



# **An Analysis of Islamic Finance Framework, Authority in Islam and a Need for Paradigm Shift in Islamic Finance**

By

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## **Bismillahir Rahmanir Rahim**

### **Abstract**

Islamic Finance has always been condemned by some of the influential advocates of interest based economies as a backward looking, less considerate and Shariah driven financial system still characterizing the principles laid in 6th century by the divine revelation of Allah (s.wt) and traditions of holy Prophet (s.a.s). Most of the scholastic and Industry efforts are aimed at providing solutions to financial issues faced by modern Islamic society with easy references to conventional banking system. They try to highlight issues with Shariah laws that underpin the fundamentals of Islamic Finance Industry and attempt to project a sense of urgency to adopt forbidden conventional forms of financial transactions like derivatives, leasing, etc in order to bring Maslaha for the society. However very few speak in length about the advantages of running a Shariah based ethical banking framework and the depths of foresightedness available in revealed sources on running a socio-ethical economic system. The aim of the study is to highlight several such issues faced by Islamic Finance industry, the distinct authority and legislative structure in Islam and a dire need to effect a paradigm shift in constructing future dialogue on Islamic Finance. While aiming at these objectives, the study also attempts to focus on addressing some of the key areas of concern ailing the present global economic system and makes a proposition towards creating a thought process that can safeguard interest of depositors, investing community and society, at large, without compromising on economic growth.

بسم الله الرحمن الرحيم

## ملخص

معظم الكتابات الحالية حول التمويل الإسلامي يميل إلى تدور حول المقارنة بين وسائل إسلامية لتمويل مع وسائل التمويل التقليدية . أنها محاولة للتركيز على الحاجة من الأشكال التقليدية لل معاملات المالية مثل المشتقات ، والتأجير، وغيرها، و تميل إلى ربط أو حفر في المشاكل الناجمة عن صناعة التمويل الإسلامي و الشريعة في تنفيذها. جميع الجهود الرامية إلى حل القضايا مع صناعة التمويل الإسلامي ويشار بسهولة إلى النظام التقليدي القائمة و يتم توجيه حلول حفظ النظام المصرفي التقليدي في الاعتبار. ولكن عدد قليل جدا من الكلام في الطول عن مزايا تشغيل إطار المصرفية الأخلاقية القائمة على الشريعة وعمق الرؤية المستقبلية المتاحة في مصادر كشفت على تشغيل نظام اقتصادي الاجتماعية و الأخلاقية. كان دائما أدان التمويل الإسلامي من قبل بعض دعاة مؤثرة من الاقتصادات القائمة على الفائدة باعتبارها المظهر، النظام المالي أقل مراعاة و الشريعة مدفوعة الى الوراء لا تزال تميز المبادئ المنصوص في القرن 6 قبل الوحي الإلهي و النبي الكريم ( ساس ) . هذه الورقة هي محاولة للتركيز على القضايا التي تواجهها الصناعة المالية الإسلامية ، وتقسيم السلطة والتفسيرات التشريعية في الإسلام ، وكيف الجوهر الحقيقي لل اقتصاد الإسلامي يمكن معالجة بعض مجالات القلق المحيطة المريض حاليا النظام الاقتصادي ؛ ؟ حاجة ماسة لإجراء نقلة نوعية في الطريقة التي تجري مناقشتها التمويل الإسلامي ، وكيفية الاقتصاد الإسلامي يمكن أن تخلق التنمية المستدامة والتقدم للمجتمع و أيضا للتركيز على بناء توافق في الآراء نحو العمل على المبادئ الإسلامية للتمويل.

