# 21 Challenges facing the Islamic financial industry

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## Introduction

The prohibition of interest in Islam, as in some other major religions, and the aspiration of Muslims to make this prohibition a practical reality in their economies, has led to the establishment of the Islamic financial services industry (IFSI). The industry has made substantial progress over the last three decades after the establishment of the first Islamic bank (Dubai Islamic Bank) in 1975. The number of institutions offering *shari'a*-compliant services has risen, as has the number of conventional banks that have opened Islamic windows and branches. The total volume of assets that all these institutions manage has risen rapidly and so has the international acceptance of Islamic finance. Nevertheless, the industry is still in its formative stage and faces a number of challenges that need to be addressed to enable it to continue its rapid expansion without facing any serious crisis and, thereby, acquire greater respectability and a much greater share of the international financial market. This raises the question of what these challenges are and how they can be faced.

### *The challenges*

Challenges arise essentially from the disparity that exits between the vision of a system (where it wishes to go) and its present position (the progress that it has made so far). The greater the disparity, the more serious may be the challenges faced. The most crucial challenge that all financial systems, including the Islamic, face at present is to be sound and efficient and free from crises and instability. All the guidelines laid down by the Basle Committee for Banking Supervision (BCBS) need to be carefully considered and implemented to meet this challenge satisfactorily. However, even if the Islamic financial system meets this challenge successfully, it may still not be able to be a genuine reflection of Islamic teachings if it fails to realize the vision of Islam by actualizing justice, which is one of the primary objectives of Islam (*maqasid al- shari'a)* (al-Qur'an, 57:25). It may not be possible to realize this vision unless all human institutions, including the financial system, contribute positively towards this end. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions. One of these is risk sharing by the financier so as not to shift the entire burden of losses on the entrepreneur, and the other is equitable distribution of the benefit of deposits provided by a wide spectrum of depositors to a similarly wide spectrum of the population by helping eliminate poverty, expand employment and self-employment opportunities, and reduce inequalities of income and wealth.

### *The first condition of justice*

The first condition would be satisfied if the profit as well as loss is shared equitably by both the financier and the entrepreneur. It is against the principles of justice that, in the event of a loss, the entrepreneur bears the entire loss in spite of his hard work and entrepreneurship,

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while the financier gets a positive rate of return without doing anything. The sharing of risks will lead to an increase in the reliance on equity and profit-and-loss-sharing (PLS) modes of financing (*mudaraba* and *musharaka*)[2] and reduce that on debt. This will help introduce greater discipline into the financial system. If investment depositors share in the risk to get a return, they will be motivated to take more interest in the affairs of their banks and demand greater transparency and more effective management. Similarly, if the bankers also participate in the risk, they will also be motivated to evaluate loan applications more rigorously.

The introduction of such a discipline in the financial system should help reduce funds available for speculation and unproductive spending and, thereby, control excessive expansion of credit and living beyond means by both the public and the private sectors. Moreover, since the rate of profit is only known ex post, it cannot change daily like the rate of interest. This, along with the check on excessive credit expansion, should help reduce volatility in the movement of funds and, thereby, inject greater stability into the financial markets (see Chapra, 2002, for details). No wonder Mills and Presley have stated: 'There are sufficient grounds to wish that, in hindsight, the prohibition of usury had not been undermined in Europe in the sixteenth century. More practical wisdom was embodied in the moral stand against usury than was then realized' (1999, p. 120).

However, since it is not possible for the *mudaraba* and *musharaka* modes to accommodate all different types of financial needs, Islam has also allowed some other modes of financing (*murabaha, ijara* (leasing)*, salam* and *istisnaa*),[3] which create debt rather than equity and in which the rate of return gets fixed in advance. *Sukuk* (asset-based Islamic bonds) have also now gained prominence as instruments for raising large amounts of finance by governments and corporations. These are based primarily on the *ijara* mode and have the advantage of converting leasing assets into *shari'a*-compatible financial assets which are tradeable in the market (for details see, Ali, 2005). There is hardly any significant need for financing that all the different modes of Islamic finance cannot together help satisfy. Nevertheless, it should be possible to create more *shari'a*-compatible modes in the future in response to need.

It may be argued that the above-specified debt-creating modes with a predetermined rate of return are not different from the interest-based modes. This is not so because the debt that arises in the case of these modes does not arise as a result of lending and borrowing on interest. It rather arises as a result of the sale or lease of goods and services on a deferred payment basis. The rate of return becomes a part of the price of the goods or services sold or leased. The debt, therefore gets linked with the growth of the economy. There is, however, a danger that these modes may degenerate into purely financing devices. The *shari'a* has therefore laid down certain conditions for their validity. The most important of these conditions is the requirement that the seller or the lessor cannot sell or lease what he/she does not own and possess. When the financer purchases an asset for the purpose of sale or lease, he converts cash into real assets and, thereby, takes risk. The return he gets is a reward for the risk that he has taken.

*The second condition of justice*

Fulfilment of the second condition of justice about the equitable distribution of credit is imperative because it would help realize the vision of Islam which is not only to improve the condition of the oppressed but also to make them leaders and heirs and to establish

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them firmly on earth (al-Qur'an, 28:5–6). One of the ways of actualizing this vision would be to spread the benefit of resources that become available to banks from a wide spectrum of depositors to a similarly large spectrum of the society rather than to just a few rich individuals, as the banking systems generally end up doing at present. Islamic finance will not be able to fulfil this criterion of justice if increased financing does not become available to the poor and the middle-class entrepreneurs. A number of these people have the talent, drive and innovative ability to establish a successful business enterprise, but do not have the resources they need to make use of their talents. Availability of finance would perform the function of pump priming in enabling such talented individuals not only to advance themselves economically but also to make a positive contribution to their economy.

*The dream and the reality*

The way the Islamic financial system has progressed so far is not in accordance with this vision. It has not been able to come out of the straitjacket of conventional finance. The use of equity and PLS modes has been scant, while that of the debt-creating sales-based modes has been predominant. Moreover, even in the case of debt-creating modes, all Islamic banks and branches or windows of conventional banks do not necessarily fulfil the conditions laid down by the *shari'a*. They try to adopt different legal stratagems (*hiyal)* to transfer the entire risk to the purchasers or the lessees, in violation of the first condition of justice stated above. Significant progress does not seem to have been made even towards fulfilment of the second condition of justice, which is realization of equitable distribution of credit. The result is that the Islamic financial system, as it is being practised, does not appear to a number of its critics to be a genuine reflection of Islamic finance.

**How to be genuine (1): greater reliance on equity and PLS modes**

The most important challenge facing the Islamic financial industry is to be as genuine and authentic a reflection of Islamic teachings as is possible within the present-day environment. This would happen not only when interest was removed definitively from the economy but also when the two conditions for realizing justice specified in the introduction were genuinely fulfilled. The system would lose its *raison d'être* if it did not make significant progress in promoting greater reliance on equity and PLS financing in the financial system and bringing about a more equitable distribution of credit with the objective of eliminating poverty, expanding employment and self-employment opportunities and reducing inequalities of income and wealth. It is only this which will enable the Islamic financial system to gain credibility in the eyes of the Muslim masses.

This raises the question of why the system has failed to make significant headway in using the equity and PLS modes and to bring about a relatively more equitable distribution of credit. It may not be possible to answer this question without answering some other questions, such as the following. Did the system ever operate successfully in Islamic history? What were the factors that contributed to its success? Can the system operate in a changed environment? If it can, then what are the different institutions that need to be established to enable it to operate in the modern environment when the favourable conditions that existed during the Classical period do not exist any more?

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*Financial intermediation in Islamic history*

From a very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilizing resources to finance productive activities and consumer needs. The system to finance productive activities was based largely on the profit-and-loss-sharing (PLS) modes of *mudaraba* and *musharaka*. Other modes, including interest-free loans (*qard hasan)*, were also used to help finance purchases on credit by consumers as well as businesses and to help the needy.

There are no empirical data available about the operation of the Islamic system in the past. However, whatever historical evidence is available seems to indicate that the system worked quite effectively during the heyday of Muslim civilization and for centuries thereafter. According to Udovitch, the Islamic modes of financing *(mudaraba* and *musharaka)* were able to mobilize the 'entire reservoir of monetary resources of the medieval Islamic world' for financing agriculture, crafts, manufacturing and long-distance trade. They were used not only by Muslims but also by Jews and Christians (Udovitch, 1970, pp. 180, 261) to the extent that interest-bearing loans and other overly usurious practices were not in common use (Udovitch, 1981, p. 257; see also p. 268). According to Goitein, breach of the Jewish, Christian and Islamic law against interest was found in the Geniza documents 'only once in the record of a judgment', even though 'an unusually large amount of Geniza documents deal with credit' (Goitein, 1967, pp. 255 and 250, respectively. See also Goitein, 1966, pp. 271–4). Schatzmiller has also concluded that 'financial capital was developed during the early period by a considerable number of owners of monetary funds and precious metals, without the supposed interdiction of *riba*, usury, hampering it in any way' (Schatzmiller, 1994, p. 102).

Financiers were known in the early Muslim history as *sarrafs*.[4] By the time of the Abbasid Caliph al-Muqtadir (908–932), they had started performing most of the basic functions of modern banks (Fischel, 1992). They had their own markets, something akin to Wall Street in New York and Lombard Street in London, and fulfilled all the banking needs of commerce, industry and agriculture (Duri, 1986, p. 898) within the constraints of the then-prevailing technological environment. However, since the *sarrafs* were not banks in the strictly technical modern sense, Udovitch has preferred to call them 'bankers without banks' (Udovitch, 1981).

The legal instruments necessary for the extensive use of financing through *mudaraba* and *musharaka* were already available in the earliest Islamic period (Udovitch, 1970, p. 77). These instruments, which constituted an important feature of both trade and industry and provided a framework for investment, are found in a developed form in some of the earliest Islamic legal works (ibid., pp. 77–8). Some of the institutions, practices and concepts already fully developed in the Islamic legal sources of the late eighth century did not appear in the West, according to Udovitch, until several centuries later (ibid., p. 261).

The ability to mobilize the financial resources, along with a combination of several economic and political factors (for a discussion of some of these, see Chapra, 2000, pp. 173–85), provided a great boost to trade which flourished from Morocco and Spain in the West, to India and China in the East, Central Asia in the North, and Africa in the South. The extension of Islamic trade influence is indicated not only by the available historical documents but also by the Muslim coins of the seventh to the eleventh centuries found through excavations in countries like Russia, Finland, Sweden, Norway and the British Isles which were on the outskirts of the then-Muslim world (Kramers, 1952,

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p. 100; see also pp. 101–6). The expansion of trade generated prosperity, which, in turn, 'made possible a development of industrial skill which brought the artistic value of the products to an unequalled height' (Udovitch, 1970, p. 104). Since businesses were in general small, even the poor and middle class entrepreneurs seem to have flourished. This takes us to the second question of what were the factors that led to the success of primary modes in the classical period.

