two ways. IBF institutions attempt to convince the pious that their funds are invested Islamically and, quite often, charge their clients more than would conventional banks. After almost three decades of Islamic Banking and Finance, we now have a sufficiently long track record to assess both its overall efficiency vis a vis conventional banking and its claim to offer a ‘better’ alternative for observant Muslims. It seems clear that Islamic Banking and Finance has fallen short on both counts.

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¹⁹ See Asiamoney (2006) and Tett (2006) for more details.

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