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# 1. Introduction

Banking activities have evolved over time from traditional activities of accepting deposits and lending monies to a more complex set of activities and a much broader range of products and services. Though, the evolution and progress in scope of banking activities are highly appreciated for catering to the growing financial needs of vast masses of people, undue exploitation of such developments have regularly created crisis situations often extending beyond national boundaries. Events like credit defaults, positional trading, bankruptcies, fall-out of financial innovations, LIBOR fixing, etc have led Corporates and governments go an extra mile towards taking steps to adopt standards and practices to mitigate and contain future events of credit, market and operational risk. Despite several attempts to regularize financial systems by implementing prudent macro as well as micro economic policies, the financial system has exhibited an inherent lack of ethical or moral behavior on part of bankers. As expressed by Richard (cited by Chapra 2008), today's financial crisis do not arise from economic instability or acts of nature but from the very design of the financial markets themselves.<sup>1</sup> According to a research published by Watkins in 2000 (as cited in Johnson, 2008), Excessive greed and motivations to prove the management capabilities have often resulted in exploitation of financial innovations to mis-selling and speculative courses.<sup>2</sup> Watkins further claimed how excessive greed in Corporate America led to toppling of barriers of religions anti-debt policy, lack of current income, lack of credit on demand and Industry regulations. Researchers like Krugman in 2009 (as cited by Shaikh, 2010), Rafe and Edib (2010) have even blamed the rationales of perfect market and Efficient Market Hypothesis itself, envisioned by capitalist society, to be cause of all evils and crisis in economic system.<sup>3</sup> Policy makers are trying to make an attempt to curb such malpractices and there is a wide spread consensus on taking serious steps towards creating an ethical code of conduct in finance. Many scholars direct such efforts at the existing tenets of

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1 Chapra, M. Umer (2008), "The Global Financial Crisis : Can Islamic Finance Help Minimize The Severity and Frequency of Such a Crisis in the Future", a keynote Forum lecture delivered at the inaugural session of the Eighth Harvard University Forum on Islamic Finance held on 19-20 April 2008 in the Harvard Law School.

2 Mark W. Johnson, 2008, Corporate Greed : A mandatory reason towards business school reforms, July 2008, Business Intelligence Journal, Vol. 1, No. 1

3 Shaikh, Salman Ahmed, 2010, Proposal for a New Economic Framework Based on Islamic Principles , Islamic Economics Project Publication Co-Sponsored by University of East. Available at SSRN: <http://ssrn.com/abstract=1618202> or <http://dx.doi.org/10.2139/ssrn.1618202>. AND Haneef, Rafe and Edib, Smolo, 2010, Reshaping the Islamic Finance Industry Applying the Lessons Learnt from the Global Financial Crisis, ISRA research Paper No 11/ 2010, accessed from <http://www.isra.my/publications/research-paper/research-paper-2010/item/47-research-paper-no-11/2010.html?tmpl=component&print=1> last accessed on 15/June/2012.

Islamic finance to provide solutions to the ailing conventional banking system. However most of these attempts are drawn towards creating Islamic products on parallels of conventional banking products. Often Islamic bank's own shariah supervisory boards, by application of Qiyas and Ijma on guiding foundations of Quranic revelations and Hadith-Sunnah of Prophet (s.a.s), are authenticating sale of Islamic products innovated on lines of complex conventional finance products. Such practices not only lend incredibility to the entire Islamic Finance industry but also prompt towards our fundamental Research question and the objectives of the study.

### **1.1. Statement of Research**

“Can a paradigm shift in approach to Islamic Finance provide an ethical economic system, free of financial instability and economic uncertainty rather than being a mere conduit of re-engineered conventional financial products?”

### **1.2. Objective of Research**

In the light of the fundamental research question, the objective of the paper shall be

- To review the prohibitory framework of Shariah Laws and existing contractual practices in Islamic Finance Industry
- To rationally evaluate the diverse authority structure existing within the Islamic World and the plurality in decision making.
- To critically examine the existing identity of Islamic finance as exposed in literary and scholarly dialogue on Islamic Finance.
- To effect a paradigm shift on Islamic Finance, thereby promoting its distinct identity as a discrete socio-ethical banking system that can safeguard interest of depositors, investing community and society at large without compromising on stability and growth of economies.