*Factors that contributed to past success*

All the functions that the *sarrafs* performed demanded minimization of the principal/agent conflict of interest so as to ensure the total confidence of all the stakeholders (*sarrafs*, and providers and users of funds) in each other. This leads us to the questions of what were the factors that made it possible to minimize the principal/agent conflict of interest in the Classical period and what can be done in modern times to create the same trust and confidence of the stakeholders in each other when the conditions have changed.

The answer lies in the support that the system received from an enabling environment. First, the market mechanism worked effectively and induced all participants in the market to do their jobs honestly and efficiently in their own long-run self-interest. This received further support from Islamic values which were generally observed by the market participants.

Second, the *sarrafs* operated in communities which were far smaller compared with the communities in which modern banks operate. Accordingly, the providers and users of funds as well as the *sarrafs* were all well-known to each other. This was further reinforced by membership of nearly all participants in tribes, guilds, fraternities or sufi orders. This established a 'moral community' with social solidarity and mutual trust and cooperation. This acted as an 'informal contact enforcement mechanism' and served as a deterrent against cheating and fraud. Anyone who tried to cheat or procrastinate unduly became ostracized. The entire community would refrain from doing business with the guilty party. This, along with the effective operation of market forces, was further reinforced by the then-prevailing religious environment which helped create self-enforcement of religious values. This climate of mutual trust and cooperation, according to Udovitch, was not based on 'a casual or occasional favour', but rather 'a recognized commercial practice looming large in the discussion of partnership [*mudaraba* and *musharaka*] on the same level as deposit, pledge and similar contracts' (Udovitch, 1970, p. 102; see also Grief, 1997; Rauch, 2001).

Third, the economic environment was also less complex and, in general, there seems to have been less volatility in economic variables, particularly prices and exchange rates, than what prevails in modern times.

Fourth, the *sarrafs* were individual proprietors or partnership firms and the separation of ownership and control was not a problem. The self-interest of the *sarrafs* themselves as well as the users of funds reinforced mutual trust and confidence in a system in which *mudaraba* and *musharaka* were the primary methods available for mobilizing financial resources. They brought to the disposal of commerce and industry the 'entire reservoir of monetary resources of the medieval Islamic world' and served as a 'means of financing, and to some extent, insuring commercial ventures, as well as providing the combination of skills and services for their satisfactory execution' (Udovitch, 1970, pp. 180, 261). The

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absence of a predetermined positive rate of return made everyone (rich and poor) a prospective candidate for financing by the *sarrafs*, provided that he had the necessary skill and experience for doing business successfully along with a reputation for honesty. The poor were not, therefore, necessarily at a disadvantage.

Fifth, the legal instruments necessary for the extensive use of financing through *mudaraba* and *musharaka* were also already available in the earliest Islamic period (Udovitch, 1970, p. 77). These instruments, which are found in a developed form in some of the earliest Islamic legal works (ibid., 1970, pp. 77–8), were inspired by the Qur'anic requirement that all loan transactions must be consummated in writing with witnesses (al-Qur'an, 2.282). Written instruments thus became an important feature of financial intermediation.

Last, but not least, what helped further was the strength and independence of the judicial system (*mahkamah al-qada*). The courts helped ensure the honest fulfilment of contractual obligations. It was also possible to get justice promptly at a low cost in terms of time, trouble and money. The office of the *qadi* (judge) 'proved to be', according to Schacht, 'one of the most rigorous institutions evolved by Islamic society'. The *qadis*, along with the *ulama* (religious scholars), 'played an important part in maintaining Islamic civilization, and in times of disorder they constituted an element of stability' (Schacht, 1970, p. 558).

Consequently, a climate of trust prevailed, conflict of interest was minimized and the transactions costs of enforcing contracts were reduced. The system worked effectively. This led to an expansion of trade and helped boost commerce, industry and agriculture to an optimum level, as indicated earlier.

*Institutions needed to enable the system to work*

This takes us to the next question of whether the revival of the *mudaraba* and *musharaka* modes of Islamic finance can operate successfully in the modern world when the enabling environment prevailing in the Classical period does not exist. Banks operate in relatively larger communities where all the different stakeholders (shareholders, depositors, directors, management and users of funds) do not necessarily know each other very well. In a situation of anonymity that now prevails, depositors may hesitate to entrust their savings to banks, and the banks may also be reluctant to provide financing to users on a PLS basis unless the moral hazard is reduced and a climate of trust is created between the principals and agents.

The question that, therefore, needs to be addressed is how to recreate the climate of trust that prevailed in the past. Without effectively addressing this question the primary modes of *mudaraba* and *musharaka* financing may not be able to gain ground and the banks may even try to avoid the risks associated with the secondary modes by adopting different stratagems *(hiyal*). Consequently, the claimed benefits of the Islamic system resulting from the greater reliance on equity and PLS modes may also fail to be realized. It is therefore necessary to create a new environment compatible with modern conditions to help minimize the risks and to create a climate of trust and confidence among all the participants in the Islamic financial market.

Risks are not a peculiarity of only the Islamic financial system. They are present in all financial systems: risks associated with fiduciary money, interest rate and exchange rate fluctuations, loan default, operational failures, natural calamities and a range of other

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human, managerial and environmental weaknesses. The Islamic financial system is equally exposed to all these risks. The only risk that gets added to the Islamic financial system is that which arises from the greater reliance on equity and PLS modes. Here also the Islamic financial system is not unique. Corporations as well as universal banks have long been exposed to similar risks and their experience in handling them can provide valuable insights to Islamic banks.

Of course it is not possible to replicate the environment that prevailed during the Classical period. It is possible, however, to create institutions that may help minimize the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations. These institutions should be able to help the banks in different ways. They should enable them to obtain reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They should also help them receive repayments on schedule, and get justice promptly in case of dispute with, or wilful procrastination by, their clients. They should also enable banks to gain liquidity when it is needed by them owing to unforeseen circumstances. The establishment of such institutions should go a long way to providing the favourable environment that was available to the *sarrafs* in the Classical period. If such institutions are not available, then even banks with the best corporate governance may face difficulties and the movement of the Islamic financial system in the desired direction may not be able to gain momentum. Some of the institutions that need to be created are briefly indicated below.

*Credit-rating agencies, chambers of commerce, and trade associations* One of these shared institutions is credit-rating agencies which rate banks themselves as well as their counterparties. In the relatively smaller communities of the Classical period, such rating was available informally without the help of any formal credit-rating agency through the operation of market discipline and the intimate personal contacts of the parties concerned. This was further reinforced by the built-in discipline of the socioeconomic structure of tribes, guilds, fraternities and sufi circles. Now it is the credit-rating agencies and chambers of commerce and trade associations which can perform this task. Most Muslim countries do not at present have private credit-rating agencies. Moreover the chambers of commerce and trade associations are perhaps not concerned with enforcement of the necessary discipline.

The International Islamic Rating Agency (IIRA), which has been established in Bahrain, is a step in the right direction. It will perform a number of functions including the rating of all public and private issuers of credit instruments with respect to their financial strength, fiduciary risk and creditworthiness. It will also assess the compliance with the *shari'a* of financial instruments as well as their issuers. It will have a *shari'a* board of its own to advise it on *shari'a* issues. It will, thus, complement the work of the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Intuitions (AAOIFI) in setting standards for adequate disclosure. This will help promote an international capital market for Islamic financial instruments.

Even though the IIRA will rate private non-bank organizations, it will not be possible for it to rate the thousands of counterparties with whom banks deal. It would therefore be desirable to have private credit-rating agencies in all Muslim countries to facilitate the task of Islamic banks in choosing their counterparties. In fact the establishment of such

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institutions would also facilitate the task of the IIRA itself in getting the information that is necessary to know the financial strength, fiduciary risk and credit worthiness of even those private issuers of financial instruments whose rating the IIRA wishes to provide.

*Centralized shari'a board* It is also necessary to standardize the shari'a modes of financing to the extent to which this is possible. Some differences of opinion are bound to remain and this may be healthy for the financial system because it will provide different alternatives for doing business instead of imposing a rigid conformity. The establishment of a centralized shari'a board should help create the needed harmony. In the absence of such a centralized board every bank is under an obligation to have its own shari'a board. This is very costly, particularly for smaller banks. Moreover, the existence of a large number of shari'a boards leads to conflicting opinions, which creates inconsistency and uncertainty. It may be expected that, with the passage of time and the free discussion of all controversial issues, the conflicts may tend to be gradually resolved. However, in the initial phase of evolution, such a centralized board seems to be necessary to minimize the differences and to standardize the instruments of Islamic finance. Such standardization will also help pave the way for the creation of an Islamic financial market. While some Muslim countries have already standardized their instruments, it may be desirable for other countries to do the same. It is also necessary that the standardization should take place, even at the level of all Muslim countries. The Shari'a Board of the Islamic Development Bank should be able to complement and accelerate the work of the OIC (Organization of the Islamic Conference) *Fiqh* Committee in the pursuit of this goal.

*Shari'a clearance and audit* Among the most crucial challenges before an Islamic bank is to create confidence in its depositors as well as all the other operators in the market about the harmony of its operations with the shari'a. For this purpose two important steps need to be taken. The first step is to get clearance from a shari'a board about the shari'a compatibility of all its products. The second step is to provide an assurance that all its transactions are actually in conformity with the verdicts of the shari'a board. The first step is like going to a legal expert to ascertain whether a specific action of the bank is in conformity with the country's laws and, if not, what changes need to be introduced in it to make it so. The second is what auditors and banking supervisors do: ensuring that none of the bank's transactions violates the country's laws.

The *shari'a* boards are like legal experts. They can only perform the first task. It is difficult for them to perform the second task, which demands a review of all, or at least a random sample of, the different transactions that have taken place in different branches of the bank to ensure that they are in conformity with the verdict of the *shari'a* board. This demands a visit to the bank's premises to examine its operations in the same way as auditors and supervisors do. It is generally assumed that the *shari'a* boards do perform this task. However, members of the *shari'a* board do not have either the time or the staff to perform such a task effectively. The question that therefore arises is how to ensure the implementation of *shari'a* board decisions by the bank management. If this is not ensured the existence of the *shari'a* board loses its meaning. There are three alternatives which may be considered for this purpose.

One of these is for the supervisory authority itself to undertake the *shari'a* audit in the course of its normal supervisory visits. This may not be considered desirable by Islamic

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banks in countries where the government and supervisory authorities are not favourably inclined towards Islamic banking. However it has the advantage that, if the supervisory authorities perform the *shari'a* audit, they will also try to standardize the *fiqhi* decisions.

The second, more preferable, alternative is to establish independent *shari'a* audit firms in the private sector. These firms would have to hire and train sufficient staff to examine the transactions of banks with a view to determining whether they are in conformity with the *shari'a*. This alternative has the disadvantage that it would involve a proliferation of institutions. Inspectors from three different institutions would knock at the doors of banks at different times. The first of these inspector would be from the supervisory authority which sends examiners to banks to determine the conformity of their operations with the country's laws and the principles of safe and sound banking. Others would be the *shari'a* auditors who go to the bank to determine the conformity of its operations with the *shari'a*. The third group would be the chartered auditors who would go to ensure that the bank's financial statements had been prepared in conformity with the generally accepted accounting standards. This might not be convenient for banks because it would keep a number of their staff engaged in assisting three inspectors at different times, and thus add to their costs.

A third, and even more preferable, alternative is for the existing chartered audit firms to acquire the necessary expertise in the *shari'a* to enable them to undertake the *shari'a* audit. This will help avoid the proliferation of institutions with which Islamic banks have to deal. The banks would probably prefer this alternative because it will be more convenient for them to have the *shari'a* audit at the same time as the accounts audit.

*External audit* The growing complexity of the banking business as well as the crises that the international financial system has witnessed have raised the function of external audit to a position of critical importance in all financial systems. It is, however, even more demanding and challenging in the Islamic financial system. It would be necessary for the external auditor to ensure not only that the bank's financial statements are prepared in all material respects in conformity with the professionally accepted financial reporting standards but also that the profit or loss declared by the bank truly reflects the bank's condition and that its profit has been derived without violating the teachings of the shari'a.

It is conventionally not considered to be the task of auditors to perform *shari'a* audit. They are not even equipped at present to do so. However, if this task is assigned to them in the light of what has been discussed above under the subject of *shari'a* audit, then the external auditors will have to create the necessary expertise to perform this task. This would demand that the training of auditors also include necessary training in the financial aspects of the *shari'a*, just as it includes training in auditing and law. If such training proves to be too cumbersome for the auditors, it may also be possible for the auditing firm to hire *shari'a* scholars and provide them with some necessary background in auditing.

For the external auditor to be able to do an effective job of auditing, he must have independence and objectivity. The experience of the auditing firm Arthur Anderson has clearly revealed that there should not be anything that indicates the auditor's vested interest in protecting the bank's management. It is only such impartial auditing that would create trust in the auditor's report and promote confidence in the bank. Even though it is the job of the internal controls system to prevent, or detect and correct, material misstatements arising from fraud and error, the external auditor cannot be exonerated from the responsibility of ensuring that this has been done conscientiously. He will have to

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design and carry out audit procedures in a way that would help reduce to an acceptably low level the risk of giving an inappropriate audit opinion. The shareholders, the Board of Directors, the management and the depositors, all depend on his report and it would be a pity if he failed them. The auditor's success in his job would, however, depend greatly on the work of internal auditing. If internal auditing is weak, the external auditor may find it very difficult to do his job effectively. The strength of internal auditor is greatly influenced by the competence, conscientiousness and integrity of the Board of Directors and management.

*Shari'a courts or banking tribunals* Another indispensable requirement of the Islamic financial system is availability of some judicial facility that would help the banks recover their loans promptly from clients who are unjustifiably procrastinating about repayment and also help bank clients get prompt justice at a low cost when the bank is itself acting unjustly. The about establishment of shari'a courts or banking tribunals would be very helpful in getting prompt verdicts on the disputes of banks with their clients, and vice versa. Normal civil court verdicts usually take several years in most Muslim countries.

The *shari'a* courts or banking tribunals would have a greater deterrent effect if the names of banks or their client whom these courts have found to be guilty were also published in newspapers. The fear of getting bad publicity would help minimize contractual violations. Furthermore, the names of parties who violate habitually may also be sent to the chambers of commerce and trade associations for blacklisting to create the same effect that social ostracism had in the Classical period.

*Audit organization* It may also be desirable to have an audit organization jointly owned by banks to evaluate the profit-and-loss accounts of those of their clients who the banks feel have tried to cheat them in a PLS arrangement. The fear of being exposed to a thorough check of their accounts by such an organization would complement the market forces in helping minimize the effort made by users of funds on a PLS basis to shortchange the banks.

The creation of such an audit organization would save the individual financial institution the need to hire a large staff of auditors. It would thus create a substantial economy in expenses for all financial institutions. It would also give assurance to investors who provide their funds directly to businesses that, in case of need, they will be able to have the accounts properly examined by a qualified, impartial institution.

The whole concept of 'audit' may have to undergo a transformation in the case of primary modes of Islamic finance.[5] Conventional auditing is 'not expressly designed to uncover management frauds' (Elliot and Willingham, 1980, p. viii). If the auditor performs a diligent audit and evaluates the financial statements according to 'the generally accepted accounting principles', the professional obligations of the auditor have been fulfilled. The auditor has no responsibility to detect management malpractices or to determine the 'real' profit. He does not have the responsibility to check and to question (Lechner, 1998, p. 143). Accounting firms generally tend to accommodate their clients, particularly the big clients, who hire them. The auditor would fail in discharging his responsibility in a PLS system if he did not try to detect and disclose dishonest and questionable acts of the management and to determine the real amount of profit so as to ensure a 'fair' return to the shareholders and *mudaraba* depositors.

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*Qualified pool of talent* To enable the Islamic system to fulfil the requirements of the *shari'a* as well as the BCBS, it is necessary to train both the staff and clients of banks, as well as the general public, in the principles of Islamic banking. This will not be enough, however. It is also necessary to create a large pool of experts and highly qualified professionals with in-depth knowledge of not only the *shari'a* and its objectives, but also Islamic and conventional finance and financial engineering. This would be possible if first-rate institutions were created for this purpose with the collaboration of financial institutions, central banks, universities and the governments. Directors and senior management of Islamic banks as well as *shari'a* advisers should also be required to take such courses. If the central banks as well as universities could make arrangements for this purpose, as is done in the case of conventional banking, the task of Islamic banks would become relatively easier.

*Islamic financial market* It is also necessary to create an Islamic financial market. The absence of a secondary market for Islamic financial instruments makes it extremely difficult for Islamic banks to manage their liquidity. Consequently, they end up maintaining a relatively higher ratio of liquidity than that which is generally maintained by conventional banks. This affects their profitability and competitiveness. The establishment of the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), and the Liquidity Management Centre (LMC) will help provide the institutional infrastructure needed for an Islamic financial market.

The IFSB will help promote uniform regulatory and supervisory practices and prudential standards for Islamic financial institutions in the same way as is done by the BCBS. The IIFM will enhance cooperation in the field of finance among Muslim countries and financial institutions by promoting product development and harmonizing trading practices. This will serve as a catalyst for the development and promotion of a larger supply of *shari'a*-compatible financial instruments. The LMC will serve as an operating arm of the IIFM in the effort to facilitate the creation of an inter-bank money market that will enable Islamic financial institutions to manage their assets and liabilities effectively. It will create short-term *shari'a*-compatible investment opportunities by providing liquid, tradeable, asset-backed treasury instruments (*sukuks)* in which these institutions can invest their surplus liquidity. It will also facilitate the sourcing and securitization of assets and trade actively in *sukuks* by offering buy/sell quotations. The three institutions will together help establish an Islamic financial market by removing the drawback experienced by Islamic banks of the lack of standardization of terms and instruments and the non-availability of quality *shari'a*-compatible assets for trading in the secondary markets. This should help the Islamic financial system to expand at a faster rate in the future and create for itself a larger niche in the financial markets of Muslim countries.

*Lender of last resort* Islamic banks also need some facility akin to the lender-of-last resort which is available to conventional banks to overcome liquidity crises when they occur suddenly as the result of unforeseen circumstances. Such a facility is available to Islamic banks at present on the basis of interest and is, therefore, unacceptable because of its incompatibility with the *shari'a*. Its use exposes Islamic banks to a great deal of criticism. It may be worth considering the creation of a common pool at the central banks to

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provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percentage of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (that is, drawings do not exceed contributions) over a given period of time.[6] In a crisis, the central banks may allow a bank to exceed the limit, with appropriate penalties, warning and a suitable corrective programme. This will in a way be a more organized means of replacing the framework for mutual cooperation that prevailed among the *sarrafs* during the Classical period.

*Reform of the stock market* Reform of the stock market is also necessary in the light of Islamic teachings to ensure that share prices reflect underlying business conditions and do not fluctuate erratically as a result of speculative forces. The discipline that the *shari'a* helps introduce through the prohibition of short sales, or the sale of what one does not own and possess, should greatly help in realizing this goal (See Chapra, 2002). In addition, rules and procedures need to be streamlined and enforced to protect investors and ensure stability and sanity in the stock market. This will help raise the confidence of savers and investors in the system and enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such a reform would constitute one of the most important pillars for supporting the edifice of an interest-free and equity-based economy.[7]

**How to be genuine (2): equitable distribution of credit**

Finance has always been a powerful political, social and economic weapon in the world. It plays a prominent role, not only in the allocation and distribution of scarce resources, but also in the stability and growth of an economy. It also determines the power base, social status and economic condition of an individual in the economy. Hence no socioeconomic reform in Muslim societies can be meaningful unless the financial system is also restructured in conformity with the socioeconomic goals of Islam in which justice occupies a prominent place.

Since the resources of financial institutions come from deposits placed by a wide cross-section of the population, it is only rational to regard them as a national resource in the same way as water supply coming out of a public reservoir. They must be utilized for the well-being of all sectors of the population and not for the further enrichment of the wealthy and the powerful. However, as Arne Bigsten has rightly observed, 'the distribution of capital is even more unequal than that of land' and 'the banking system tends to reinforce the unequal distribution of capital' (1987, p. 156). This bodes ominously for society because it leads to the recruitment of entrepreneurs from only one social class and to the failure to utilize its entire resource of entrepreneurial talent (Leadbearer, 1986, p. 5).