To meet the objectives of the current study, the framework of this paper is structured in following manner; Chapter 2 shall form a broad review of distinct prohibitory framework of Shariah Laws and prevailing forms of various Islamic Finance contracts often forming areas of contention and debate. An attempt is made in Chapter 3 to explore the state of authority in Islamic society and how the pluralistic and fragmented authority structure present sustainability challenges for the Islamic Finance Industry. A detailed literature review in Chapter 4 shall frame a broad range of issues and criticisms that surround the ethical framework of Islamic Finance Industry and suggests how the existing literature creates a fragmented and paralyzed Islamic economic system that essentially draws its references from the conventional economy. A subtle attempt is made in chapter 5 to address some of these contentious issues highlighted in preceding discussions and to bring a paradigm shift in promoting Islamic economics as a distinct economic system that can provide ethical solutions to safeguard interest of depositors, investing community and society at large without compromising on growth of economies. The final referendum in chapter 6 shall conclusively re-affirm the need to effect a paradigm shift in future dialogue on Islamic Finance and to endorse Islamic Finance as an ideal ethical banking framework that can safeguard interest of all stakeholders.

#### **1.4. Limitations of the Study**

The study primarily aims at reviewing some of the existing literatures on Islamic ethos with more concentrated efforts on discussion based on tenets of Islamic Finance. It aims to provide conclusion based on primary and secondary tools of research employed in many of the referenced scholarly depositions and as such the outcome of the study may inherit research inconsistencies existing in these depositions. Also the statements and conclusions arrived, may tend to exhibit bias towards some of the ideological thought processes derived from these referenced sources. However a genuine attempt is made to make this study an independent thought directed at providing a more rationalistic approach. The study shall also familiarize readers with some basic concepts and contracts in Islamic banking with least possible reference to conventional banking system and its products. However any references made, shall be primarily used to derive maximum understanding of the need to introspect the richness of Islamic principles.

## 2. Prohibitory Framework and Current Practices in Islamic Finance Industry.

Islamic Finance promotes several contractual relationship to promote trade and finance between the contracting parties. However these contractual relationships are governed by the regulatory framework of Shariah Laws. Hence it becomes imperative to understand the regulatory precincts of Shariah Laws and some of the contracts structured with reference to these regulatory framework in existing Islamic Finance Industry.

### 2.1 Prohibitory Framework in Islamic Finance

*'O' my son! Establish prayer and enjoin the good and forbid the evil and be patient against what befalleth thee; verily this is the task of steadfastness" (Q31 : 17)*

*"And It is not fitting for a believer man or woman to have any choice in their affair when God and his apostle have decided a matter; and whoever disobeyeth God and His Apostle, indeed he hath strayed off a manifest straying."(Q33:36).*

Prohibitions in Islam are ordained over mankind either through Divine revelation in form of Quran-E-Sharif or through Hadith-Sunna of his chosen Prophet. These prohibitions govern all aspects of life of a Muslim and show them the path to remain steadfast to the will of Allah. Islam does not distinguish the material aspects of life from the spiritual aspects of life and Islamic economics is no exception to these principles. It is obligatory for Muslims to remain loyal to Shariah practices and abide to such laid forbearances. Most of the scholarly articles on prohibitions in Islamic Finance revolve around Riba and Gharar. However there is a lot more to abide than just the prohibitions of Riba and Gharar. An effort is made below to review some of the important prohibitions guiding the ethical framework of Shariah system.

**2.1.1. Innovation** : The most important prohibition to be discussed in today's growing controversies about Islamic financial products is the idea of innovation and an ever increasing need generated to be at par with the conventional Riba based economy. Innovation is basically referencing some of the basic ideas and creating new ways of thoughts or process. The idea of

innovation in Islamic concepts emanate from the need to provide maslaha to issues faced by society, at large, by enforcing some added thoughts on the foundations of laid Shariah laws.

In context of Islamic Finance, Innovation is often directed at referring and exploiting the Mutsahabihat contents of law and trying to create product differentiation within the newly defined peripherals of Shariah laws and practices. Such conceptual innovation has found strict condemnation from Allah (s.w.t), The Prophet (s.a.s) and 1st four Caliphs of Islam, also termed as Khulfa-e-Rashidin (mpbut), who are considered high in respect and honor due to their proximity with Prophet (s.a.s) and their contribution to the world of Islam. Some of the interesting and regulating thoughts come from H.Ali (a.s), one of the closest Khulfa to Prophet (s.a.s) and 1st rightful Imam of Shia traditions.<sup>4</sup> He categorically advocated that innovations in Islam are not introduced unless one Sunnah is forsaken and as such declared the broad ways of innovation as immoral and bad.<sup>5</sup> Also predicting the influence of innovative ideas penetrating Islamic thoughts, H. Ali (a.s) has condemned the very thought of innovation with a simplistic rationale to believers to regard lawful this year what was lawful the previous year and should consider unlawful this year what was considered unlawful the previous year.<sup>6</sup> He further cautioned people from following those who follow innovations with warnings of being deprived by Allah from his testimony or the light of any plea.<sup>7</sup>

In light of above references made from one of the eminent Khulfa-e-Rashidin of Islamic world, innovations those try to make lawful that which was earlier described as unlawful is strictly forbidden and has disapproval from Allah and His prophet. Keeping these statements in mind, a true believer needs to evaluate the trading of lucrative products offered by today's financial wise based on interpretations of various Shariah concepts like Riba, tawaruq and reverse tawarruq and used as an alternate to achieve competitive returns as those obtained from trading in conventional derivative and structured products.

**2.1.2. Riba** : Several research and scholarly papers have lent discussions on meaning and classification of Riba, composition and constituents of Riba, comparison between and implications of Riba and non-Riba based economies and Riba associated matters. As

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4 Reference to H. Ali's importance in directing Muslim Ummah can be aligned to several proclamations made by Prophets (s.a.s) and citing one such edict where Prophet (s.a.s) praised the leadership of H. Ali (mpuh). (hadith – 'Man Kuntu Mawlahu fa Hadha Aliun Mawlahu' – meaning of whomsoever I am the Mawla, Ali is his Mawla).

5 "Nahjul Balagha : Peak of Eloquence", Sermons of Imam Ali bin Ibn Taalib, PP- 294

6 "Nahjul Balagha : Peak of Eloquence", Sermons of Imam Ali bin Ibn Taalib, PP- 359

7 "Nahjul Balagha : Peak of Eloquence", Sermons of Imam Ali bin Ibn Taalib, PP- 359

expressed by Arif et al (2012), all major revealed (Ilhami) religions, i.e., Islam, Christianity and Judaism have strongly condemned and proscribed Riba in its original versions.<sup>8</sup> However the definition, meaning and what constitutes as Riba is still a subject matter of differences amongst religious scholars and different schools of thought. As noted by Montgomery, Al-Bukhari records Umar ibn Al-Hattab as saying that after the last revelation on Riba (Q 2 : 275-278), Prophet (s.a.s) passed away from this world before Arabs could question him on the subject.<sup>9</sup> Netzer (2004) remarks that Caliph, H. Umar (mpbuh) abjures faithful to leave behind what constitutes Riba and doubt.<sup>10</sup>