Hence it is necessary to correct the tendency of the financial system to contribute to concentration of wealth by promoting an equitable distribution of credit in the economy. Micro enterprises have generally proved to be not only viable institutions with respectable rates of return and low default rates but also a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings (*The Economist*, 16 February 1985,

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p. 15). Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 per cent since the Bank's inception (Yunus, 1984, p. 12). The Select Committee on Hunger established by the US House of Representatives concluded in its Report that 'the provision of small amounts of credit to micro enterprises in the informal sector of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies' (1986, p.v). Dr Muhammad Yunus, founder of the Grameen Bank, has aptly emphasized that financing for self-employment should be recognized as a right that plays a critical role in attaining all other rights (1987, p. 31).

No wonder a number of countries have established special institutions to grant credit to the poor and lower middle-class entrepreneurs. Even though these have been extremely useful, they have proved not to be adequate and, therefore, unable to make significant headway in realizing the goal of equitable distribution of credit. This goal may be difficult to realize unless the microfinance sector is scaled up by integrating it with the commercial banks to enable the use of a significant proportion of their vast financial resources on a commercial basis for actualizing a crucial socioeconomic goal. Commercial banks do not at present fulfil this need and the Select Committee on Hunger is right in observing that 'formal financial institutions in these countries do not recognize the viability of income generating enterprises owned by the poor' (1986, p. v).

Commercial banks need not get directly involved in the business of financing micro enterprises if they find this to be too cumbersome. They can operate through their own subsidiaries or through the institutions that already exist for this purpose, like the agricultural banks, cooperative banks, development banks and leasing and finance companies. To enable the commercial banks to be integrated into the micro finance business, it is necessary to make it profitable for them to do so. This requires significant improvement in the environment for micro business through better access to markets and the provision of the needed physical and social infrastructure. Such an infrastructure, including vocational training institutions, roads, electricity and water supply, will help increase the efficiency of micro enterprises and reduce their costs, thereby enabling them to compete successfully in the market.

The reason normally given by commercial banks for diverting a very small proportion of their funds to micro enterprises is the greater risk and expense involved in financing a large number of small firms instead of a few large ones. Hence small enterprises are generally unable to get financing from banks and have to go to the informal sector where they are able to borrow only at prohibitive rates of interest. Thus the growth and survival of these firms is jeopardized even though they carry a great potential for increased employment and output and improved income distribution.

It is therefore necessary to reduce the risk and expense of such financing for commercial banks. The risk is great because micro enterprises are unable to provide acceptable collateral to the banks. The risk would be reduced to a substantial extent if the group solidarity method used by the Grameen Bank was employed and the financing was not provided in the form of cash loans but rather in the form of tools and equipment through the *ijara* mode of Islamic finance. The raw materials and merchandise as well as the working capital they need may be provided on the basis of *murabaha, salam* and *istisnaa*. These would involve greater risk than the *ijara* mode. To handle the risks involved in all such financing, it is imperative to establish the now-familiar loan guarantee scheme which has

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been introduced in a number of countries. It may also be possible to cover from the *zakat* fund the losses arising from the default of very small micro enterprises.

The additional expense incurred by commercial banks in evaluating and financing micro enterprises also needs to be reduced. In the case of financing provided to the very poor, the expense may also be covered from the *zakat* fund, one of the primary purposes of which is to enable the poor to stand on their own feet. For those who are not eligible for *zakat* but still deserve some help, it would be worthwhile for the governments to consider subsidizing a part of the cost, at least in the initial phase, in the interest of helping realize an important socioeconomic goal of Islam. As the system matures, the dependence on *zakat* as well as the government subsidy may tend to decline.

**Effective corporate governance**

What has been discussed so far in the sections above has been related primarily to the challenge of gradually raising the share of equity and PLS financing in the financial system and bringing about a more equitable distribution of credit by removing the obstacles that prevent this from happening. This, however, is only one of the challenges faced. An equally important challenge is to ensure the soundness, stability and accelerated development of the system, without which it will be difficult not only to meet successfully the first challenge, but also to ensure the system's survival. This necessitates effective corporate governance, prudent regulation and supervision, protection of depositors, and resolution of unresolved *fiqhi* disputes. This is what will be discussed in this and the following sections.

Corporate governance has gained great prominence over the last two decades even in the conventional financial system because of continued financial instability. It would be of even greater importance in the Islamic system because of the additional risk to which the depositors would become exposed when the banks really started moving into the risk-sharing modes. This poses an important challenge before Islamic banks to improve all crucial aspects of corporate governance. The challenge will become more serious as these institutions expand and their problems become more complex. This challenge could be successfully met if the Board of Directors and senior management become more effective in the performance of their responsibilities.

For this purpose, it is important to sharpen the tools of corporate governance, the most important of which are internal controls, risk management, transparency, loan accounting and disclosure, *shari'a* clearance and audit, external audit, and prudential regulation and supervision. Total reliance on these would, however, not be sufficient. Moral commitment on the part of all market operators is indispensable. Without such commitment, market operators will find different ways of violating the law without being detected and punished. This will create the need for more and more legal checks and controls, which will raise transactions costs to an unbearably high level. Making them truly accountable before shareholders and depositors by the adoption of measures discussed in this chapter should also be of great help. What is also needed is the establishment of a number of shared institutions, as discussed above. Without such institutions even banks with the best corporate governance may not be able to avoid crises.

However, corporate governance is generally weak in all countries and particularly so in developing countries, in which category nearly all Muslim countries fall at present. This is because all the institutions that play a crucial role in disciplining markets and ensuring efficiency and integrity are not well-developed in these countries. Information asymmetries

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are more severe, market participants less experienced, and regulations, even if they exist, are not always enforced effectively and impartially because of political corruption and the general weakness of judicial systems. Disclosures are also not adequate and accounting practices are not well developed (see Prowse, 1998, p. 16). The adverse effects of ineffective corporate governance can be more serious in the case of financial institutions because their leverage is much higher, the number of their stakeholders is more extensive and the systemic risks of their failure are far more serious. There is no reason to assume that, even though the Islamic financial institutions have done fairly well so far, they have necessarily been able to escape the trappings of the prevailing weak corporate governance in developing countries. It is therefore not possible to avoid the taking of all those measures that would help improve the functioning of these institutions. The role of the Board of Directors and senior management is of crucial importance in this respect. It is gratifying to note that almost all Muslim countries are currently in the process of implementing the BCBS guidelines.

*The board of directors*

The Board of Directors cannot, however, play this role effectively if its members do not have a high degree of moral integrity as well as professional competence in banking business. They must be adequately aware of the risks and complexities involved in the banking business. In an Islamic system, they must have the additional qualification of being well-versed in the *shari'a* and its objectives and in particular the rationale behind the prohibition of interest. They should ensure adequate transparency in keeping with the standards laid down by the BCBS, the IFSB and the supervisory authority of their own country through a smooth flow of relevant information to directors, senior management, auditors, supervisors, shareholders, depositors and the public according to the needs of each with a view to ensure a proper check on the affairs of the bank. They must establish a strong internal control system, proper accounting procedures, effective internal and external audit, efficient risk management and all necessary checks and balances, rules, regulations and procedures (for some of these, see Iqbal, Khan and Ahmad, 1998; Chapra and Khan, 2000; Khan and Ahmed, 2001; and Al-Jarhi and Iqbal, 2001).

Experience has shown that directors do not necessarily perform their roles effectively (Mace, 1996). There are a number of reasons for this. One of these is that the Board members may not necessarily have the professional competence and the moral integrity that are needed to manage the bank efficiently. Another reason is that Board members are not always genuinely elected by shareholders and are not necessarily accountable before them. Elections do not take place regularly at defined intervals and, even if they do, evidence indicates that shareholders are not actively involved in the election or removal of directors (Prentice, 1993, p. 31). This enables board members to perpetuate themselves and it is generally difficult to dislodge them except through takeovers. These are, however, expensive and potentially disruptive and may not, therefore, be a possible remedy except in extreme cases (Morck, Schleifer and Vishny, 1990). To correct this situation, it is necessary to have a transparent procedure for elections and to adopt measures that would enable minority shareholders and investment depositors to have a say in Board decisions. It is also necessary to enable shareholders to remove Board members in the event of their performance falling far short of what they expect. It is, therefore, imperative to institute reforms in election procedures as well as proxy rules to enable shareholders to elect competent and

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conscientious persons to the Board of Directors and to prevent them perpetuating themselves in spite of their poor performance.

It is also necessary to develop a legal and regulatory infrastructure to protect the rights of not only minority shareholders but also depositors (both being outsiders). In a number of countries companies are allowed to ask registered shareholders, who are unable to attend general meetings, to transfer their votes to the Board of Directors. This further strengthens the hands of the Board and enables it to control decisions at shareholder meetings. Since the transfer of voting rights often leads to far-reaching consequences, which may not always be in the interest of all stakeholders, it would be desirable to transfer voting rights to shareholder associations, if they exist. If such associations do not exist, then voting rights may be transferred to supervisory authorities or to specialized chartered firms established in the private sector to protect the interest of stakeholders, against a fee, as discussed below. All three of these institutions would perhaps be better qualified to protect the interests of stakeholders.[8]

It would also be helpful if there were an adequate number of non-executive directors on the Board. Empirical evidence in the conventional system indicates that non-executive directors influence positively a Board's capabilities to evaluate and discipline managers (Alvarez et al., 1998, p. 2). This is perhaps because such directors do not have any management responsibility and may not, therefore, have a vested interest in protecting the management. They may, therefore, be expected to attach greater weight to the interests of minority shareholders and depositors and, thereby, help inject equity into the company. If they do not come up to this expectation, they would hurt their own reputation in the directors' labour market. Removal of the Chief Executive Officer (CEO) caused by poor performance is more likely in outsider-dominated Boards than in insider-dominated ones. However, here too there are problems. If the non-executive directors have not been elected by shareholders but rather handpicked by the dominant shareholder or the CEO, they would owe their careers to him and would, therefore, 'lack the information and incentives required to provide consistent effective corporate governance' (Herzel, 1994, p. 472). There will thus be conflict of interest, which will create a lack of willingness on their part to discipline senior management (Sykes, 1994, p. 118). Moreover, Board meetings may not be frequent and non-executive directors may not, therefore, be able to monitor the activities of the company effectively and ensure correction, particularly if overt criticism of management policies in Board meetings is considered to be rude (Morck, 1994, p. 476).

Since Islamic banks are generally small compared to their conventional counterparts even in Muslim countries, leave alone the rest of the world, the amount of capital held by them is also very small. This enables concentration of shares in the hands of a few executive directors.[9] The number of non-executive directors who can serve as a check on the executive directors is also accordingly small. Since the small size as well as the concentration of shareholdings carries the potential of leading to undesired consequences for protecting the interests of all stakeholders, it is desirable to enlarge the size of banks and to institute legal reforms with the objective of reducing concentration, diversifying risks and increasing the ability of these banks to absorb losses.

It would also be desirable to introduce some other reforms to make the Board of Directors more effective in its functions. One of these, which needs to be considered seriously, is to relate the remuneration of Board members to their performance in the

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same way as is required in *mudaraba* contracts.[10] The directors in their capacity as *mudaribs* (managing entrepreneurs) should be compensated only for their actual expenses and not be entitled to a fixed management fee or remuneration as they do in modern corporations. Their remuneration should be a certain percentage of the profit earned by the bank, if the bank makes a profit. This must be in addition to their normal share in profit like other shareholders on the basis of their shareholdings. The percentage share of profits to be allocated to the directors for their management services must be clearly specified in the Articles of Agreement so that it is well known to the shareholders. If the corporation makes a profit, the directors receive the specified percentage of profit for their services. But if the corporation makes a loss, the directors do not, like the *mudarib*, receive a 'fee' for their management services, and should share in the losses in proportion to their stockholdings. The directors would thus have a reward for their services only if they had contributed to profits: the higher the profit, the greater their reward. This should prove to be an incentive to them for better performance.

*Senior management*

While the Board of Directors refers to persons who are generally not only shareholders themselves but also participate in the governance of the bank, senior management refers to the CEO and other senior members of the staff who perform management functions but are not necessarily shareholders. Modern corporations are in general not managed by their owners (shareholders) (Berle and Means, 1932; Jensen and Meckling, 1976). Instead, professional managers are hired to run the business. They are 'fiduciaries'.[11] This creates the principal/agent problem and leads to a conflict of interests. It is therefore necessary to impose restrictions on self-dealing, fraud, excessive compensation in different hidden forms, and other malpractices.

One of the most important constraints on management is that key positions should not be held by one person ('four eyes principle'). Since the CEO and the Chairman of the Board perform two distinct functions in the bank, it would be preferable to have two different persons holding these positions so that there is a clear division of responsibilities at the top of the bank to ensure independence and balance of power and authority. Neither the directors nor the management should be allowed to stay on the job if they are no longer competent or qualified to run the bank. As argued by Jensen and Ruback, poor managers who resist being replaced might be the costliest manifestation of the agency problem (cited from Jensen and Ruback, 1963, by Schleifer and Vishny, 1997, p. 743). A survey conducted by IRTI has revealed that, in all the banks covered by the survey, the positions of CEO and Chairman were held by different persons (Chapra and Ahmed, 2002). This is gratifying. However, it need not necessarily be true for banks not covered by the survey, and it is necessary to ensure that this is the case.

It is the responsibility of the Board of Directors and senior management to ensure proper internal controls, and effective management of all risks, including credit risk, liquidity risk, interest-rate risk and operational risks. Even though the exposure of most Islamic banks to these risks seems to be relatively high, they have been able to manage them fairly well so far. Nevertheless, this may not necessarily continue in the future. It is, therefore, extremely important to cultivate an effective risk management culture in these banks to ensure their competitiveness and survival in a world full of uncertainties

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and crises. This cannot be done, however, without the active collaboration of the Board of Directors, senior management, the *shari'a* scholars and bank supervisors.

**Prudential regulation and supervision**

A survey conducted by IRTI has revealed that, while the overall regulatory environment for conventional banks seems to be relatively good and the variation among them is also relatively less in Muslim countries, the regulatory and institutional environment for Islamic banks does not appear to be adequate and the variation is also relatively greater (see Chapra and Ahmed, 2002, Tables 1.2, 1.3 and 1.5). This indicates that there are a number of issues confronted by the authorities with respect to the regulation and supervision of Islamic financial institutions. The first of these issues relates to the removal of all the legal obstacles that hinder the rapid expansion of Islamic financial institutions. The second issue is about the clarification and harmonization and codification of standards of Islamic finance as much as is possible and about ensuring the compliance of these institutions with these standards; and the third issue relates to implementation of the guidelines provided by the BCBS.

The removal of legal obstacles does not seem to have received due attention so far from regulatory authorities in most Muslim countries. The laws with respect to financial institutions were formulated in these countries in the image of conventional banking before the initiation of Islamic finance. These have in general remained unchanged, with some cosmetic changes introduced here and there. For example, while interest payments continue to be tax-deductible, dividend payments do not get the same treatment in most jurisdictions. This puts firms using the Islamic modes of finance as well as Islamic banks at a disadvantage. What is needed is a thorough review of the whole legal structure so as to bring it into harmony with the needs of Islamic finance.

The harmonization of standards is a difficult task because of the differences of opinion among the jurists. While the existence of some differences is natural and healthy, an effort needs to be made to bring about as much harmony as possible. This is happening as a result of the continuing dialogue among the jurists and the role that the IDB and the IFSB are playing. Where there are differences of opinion, the differences should appear as alternative ways of conducting Islamic finance. In this case, the law should require transparency in contacts about the alternative that is being used so as to avoid misunderstanding. It also needs to be clearly stated that the liability of the financers in a *mudaraba* contract is limited to the extent of finance provided by him/her. This is generally understood to be the case. It would nevertheless be desirable to have a clear *fiqhi* verdict on this issue and the reflection of this in the laws so that no ambiguity remains. All this would help introduce greater clarity and harmony in Islamic finance and make the job of *shari'a* courts or banking tribunals relatively easier in the resolution of disputes.

While the successful resolution of the first two issues will enable the Islamic financial industry to grow rapidly and gain credibility in Muslim countries, the third, which is in the process of being fulfilled, will help it gain respectability in the international financial markets. All these will together help in not only promoting accelerated development of an Islamically compliant safe and sound financial system but also protecting the payments system from instability and ensuring efficient operation of the capital market and its institutions.

The regulatory authorities should not, however, make the regulations so tight and comprehensive that they may raise compliance costs unbearably and also strangulate innovation and creativity. They should, nevertheless, ensure the following:

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- that the banks are preferably joint stock companies and that all the members of their Board of Directors and senior management do not belong to a single family or business group;
- that the major shareholders, and members of the Board of Directors and senior management not only enjoy a reputation for integrity and fairness as well as financial strength but also possess adequate knowledge of the *shari'a* and the skills and experience necessary to operate an Islamic bank in a safe and sound manner;
- that the banks have adequate risk-weighted capital in conformity with the requirements of the BCBS;
- that the banks have appropriate checks and balances, and their internal controls and risk management systems are effective to ensure not only efficient operation but also freedom from fraud, overlending, credit concentration, exploitation and mismanagement; and their non-executive directors and external auditors are independent and do not have a vested interest in supporting the banks' board or management;
- that the banks disclose adequate qualitative and quantitative information about their operations, particularly their capital, reserves, liquidity and risk profile to enable all market participants and particularly the shareholders and depositors to monitor the banks effectively.

Regulation cannot, however, be effective if it is not enforced. It should therefore be accompanied by effective supervision. The objective of supervision must be to ensure that, first, the financial system is safe and sound in accordance with the guidelines laid down by the BCBS, and, second, that it is also in conformity with the teachings of *shari'a*. This is what will help it gain credibility in the domestic as well as international financial markets and enable it to compete successfully and achieve an accelerated rate of growth. For this purpose the supervisory authorities will have to develop effective mechanisms to monitor and limit (and if possible, also measure) all the different types of risks to which banks are exposed. They will also have to assess the quality of the banks' loans and investments, and in particular the risk of default of a debtor, which is crucial in the case of Islamic banks. It is this assessment which may turn out to be the most critical determinant of an Islamic bank's financial condition and ability to survive. It is also important for the supervisor to ensure that the bank has in place an effective internal controls system in conformity with the nature and scale of its business and that its management has the necessary training and experience to manage the risks and to handle the challenges that it faces.

It is also important for the supervisors to develop and institute a set of indicators of financial soundness to help assess and monitor the strengths and vulnerabilities of the financial system at both micro and macro levels. At the micro level, the indicators should show the condition of individual institutions while at the macro level they should help assess and monitor the soundness and vulnerabilities of the financial system as well as the economy. The International Monetary Fund (IMF) has suggested a set of these indicators, called 'macro-prudential indicators', which include a core set as well as an enlarged set of financial soundness indicators (see Sundararajan, et al., 2002, for details of these indicators, especially pp. 3 and 8).

Asymmetric information from which banks suffer makes supervision a difficult task. This difficulty is accentuated if accounting, auditing and information systems are less developed, as they are in most developing (including Muslim) countries. These difficulties

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make the role of shareholders and depositors absolutely crucial in monitoring the banks and strengthening the safety and soundness of the banking system. It may be hoped that the risks to which investment depositors are exposed would motivate them to monitor the banks more carefully and thereby help strengthen them. Risk-based adequacy of capital also has an important role to play. However, it cannot be relied upon fully because the problem with capital is that, while supervision can ensure its quantity, it cannot ensure its quality. Excessive reliance on capital may not, therefore, be prudent.

This call for regulation and supervision of Islamic banks is not something new. It has always been considered to be a challenge for the Islamic financial system, as is evident from the attention drawn towards it more than two decades ago by the governors of central banks and monetary authorities of the member countries of the OIC in their detailed report on 'Promotion, Regulation and Supervision of Islamic Banks', approved by them in their Fourth Meeting held in Khartoum on 7–8 March 1981. This was done at a time when Islamic banking was still in its infancy. The first full-fledged Islamic bank had been established in Dubai in March 1975, just six years before this report. Now that Islamic banking has spread and is expected to continue to spread, regulation and supervision are even more crucial. The more conscientiously this challenge is met, the better it will be for the development of a sound and healthy Islamic financial system.

However it is not just the soundness of the financial system at both the micro and the macro levels that the supervision of an Islamic financial system should be concerned about. It is also necessary to ensure that the Islamic goal of justice is also being realized. This cannot be done by means of regulation. What needs to be done is to remove the obstacles that prevent banks from being integrated with the microfinance network to be able to provide credit to a larger spectrum of society. This will necessitate the establishment of institutions that help banks overcome their difficulties in the realization of this goal, as discussed earlier.

**Protecting the depositors**

The financial crises faced by almost three-fourths of the member countries of the IMF over the last two decades have brought into focus the question of protecting the depositors. Although effective corporate governance along with prudential regulation and supervision can greatly help protect the depositors, they cannot be considered to be sufficient and there is need to find other ways.