Riba is derived from the root r-b-w meaning excess or an increase. Various scholars have interchangeably used Riba to mean Interest as well as denote it as an increase in capital without any application of labour. According to Nomani (n.d), Several scholars have termed Riba as a mujmal word and is left open to interpretation and Ijtihad by means of deduction (applying general principles to specific cases) or analogy (establishment of similarity in certain properties and aspects between dissimilar cases or objects) and more often by induction (applying specific case to general propositions) amongst Sunni's and by means of aql ( which again relies on induction and analogy).<sup>11</sup> The depth in meaning of forbidden Riba is accounted by Gamal (2000) from one of the hadith narrated by Ibn Majah and Al-Hakim on the authority of Ibn Mas'ud (mAbpwh) that Prophet (s.a.s) once said : There are 73 different types of Riba, the least of which is equivalent (in sin) to committing incest and the worst of which is equivalent (in sin) to destroying the honor of a Muslim.<sup>12</sup> He further cautions believers based on hadith of Prophet (s.a.s) that the extent of fault in Riba transaction is laid not only on the transacting parties but also on one who witnesses it and also on one who documents it. Keeping the idea of prohibition to innovate in mind, the interpretative ideas to benefit from the concept of Riba so expressed as being mushkil, has led to several debates in terms of fair return on principal and evolution of products based on selective interpretation of Riba. It would be apt to consider the

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8 Muhammad Arif, Dr. Ashiq Hussain and Muhammad Azeem, 2012, International Journal of Humanities and Social Science Vol.2, No. 6 [special Issue on Behavioral and Social Science - March 2012]

9 Montgomery, John, 2010, "Ethics, "Practice, and Future of Islamic Banking and Finance", Senior Thesis, link - <http://dukespace.lib.duke.edu/dspace/bitstream/handle/10161/2523/Senior%20Thesis.pdf?sequence=1>

10 Netzer, Miriam. 2004, "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>

11 Farhad Nomani, (n.d), "The Interpretative Debate of the Classical Islamic Jurists on Riba (Usury)", The American University of Paris, link - <http://www.luc.edu/orgs/meea/volume4/NomaniRevised.htm> last accessed on 03/July/2012

12 Mahmoud Amin El-Gamal, June 2000, "A Basic Guide to Contemporary Islamic Banking and Finance", Rice University Paper

prophecy of Prophet (s.a.s), as rightly pointed out by Arif et al. (2012), that a time will come over people when not a single person will remain who does not devour riba and if there be any who refrain from it still its vapour will overtake him.<sup>13</sup>

According to Chong & Liu (2007), the basis for prohibition of Riba in Islam may be traced to pre-Islamic or medieval Arabian practices of doubling or tripling of debt in case of failure by the debtor to meet his obligations.<sup>14</sup> This usurious practice led to social injustice, exploitation and a system of slavery. It often resulted as a disincentive to the entrepreneurs to venture into trade and manufacturing activities for the mere fear of failure could lead them into vicious circles of debt. Netzer (2004) has particularly classified Riba into 4 types (Riba al-Buyu, Riba al-fadl, Riba al-duyun and Riba al-nasiya) with particular reference to Riba al-buyu and Riba al-nasiya as particularly existing in the 7th century.<sup>15</sup> According to several scholars, the usurious practices in ancient barter and credit are considered to be the forbidden Riba and against principles of Islam. As cited by Arif et. al. (2012), The extent of practice in Riba transactions can be imagined from one of the prophetic hadith of Prophet (s.a.s) where prophet (s.a.s) declares that a time will come over people when not a single person will remain who does not devour riba and if there be any who refrain from it still its vapor will overtake him.<sup>16</sup> However there are various debates on elements of time value of money, preservation of wealth in inflationary and Riba based economic system, etc which needs to be carefully evaluated under the exegesis of rightful authoritative interpretations and prohibitions of innovations.