*Deposit insurance*

Deposit insurance has received maximum attention as a way of protecting the depositors from losses, and many countries have adopted this (Laeven, 2002). Even countries which do not have deposit insurance have rescued the depositors in the case of bank failures because of the fear that refusal to do so may lead to the collapse of the financial system. If this is the case in countries where the conventional financial system prevails and the depositors do not participate in the risks of banking business, then the imperative of PLS brings into even sharper focus the challenge of protecting the depositors. While this has the hazard of making depositors complacent and, thereby, less motivated towards the monitoring of their banks' affairs, it has the advantage of making the insurance provider complement the regulatory and supervisory authorities in their task of ensuring the health of financial institutions. This raises the question of whether all

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deposits should be insured, as it is in the conventional financial system, or only the demand deposits.

Since demand depositors do not participate in the risks of banking business and do not, therefore, get a return, their deposits need to be fully protected. However, deposit insurance systems do not normally insure demand deposits beyond a certain limit. This raises the question of whether demand deposits should, or should not, be fully insured in the Islamic system. The knowledge that their deposits are protected will inspire the depositors' confidence in the Islamic financial system as a whole and prevent panics. It is of particular importance to fully protect small depositors. Large depositors may or may not be fully protected because they have the resources to monitor the condition of their banks, and giving them full protection may tend to reduce market discipline by lowering the motivation to assess the soundness of their banks.

Protecting investment depositors may, however, be in conflict with the spirit of Islamic finance. Nevertheless a case has been made by some *shari'a* scholars in favour of protecting small investment depositors from losses (see Al-Misri, 1998). This proposal is worth considering seriously because it would remove the criticism levelled against Islamic finance that it does not protect small depositors who need income but are not able to risk the loss of their principal. Even if it is not possible to do this because of a lack of consensus on this issue, it should always be possible for banks to invest such deposits in relatively safe ventures so as to minimize the risk of loss. There also arises the question of whether large investment deposits can be insured against fraud, mismanagement and violation of the *mudaraba* contract. The answer would depend on the willingness of insurance providers to provide such insurance. However, if it is possible to have medical malpractice insurance, it should also be possible to provide insurance against fraud and mismanagement in the case of investment deposits. This would help introduce greater discipline in the financial system by also making the insurance provider assess more carefully the quality and practices of bank management and requiring greater transparency.

Keeping in view the nature of Islamic finance, it would be desirable to have an explicit insurance scheme specifying the kind and extent of coverage available to different categories of depositors. This would be better for building the depositors' confidence in the Islamic financial system. They would be aware of the extent of protection they have. In the absence of such an explicit coverage, the depositors may tend to assume a full implicit coverage, particularly in the case of large banks, because of the 'too big to fail' doctrine. This will be more costly for the financial authorities because they will have to bail out all depositors, irrespective of the size and nature of their deposits. It will also introduce a moral hazard and reduce depositor watchfulness of large banks which is necessary for greater market discipline and systemic stability.

*Other ways of protecting depositors*

Another way of protecting the depositors would be to allow them to have a representative on the bank's Board of Directors and also a voice in the shareholders' meetings. The ease with which shareholders as well as depositors can participate in meetings and use their votes to influence important bank decisions or to remove directors and senior management from office, can play an important role in improving corporate governance in Islamic banks. However, when even shareholders do not necessarily attend shareholders' meetings, it may not be possible for depositors, being far greater in number than shareholders, to do

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so, particularly if the banks are large and have several branches, not only within the country but also abroad. Moreover, if shareholders and depositors can exercise voting rights only by attending the meetings, this will virtually guarantee non-voting and the voting rights will be almost meaningless. One way of solving the problem of non-voting would be to transfer voting rights to the regulatory authorities who may appoint a representative on behalf of depositors on the banks' Board of Directors. The banks may perhaps resent this. It is, however, important not only for safeguarding the interests of depositors but also for systemic stability.

If such representation is ruled out, it may be desirable to encourage the formation of depositors' associations to protect the depositor's interests. If this also happens to be practically difficult, it would be worth considering the establishment of specialized chartered firms in the private sector to protect the interests of depositors, just as it is the job of external auditors to protect the interests of shareholders. Their fee could be paid by the banks out of the dividends distributed to the investment depositors. An important objection to this suggestion may be that it would lead to an unnecessary proliferation of institutions. To avoid such proliferation, external auditors may be assigned the task. It will be cheaper and more convenient if the external auditors are required to act as guardians not only of the rights of shareholders but also those of of the depositors. It is also necessary to ensure that adequate transparency prevails so that the depositors know what is going on in the bank and are thus able to play a greater role in safeguarding their own interests.

There is also another aspect of safeguarding the interest of depositors in Islamic banks. The depositors would like to ensure that what they are getting is not wine with the label of honey. Compliance of Islamic banks with the *shari'a* in the acquisition as well as the use of funds is, therefore, an important challenge. This has already been discussed.

**Some unresolved *fiqhi* issues**[12]

*Fiqhi* verdicts related to the financial system have remained dormant for a long period and, in particular, over the last two centuries, during which time the conventional financial system has made tremendous advances. However, a great deal of progress has been made over the last three decades in facing the new challenges, although a number of crucial issues still remain unresolved. It is not possible to encompass all of these in this brief chapter. Some of these, however, are discussed below for the consideration of jurists. In case it is found that the prevalent *fiqhi* opinion cannot be changed, it will be necessary for the jurists and financial experts to join hands to find practical *shari'a*-compatible solutions for the problems faced by Islamic financial institutions. In the absence of such solutions, the risks faced by Islamic banks may be higher and the need for capital greater. Capital standards which are significantly higher than those for conventional banks may reduce the profitability of these banks and make them less competitive.

*Late settlement of financial obligations*

One of the most important of these issues relates to the failure of the purchaser of goods and services under the *murabaha* mode of financing to settle payment on time even when he is capable of doing so. If this failure were due to strained circumstances, then Islam recommends not just rescheduling but even remission, if necessary. However, if it is due to unscrupulousness, then the question is whether a penalty can be imposed on the defaulter and whether the financier or the bank can be compensated for the damage as well as the

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loss of income caused by such default. If the late payment does not lead to any penalty, there is a danger that default may tend to become a widespread phenomenon through the long-run operation of path dependence and self-reinforcing mechanisms. This may lead to a breakdown of the payments system if the amounts involved are significantly large.

Scholars have expressed a number of opinions on the subject, but so far there is no consensus.[13] The conservative view allows blacklisting of the defaulter's name and also his imprisonment if the delay is unjustified, but prohibits the imposition of any monetary penalty on the defaulter or the payment of any compensation to the aggrieved party for fear that this may become a disguise for charging interest.

The possibility of blacklisting and imprisonment of the defaulter can serve as a strong deterrent and help minimize default cases provided that this can be enacted promptly. However, if the lender and police highhandedness are to be eschewed, imprisonment should not be allowed except on the basis of a court decree issued after a due process of law. This may be difficult because, given the present-day inefficient judicial system of many Muslim countries, court decisions usually take several years and involve substantial litigation costs. It is therefore imperative that special *shari'a* courts or banking tribunals be established, as discussed earlier, to penalize promptly the unjustifiably defaulting party and thereby help minimize default cases. Although blacklisting and imprisonment may serve as deterrents to the unjustified delaying of payments, it does not provide any relief to the aggrieved party, which has suffered damage and loss of income.

The relatively liberal view, therefore, allows the imposition of a financial penalty on the debtor who delays payment without any justification, but allows it to be made available to the aggrieved party as compensation only if the penalty is imposed by a court. However, even in the case of a court decision, there are two different views. One view permits the court to determine compensation for the damage caused by late payment as well as the loss of income suffered by the aggrieved party. The other view allows the court to determine compensation for only the actual damage but not for the loss of income. If the penalty is not determined by a court, the proceeds must be utilized for charitable objectives only and cannot be made available as compensation to the aggrieved party.

If the concept of compensation for loss becomes accepted by the jurists, there will arise the question of how to determine the compensation in a way that reduces subjectivity as well as the possibility of injustice to either the defaulting or the aggrieved party. The answer may lie in developing an index of 'loss-given-default' (LGD). It should be possible to develop and maintain such an LGD index using internationally recognized standards. The LGD will, for example, provide a schedule of the loss incurred by a bank if $100 is defaulted in payment for a given number of days. The LGD will capture all costs related to the administration of the default until its settlement, the litigation cost and the loss of income. The ultimate decision will, of course, have to be made by a special banking tribunal in keeping with the LGD schedule with adjustments for individual circumstances.

*Some issues about leasing*

The jurists are unanimously agreed on the need for the lessor to bear at least a part of the risk of lease financing to make the lease contract lawful. Nevertheless there are differences of opinion among them on the permissibility of different types of lease contacts.

The kind of leasing which the jurists have generally discussed in the classical *fiqh* literature, and about the permissibility of which there is no difference of opinion, is what is

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now called the operating lease. This form of lease distinguishes itself from the other forms in a number of ways. First, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and costs of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Second, the lease is not for the entire useful life of the leased asset, but rather for a specified short-term period, and ends at the end of the agreed period unless renewed by the mutual consent of both the lessor and the lessee. The entire risk is thus borne by the lessor. This has, however, the potential of introducing a moral hazard through the misuse of the leased asset by the lessee.

The financial lease helps take care of the moral hazard problem by making the lease period long enough (usually the entire useful life of the leased asset) to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase the asset from the lessor at a price specified in advance or at its market value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little, danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and, in the case of default on the part of the lessee, the lessor can take possession of the equipment without court order. It also helps reduce the lessor's tax liability owing to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period so that the lease payments accrue to the new buyer. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the prevailing *fiqhi* position allows the sale of physical assets, it does not allow the sale of financial debt instruments except at their nominal value.

Some of the jurists have expressed doubts about the permissibility of a financial lease. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. A financial lease thus has the potential of becoming more exploitative than outright purchase. Supposing the lease contract is for five years, the lessee would have to continue making lease payments even if he does not need the asset, say, after two years. In the case of a purchase through an interest-bearing loan, the purchaser can sell the asset in the market and repay the loan, thus reducing his loss. This he cannot do in a financial lease. If he is unable to make lease payments, he may lose his stake in the asset even though he has paid a part of the asset price beyond the rental charge he would normally pay in an operating lease.

There are, however, jurists who consider financial lease to be permissible if certain conditions are satisfied. First, the lessor must bear the risks of leasing by being the real owner of the leased asset. He cannot lease what he does not own and possess, and should be responsible for all the risks and expenses related to ownership.[14] Therefore a lease contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying it and taking possession of it, and gets a reward without bearing any risk. Second, obligation of the lessee to make lease payments does not start until he has received possession of the leased

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asset and can continue only as long as it remains useable by him.[15] Third, all manufacturing defects and related problems should be the lessor's responsibility. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset. Fourth, the lease contract should be separate from, and independent of, the contract for the purchase of the residual asset. The residual value has to be market-related and cannot be fixed in advance. The purchase contract has, therefore, to be optional and not a condition for the lease contract because the quality of the asset at the end of the lease period as well as its market-related price, two of the essential requirements for a valid contract, are unknown when the lease contract is signed.

Almost all Islamic banks use the financial lease by fulfilling, or at least making an effort to fulfil, the *shari'a* conditions. The residual value remains a problem, but the banks have tried to overcome it by setting a small nominal value for the residual asset or transferring it as a gift from the lessor to the lessee. This does not satisfy the jurists who are opposed to the financial lease because, according to them, it does not fulfil the *shari'a* requirements. The residual value is automatically predetermined and becomes built into the lease payments, and thereby leads to injustice. The lessee loses the asset as well as the extra payments made by him in the case where he dies or is unable to continue lease payments. The alternative suggested by them is that the lessor should sell the asset to the 'lessee' on an instalment basis and then get it hypothecated to ensure full payment. However, once the asset is owned by the 'lessee', it is very cumbersome for the bank to get it back from him in a number of Muslim countries even if he is unable to make payments. Moreover, the ownership of the asset enables him to sell the asset and use the money, leaving the bank with nothing to fall back upon.

The jurists are agreed that the security lease (also referred to as 'financing' lease) is not acceptable from the point of view of the *shari'a* because it is not a lease contract in the traditional sense. It is just a financing transaction, and nothing more than a disguised security agreement. It involves the effective transfer to the lessee of all the risks and rewards associated with ownership. The security lease has therefore been ruled out from the modes of Islamic finance.

*Securitization and sale of debts*

There is a general agreement among the jurists that the sale of debts is not allowed except at their face value. The rationale usually given for this position is that the sale of debts involves *riba* (interest) as well as *gharar* (excessive uncertainty),[16] both of which are prohibited by the *shari'a*. Such a position is undoubtedly true with respect to the sale of debts incurred by borrowing money. Since it is normally not possible to sell a debt except at a discount, such a sale would be nothing but a disguised way of receiving and paying interest. It is also argued that, as a result of what is now called 'asymmetric information', the buyer of the debt may be unaware of the true financial position of the debtor and of his willingness and ability to honour the debt. Consequently there is *gharar* in the transaction. Hence the jurists have a strong rationale in not allowing the sale of debts.

The rationale does not, however, apply to debts sold by Islamic banks in modern times, for two main reasons. First, the debt is created by the sale of goods and services through the sales-based modes of Islamic finance, particularly *murabaha*. If, say, an airplane or a ship is sold by a bank or a consortium of banks to a government or a corporation, the debt is not incurred by borrowing money. The debt is created by the *murabaha* mode of

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financing permitted by the *shari'a* and the price, according to the jurists themselves, includes profit on the transaction and not interest. Therefore, when the bank sells such a debt instrument at a discount, what it is selling is a part of an asset and the return that the buyer is getting is not interest but rather a share of the profit that the bank has earned in the *murabaha* transaction.

Second, in the present-day sale of debts by banks, we are not talking of a debt owed by an unknown *(majhul)* person with an unknown credit rating, such that the buyer of the debt instrument does not know whether the debt will be honoured or not. The debt instruments intended to be sold are generated by the financing provided through the sales-based modes to governments and well-known corporations and firms having a high credit rating. The buyer of the debt instrument can know about the rating as much as the bank. Moreover, the debt is not unsecured. It is rather asset-based and well-secured. Its payment is therefore almost certain and there is no question of any *gharar*. The past ruling of the jurists, given in entirely different circumstances, does not, therefore, seem to fit the changed realities of modern times.

The jurists, may therefore wish to reconsider their verdict, not because the earlier verdict was wrong, but because circumstances have changed. They should definitely retain the ban on sale of debts in the form of treasury bills, bonds and other such interest-based instruments which involve pure lending and borrowing against interest. However, their ruling with regard to the sale of asset-based debt instruments, which originate in the sale of real goods and services and which transfer a part of the profit, and not interest, from the original financier to the new financier, needs to be reviewed. The development of a general agreement on this important issue would help create a secondary market for such debt instruments and thereby lead to the accelerated development of an Islamic money market.

The absence of such a secondary market for debt instruments creates two major problems for banks and thereby serves as a hindrance to the further development and expansion of Islamic banking. First, the banks are stuck with the debt instrument until its maturity. There are so many uncertainties facing banks in the modern volatile financial system that, even without being guilty of overlending, it is possible for them to get into a tight liquidity situation. This may be the result of an excessive net outflow of funds from the banks for some unexpected reason. It may also be due to the failure of a major client of the bank to settle payment on time because of some unexpected developments. There may be a number of other unforeseen reasons for the liquidity crisis of an individual bank. If the bank cannot sell some of its debts to acquire the badly needed liquidity before the maturity date of those debts, it may not be able to meet its obligations or to fund more profitable opportunities for investment.

Second, it is difficult for banks to play their role of financial intermediation effectively without being able to securitize their receivables. When banks grant a big sales-based credit for an expensive item (say, an airplane, a ship or a building), they would like to package it into small portions and sell these to small financiers. In this way they would be able to provide a large amount of credit without straining their own resources excessively and would simultaneously be able to provide investment opportunities to small investors. If they are unable to play this role effectively, the economy may suffer from the hesitation on the part of banks to finance the purchase of costly items. Companies will have to sign loan agreements separately with numerous investors to raise a large amount. This would

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undoubtedly be a cumbersome task. Syndicated loans may not be a substitute for the sale of debts because, in addition to the lead bank, there are generally only a few big lenders participating in such loans. Therefore, while a large purchase may be facilitated for a major borrower, the packaging of the amount into small portions would not be possible and small financiers would not be able to benefit from the investment opportunity.

*Hedging and financial engineering*

Hedging has become an important instrument for the management of risks in the present-day international economic and financial environment where there is a great deal of instability in exchange rates as well as other market prices. If individuals, businesses and financial institutions do not resort to this instrument for the management of their risks, there is a strong likelihood that they may suffer substantial losses with knock-on effects for the whole economy.

Exchange rate risks do not seem to have been common during the days of the Prophet, peace and blessings of God be on him, and the *Khilafah al-Rashidah*. The rates of exchange between gold and silver coins in the then-prevailing bimetallic monetary system were relatively stable at around ten. Such stability did not, however, persist later on. The two metals faced different supply and demand conditions, which destabilized their relative prices. The ratios sometimes moved to as low as 20, 30 and even 50 (Al-Qaradawi, 1969, vol. 1, p. 264; Miles, 1992, p. 320). This instability enabled bad coins, according to al-Maqrizi (d.1442) and his contemporary al-Asadi (d.1450), to drive good coins out of circulation (Al-Misri, 1990, pp. 54, 66), a phenomenon which has become known since the sixteenth century as Gresham's Law. Such instability created difficulties for everyone, but there was no solution at that time to protect individuals and economies from its adverse effects.

To solve this problem the world abandoned the bimetallic standard and moved to the gold standard and then to the dollar exchange standard, both of which helped stabilize exchange rates because of the fixed parities. These two standards, however, created other difficult problems and had to be abandoned in favour of floating exchange rates. The farewell to fixed parities has introduced a great deal of instability in the foreign exchange markets and the risks involved in foreign trade and finance have become unduly intensified. In such an unstable climate, hedging has proved to be a boon. It has made it possible for banks and businessmen to manage the exchange rate and price risks by passing them on to those who are willing to bear them at a certain cost.

To understand the problem, let us assume that a Saudi businessman places an order for Japanese goods worth a million dollars (Rls 3.75 million) to be delivered three months from now. If the rate of exchange is 117 Yen per dollar, and if the exchange rate remains stable, ¥117 million will become due at the time of delivery of the goods. Since exchange rates are not stable and, consequently, if the Yen appreciates over these three months by, say, 5 per cent, the Saudi importer will have to pay Rls 3.94 million for the goods instead of Rls 3.75 million. The Saudi businessman will therefore incur an unforeseen loss of Rls 190 000.

One way of protecting himself against such loss would be to purchase now the Yen that will be payable three months later. This will freeze his financial resources unnecessarily and create a liquidity crisis for him. To avoid such liquidity tightness, the alternative solution available in the conventional financial system is to purchase ¥117 million in the

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forward market at the current exchange rate of ¥117 per dollar plus or minus a premium or discount. All that the importer has to do is to pay a small percentage of the total amount as deposit for this purpose. Such a transaction is called hedging.

The question that therefore arises is whether the mechanism of hedging to protect the importer from exchange rate fluctuations is permissible. The verdict of the jurists so far is that hedging is not permissible. This opinion is based on three objections: hedging involves *gharar* (excessive uncertainty), interest (*riba)* payment and receipt, and forward sale of currencies. All three of these are prohibited by the *shari'a*.

As far as *gharar* is concerned, the objection is not valid because hedging in fact helps eliminate *gharar* by enabling the importer to buy the needed foreign exchange at the current exchange rate. The bank, which sells forward Yen, also does not get involved in *gharar*, because it purchases the Yen spot and invests them until the time of delivery. The bank therefore earns a return on the Yen that it invests for three months but also loses the return that it would have earned on the Riyals or the dollars that were used to purchase the Yen. The differential in the two rates of return determines the premium or the discount on the forward transaction.

The second objection with regard to interest can be handled by requiring the Islamic banks to invest the Yen or other foreign currencies purchased by them in an Islamically permissible manner to the extent to which it is possible for them to do so. There would not then be any interest, but rather profit earned on the investments.

The third objection is, of course, very serious. The Prophet, peace and blessings of God be on him, has clearly prohibited forward transactions in currencies. However, we live in a world where instability in the foreign exchange markets has become an unavoidable reality. It is not possible for businessmen as well as Islamic banks to reduce their exposure to this risk. How are they going to manage it? It is very risky for them to carry unhedged foreign exchange liabilities or assets on their balance sheets, particularly in crisis situations when exchange rates are volatile. If they do not resort to hedging, they actually get involved in *gharar* more intensively. In addition, one of the important objectives of the *shari'a*, which is the protection of wealth *(hifz al-mal)*,[17] is compromised unnecessarily.