**2.1.3. Debt Financing and Trading in Debt :** Aligned to the concept of Riba is the idea of debt and debt financing. As quoted through several references from authenticated Hadith's, Haneef (2010) points out that Prophet (s.a.s) himself disliked the idea of Dayn (debt) and bringing it to the simile of Kufr (disbelief), had categorically instructed its use only in case of stark necessity.<sup>17</sup>

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13 Reference in compilation of hadith (Abu Daud, Sunan Kitab-al-buyu, Bab fi ijtinab-al-shubukat) cited by Muhammad Arif, Dr. Ashiq Hussain and Muhammad Azeem, 2012, International Journal of Humanities and Social Science Vol.2, No. 6 [special Issue on Behavioral and Social Science - March 2012]

14 Beng Soon Chong and Ming-Hua Liu, October 2007, "Islamic Banking : Interest Free or Interest Based ?"

15 Netzer, Miriam. "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>

16 Muhammad Arif, Dr. Ashiq Hussain and Muhammad Azeem, 2012, "Riba Free Economy Model", International Journal of Humanities and Social Science Vol.2, No. 6 [special Issue on Behavioral and Social Science - March 2012]

17 Hadith - (Al-Nasa'i, 1420, p. 658) as cited by Haneef, 2010, "Reshaping The Islamic Finance Industry : Applying The Lessons Learnt From The Global Financial Crisis", source - <http://www.isra.my/publications/research-paper/research-paper-2010/item/47-research-paper-no-11/2010.html?tmpl=component&print=1>) last accessed on 15/June/2012

He quotes one hadith where Prophet (s.a.s) refused to pray for deceased man until his debt was taken over by his fellow companion.<sup>18</sup> Dusuki (2009) relates the rationale to avoid use of Debt and Riba based financing as root cause of unjust and uneven distribution of wealth that damages the interest of common people. The very idea of creating an unjust and inequitable society is against the maqasid of Shariah. The evils of debt financing can be very well related to the 2008 sub-prime crisis from which the global economy is still struggling to recover. According to Minsky as cited by Haneef (2010), accumulation of debt is the initial trigger for financial crisis and economic instability.

**2.1.4. Gharar :** Any Islamic contract needs to be free from Gharar. Gharar refers to uncertainty or an element of doubt in the terms of contract agreed between the contracting parties. As enumerated through reference by Montgomery (2010), the practice of Gharar has its roots in the pre-Islamic practice of 'Habal-il-Habala', in which one would pay the price of a she-camel which was not born yet and would be born by the immediate offspring of an extant she-camel. This practice of trading in things not yet determined or in existence and might not materialize is forbidden in Islam and strictly condemned by Allah and his Prophet. One of the rationales behind prohibition on Gharar as noted by world bank in its 2008 report advocates that prohibition of Gharar forces parties to avoid contracts with a high degree of informational asymmetry and with extreme pay-offs; it also makes parties more responsible and accountable.<sup>19</sup>

Several scholars have segregated Gharar in two categories based on its severity and impact, i.e. Gharar Yasir and Gharar Fahish. According to Iqbal et. al. (2005), minor Gharar (Gharar Yasir) is permitted as long as the process of gathering information to resolve unknowns will not cause great damage to one of the parties.<sup>20</sup> An example of such permissibility is provided by Iqbal, Munawar and Molyneux (2005), where upon enquiry, the seller may not be in a position to reveal the foundation of the house that supports it as it may risk the structural integrity of the building to reveal the foundation. However Gharar Fahish is totally forbidden in Islam. The

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18 Hadith - (Al-Bayhaqi, 1994c, p. 73; n.d., p. 96) as cited by Haneef, 2010, "Reshaping The Islamic Finance Industry : Applying The Lessons Learnt From The Global Financial Crisis", source - <http://www.isra.my/publications/research-paper/research-paper-2010/item/47-research-paper-no-11/2010.html?tmpl=component&print=1> last accessed on 15/June/2012

19 Hennie Van Greuning and Zamir Iqbal, 2008, "ISLAMIC LAWS ON RIBA (INTEREST) AND THEIR ECONOMIC IMPLICATIONS", International Bank for Reconstruction and Development, World Bank DOI 10.1596/978-0-8213-7141-1

20 Iqbal, Munawar and Philip Molyneux., 2005, Thirty Years of Islamic Banking: History, Performance and Prospects. New York: Palgrave Macmillan, 2005.

financial contracts of Insurance and financial derivatives are forbidden in Islamic economics based on the element of Gharar involved in the same.

**2.1.5. Maysir** : Acts of maysir (Gambling) are forbidden by Allah and his Prophet. In Quran-E-Sharif, Allah (s.w.t) has described Maysir as an act of Satan to misguide people, create enmity and hatred amongst people and divert man from remembrance of God. (Q5 : 90-91). As categorically referred by Netzer (2004), Prophet (s.a.s) forbade the process of sale based on throwing of pebble.<sup>21</sup> Widening the scope of prohibition on Maysir with adequate references, Montgomery (2010) has referred to all risks that are manufactured or fabricated through game of chance fall under the category of Maysir and are forbade to the believers.<sup>22</sup>

**2.1.6. Price Fixing** : One of the important issues surrounding the debate on Riba, Gharar and Maysir is the idea of developing a pricing mechanism. However Islam envisages a free market where prices are determined by market forces of demand and supply. The presence of Ghubn, where there is a difference between executed price and fairly determined valuation, makes a transaction unethical. Any interference in price formation is condemned by Allah and his beloved Prophet (s.a.s). Azmi et. al. (2010) notes an instance narrated by H.Ali (a.s) where once People came to Prophet (s.a.s) and requested him to fix price on their behalf and Prophet (s.a.s) in turn said – “Indeed the rise and decline of prices is in Allah’s hand. I want to meet my Lord with none of you having any claim against me for any injustice”.<sup>23</sup> As such any acts of Ghish (concealment of vital information), Jahalah (misrepresentation), and najas (act of bidding up prices without intention to take delivery) while fixing the prices are unethical and condemned in Islam.

In light of some of the above discussed prohibitory framework in Islam, an analysis of several widely used financial contracts prominently marketed under the aegis of Islamic finance becomes essential to provide a backdrop for critical evaluation of several highly contested practices in Islamic finance Industry.

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21 Netzer, Miriam. "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>

22 Montgomery, John, 2010, “Ethics, Practice, and Future of Islamic Banking and Finance”, Senior Thesis, link - <http://dukespace.lib.duke.edu/dspace/bitstream/handle/10161/2523/Senior%20Thesis.pdf?sequence=1>

23 Dr. Mohd Azmi Omar, Dr. Azman Md Noor and Dr. Ahamed Kameel Mydin Meera, 2010, “Islamic Pricing Benchmarking”, Research paper No. 17/2010 - ISRA

## **2.2. Contractual Framework in Islamic Finance**

Lending and Borrowing activities have always been a part of any commercially organized civilization irrespective of whether any additional charge was involved in the transaction. The history of banking related activities dates back to as far as 2000 B.C with its practices being discovered in several geographies of Assyria, Babylon, Greece, Rome, ancient India and China. However these activities bore different names during each civilization. Islamic history is a no exception to these developments. As noted by Greuning and Iqbal (2008), Financiers (also known as Sarrafs), in the early days of Islam, undertook many of the traditional and basic functions of a conventional financial institution, such as intermediation between borrowers and lenders, operation of a secure and reliable domestic as well as cross-border payment system, and provision of services such as the issuance of promissory notes and letters of credit.<sup>24</sup> Sarrafs operated through an organized network and well-functioning markets, which established them as sophisticated intermediaries, given the tools and technology of their time. The Quranic ban on usurious practices followed in Pre-Islamic Arabia itself is an evidence of borrowing and lending activities being conducted to facilitate production and trade. The organized form of Islamic Finance and contracts, as such has its roots in these guidance provided by Allah (s.w.t) through holy Quran-E-Sharif and Hadith-Sharif of Prophet (s.a.s).