Institutions, which provide the needed protection through hedging, are well-qualified for this service because of their greater financial resources and better knowledge of market conditions. The fee that they charge can be 'Islamized' by resort to Islamic instruments. The question, therefore, is about whether hedging could be accepted in an unstable exchange rate environment. Here we need to look at the reason (*illah)* for the prohibition of forward transactions. If the *illah* is to prevent speculation in the foreign exchange markets, which is a source of great volatility in the flow of funds and exchange rates, this could be overcome by confining hedging to only foreign exchange receivables and payables related to real goods and services.

**Concluding remarks**

The Islamic financial industry has made commendable progress over the last three decades since the establishment of the first Islamic bank in Dubai in 1975. Nevertheless, the industry has a long way to go before it can hope to realize the vision for which it was established.

The vision consists of two indispensable parts. The first part relates to the removal of interest from the financial systems of Muslim countries in such an orderly manner that all

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their financial needs are satisfied in conformity with Islamic teachings without creating any setback for their economies. It is hoped that, with the gradual coming of age of Islamic finance, reliance on equity and the PLS modes of financing will steadily rise in Muslim countries and that on the debt-creating modes will decline until a suitable mix of the two has been achieved in accordance with the needs of accelerated development of their economies within the framework of financial health and stability. The second part of the vision is to bring about a more equitable distribution of credit so that the financial system helps reduce poverty, unemployment and concentration of income and wealth instead of continuing its existing tendency of making the rich richer at the expense of the poor.

As far as the quantitative aspect of the vision is concerned, there has been an unexpectedly rapid progress in the expansion of the industry in terms of the number of banks and the volume of deposits and assets. What has helped greatly is the recent emergence of *sukuk*, which have made it possible for governments and corporations to have access to a relatively large volume of financing. Experience so far leads to the hope that *shari'a*-compatible products will continue to respond to the increasing demand for these in the future to satisfy the rising financial needs of all countries until a respectable niche has been achieved in the international financial markets.

The movement into equity and PLS financing, however, has not been significant. This is because the kind of institutional infrastructure that is needed to make progress in this direction does not exist to a satisfactory level. This indicates the urgency of establishing shared institutions that would enable banks to minimize the principle–agent conflict of interest through appropriate incentives and deterrents and the prompt settlement of disputes. It is also necessary to strengthen corporate governance through well-enforced internal controls, risk management, transparency, loan accounting and disclosure, *shari'a* clearance and audit, external audit and prudential regulation. Total reliance on these may not, however, be sufficient. Moral commitment on the part of all market operators is indispensable. Without such commitment, market operators will be able to find clandestine ways of violating the law without being detected and punished. This will blunt the system of incentives and deterrents and accentuate the need for more and more legal checks and controls which will raise transactions costs to an unbearably high level. It may not be an exaggeration to say that no human institution can work effectively without the injection of a moral dimension in human society.

Progress in the realization of the second part of the vision – equitable distribution of credit – has not been significant. It may be difficult to realize this part of the vision without integrating the microfinance sector with the mainstream financial system. This will make available a significantly larger volume of funds for financing micro enterprises in urban and rural areas to reduce poverty, unemployment and income inequalities. Commercial banks need not enter directly into microfinance if they find this to be cumbersome. They may do it through their subsidiaries and the institutions that already exist for this purpose. If a relatively greater share of the resources of the financial system does not become available to the poor and lower middle classes, then Islamic finance will not be able to contribute positively to the realization of the *maqasid* (objectives) of *shari'a* and, thereby, fail to come up to the expectations of the people.

In conclusion, one may say that, even though a substantial degree of progress has been made in quantitative terms, progress toward the realization of the Islamic vision has lagged behind. This is because the Islamic system has so far been unable to escape the

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trappings of conventional finance. A part of the explanation lies in the difficulties faced in the successful establishment of a new system in place of the well-entrenched interest-oriented conventional system when even the necessary shared institutions do not exist to support its operations.

However, a number of things have happened that will help reduce the difficulties in the future and enable the industry to meet successfully the challenges that it faces. The most important of these is the establishment of some needed infrastructure institutions. One of these is the Islamic Development Bank, which was established in the very initial phase of Islamic finance, and is in the nature of a World Bank for Muslim countries operating on Islamic principles. It has also played a catalytic role in the accelerated development of the Islamic financial industry. Another is the IFSB, which is in the process of setting standards and guidelines for the industry. Once these guidelines are set, their implementation by the regulatory and supervisory authorities will begin. This will bring about greater harmony in the operations of the industry and help not only remove some of its weaknesses but also strengthen and expand it significantly. The establishment of the IIRA, AAOIFI, IIFM and LMC will also bring positive results. Other infrastructure institutions, particularly academic institutions for training highly qualified expertise in Islamic finance, will add further strength to the industry. The central banks have also become more active and are trying to help remove the difficulties that lie in the path of ensuring Islamization of the industry in the real sense. On the whole the future looks bright for the industry.

## Notes

1. This chapter draws heavily on the author's previous wirtings, especially Chapra (1985, 1992, 2000), Chapra and Khan (2000) and Chapra and Ahmed (2002). He is grateful to the co-authors of the latter two occasional papers for their permission to adapt some of the material here. The views expressed in this chapter do not necessarily reflect the views of IRTI or IDB. The author is also grateful to Abdel-Hameed Bashir for his valuable comments on an earlier draft and to Shaikh M. Rashid and M. Rasuil Hoque for the efficient secretarial assistance provided by them.
2. *Mudaraba* (commenda) refers to an agreement between two or more persons whereby one or more of them provide finance, while the others provide management. The purpose is to undertake trade, industry or service with the objective of earning profit. The profit may be shared by the financiers and the managers in any agreed proportion. The loss must, however, be borne only by the financiers in proportion to their share in total capital. The loss of the manager lies in having no return for his /her effort.

   *Musharaka* (partnership) is also an agreement between two or more persons. However, unlike *mudaraba*, all of the partners contribute finance as well as entrepreneurship and management, though not necessarily equally. Their share in profits can be in accordance with the agreement but the share in losses must be in proportion to their share in capital.
3. *Murabaha* (also called *bai' muajjal)* refers to a sales agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within a specified time frame, either in instalments or a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer.

   *Salam* refers to a sales agreement whereby full payment is made in advance against an obligation to deliver the specified fungible goods at an agreed future date. This is not the same as speculative forward sale because full, and not margin, payment is required. Under this arrangement the seller, say a farmer, may be able to secure the needed financing by making an advance sale of only a part of his expected output. This may not get him into delivery problems in case of a fall in output due to unforeseen circumstances.

   *Istisnaa* refers to a sales agreement whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or premise) at a given price on a given date in the future. This, like *salam*, is an exception to the general *Shari'a* ruling which does not allow a person to sell what he does not own and possess. However, unlike *salam*, the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties, or partly at the front end and the balance later on as agreed.
4. These were also called *sayarifah* (sing., *sayrafi) (s*ee the word *sarf* in Ibn Manzur, *Lisan al-'Arab)*. Another less popular word used for *sarrafs* was *jahabidhah* (sing., *jahbadh)*. The *sarrafs* were more widespread

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because they provided banking facilities to the public sector as well as an extensive private sector. The *jahabidhah* were less prevalent because they served mainly the public sector (cf., Duri, 1986, p. 898).

5. Abdul Jabbar Khan, ex-President, Habib Bank of Pakistan, has emphasized that the 'auditing system presently in vogue suffers from a number of weaknesses. There is, therefore, an urgent need for a thorough reappraisal of the existing laws and practices governing the role of auditors and for evolving a really independent auditing system'. (See his privately circulated paper, 'Commercial Banking Operations in the Interest-Free Framework', p. 39). See also al-Qabbani (n.d.) and Khan (1981).
6. Some of the jurists do not find this to be acceptable because it appears to them as a form of reciprocal lending *(qurud mutabadalah)* which is like deriving benefit from a loan, and hence equivalent to interest. However, some other highly respectable jurists have allowed this, provided that it does not involve the taking and giving of interest (see Ahmad and Abu Ghuddah, 1998, p. 236). Mutual help of this kind is a form of cooperative insurance, whereby the banks provide themselves with protection in case of need. Such cooperation had prevailed in Muslim history between businesses in the form of what was then called *ibda' or bida'ah* (see Chapra, 1985, pp. 75, 250).
7. The detailed discussion that this subject requires is beyond the scope of this chapter. For some relevant discussion on the reform of the stock market, see Chapra (1985, pp. 95–100) and Chapra (2002).
8. In Germany it is customary for individual shareholders to transfer their voting rights to banks or to shareholder associations who send their representatives to the meeting (Balling et. al., 1998, p. xxii).
9. See Tables 2.3 and 2.4 in Chapra and Ahmed (2002) for the results of a sample survey conducted by IRTI. Figures have not been given above because of the small size of this sample.
10. The *mudaraba* form of business allows only normal expenses of the *mudarib* to be charged to the *mudaraba* account. The *mudarib* is not entitled to a fixed remuneration or an absolute amount of profit specified in advance. His only entitlement beyond the normal expenses of business is a mutually agreed share in profit as a reward for his management services.
11. A fiduciary is 'a person who is entrusted to act as a substitute for another person for the sole purpose of serving that person' (Iwai, 2001).
12. This section has been adapted from Chapra and Khan, (2000, pp. 71–83).
13. For a range of opinions expressed on the subject, see M.A. Zarqa and M.A. El-Gari (1991, pp. 25–27) as well as the comments by M. Zaki 'Abd al-Barr, and Habib al-Kaf, on pp. 61–4 of the same issue, and by Rabi' al-Rabi on pp. 67–9 of the 1992 issue of the same journal. See also al-Misri (1997, pp. 131–54; al-Zu'ayr, 1997, pp. 50–57; Abu Ghuddah and Khoja, 1997, pp. 55 and 91).
14. The jurists, however, allow the sub-lease of a leased asset even though the sub-lessor is not the owner of the asset. The sub-lessor then bears the risk, but can pass it on to the original lessor.
15. This does not mean that the lessee cannot make lease payments in advance of the lease period. However, his liability cannot start until he has received the leased asset.
16. For a detailed meaning and explanation of *gharar*, see Saleh (1986, pp. 49–52).
17. According to al-Ghazali (d.1111): 'The objective of the *Shari'a* is to promote the well-being of the people, which lies in protecting their faith, their life, their intellect, their posterity, and their wealth. Whatever ensures the protection of these five serves public interest and is desirable' (1937, pp. 139–40). The same objectives have been upheld in the same, or a somewhat different, order by a number of other jurists. (For a discussion of these *maqasid*, see Chapra, 2000, pp. 118–123.)

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