Contracts in Islamic Finance, irrespective of their accounting positions, are based on two famous fiqh maxims derived from Hadith of Prophet (s.a.s), i.e., the notion of “al-Kharaj bil-daman” and “al-ghunm bil-ghurm”. The notion of al-kharaj bil-daman explains that with right to profit follows the ownership responsibilities of damage or loss to the contractual asset. While the notion of al-ghunm bil-ghurm suggest that profits can be earned only upon assuming responsibility of expenses and losses. As such both maxims relate gains from trade with assumption of responsibility of losses and expenses as well as responsibility of damage or loss to the contractual asset. Keeping the above maxims in view, Islamic contracts can be categorized in 5 broad areas of differentiation

### **2.2.1. Equity based contracts**

### **2.2.2. Debt based contracts**

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<sup>24</sup> Hennie Van Greuning and Zamir Iqbal, 2008, “ISLAMIC LAWS ON RIBA (INTEREST) AND THEIR ECONOMIC IMPLICATIONS” - World Bank, International Bank for Reconstruction and Development, World Bank DOI 10.1596/978-0-8213-7141-1.



2.2.3. Fee based contracts

2.2.4. Hybrid contracts

2.2.5. Derivative contracts

2.2.1. **Equity based contracts**, commonly, referred as profit and loss sharing (PLS) contracts in Islamic Finance, form the most important and sought after contracts with respect to the essence and validity of Islamic principles. The basic understanding behind equity contracts is the justification that providers of capital and resources should participate in the outcomes of the business and should not just benefit out of mere lending of surplus resources. This also implies a need to employ human efforts in deriving benefits out of any commercial activities. Based on entity relationship in the contract, Equity contracts are broadly classified as Mudarabah contract and Musharaka contracts.

Mudarabah Contracts, also commonly referred as silent partnership contracts is often regarded as best source of PLS arrangement keeping in mind the segregation between availability of skills with the Mudarib and financial resources with Rabb-ul-Maal. From the financial institutions point of view, this relationship may represent Mudarib as Entrepreneur on respective Asset Side while similar arrangement shall place depositors as Rabb-ul-Maal on respective Liabilities side of their balance sheet. Mudarabah model of equity partnership offers equitable opportunities across sections of society to explore their potentials and skills by engaging in meaningful production alongside households having sufficient and excessive cash but no equitable means for deployment.

Advocating a variant of equity contracts to those not believing in Mudarabah contractual relationship, Gamal (2000) highlights Musharaka contractual relationship as an ideal source of financing, truly complying to the Islamic principles of PLS.<sup>25</sup> Under Musharaka contract, Parties to the contract jointly share capital to the business and equally participate in the management of the venture. As such returns from the operations of the venture are generally in distributed in proportion of principal contribution by the partners.<sup>26</sup>

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25 El-Gamal, Mahmoud Amin, June 2000, "A Basic Guide to Contemporary Islamic Banking and Finance", Rice University.

26 Additionally as cited by Ismal, Antonia describes some variants to these basic forms of PLS contracts in the forms like Muzara'ah (harvest yield profit-sharing) and Musaqah (Plantation management fee based on certain portion of yield) – (Antonio, 1999:143-155 as cited by Ismal, Rifki (2010), The Management of Liquidity Risk in Islamic Banks: The Case of Indonesia. Doctoral thesis, Durham University. Available at Durham E-Theses online : <http://etheses.dur.ac.uk/550/>)

**2.2.2. Debt Based Contracts:** Although debt creation and trading in debt is advised to be used selectively where Musharaka and Mudarabah contracts are not permissible,<sup>27</sup> Farooq (2007) claims that more than 80% of Islamic financing still revolves around debt-based financing models.<sup>28</sup> A review of some of these debt-based contracts shall support a broader framework to growing criticism surrounding mark-up products in Islamic Finance.

**Murabaha:** Murabaha, one of the most widely used as well as widely contradicted contracts in Islamic Finance, is often compared to conventional cost-plus financing modes of finance used to finance trade and working capital requirements of Enterprises. Broadly used to facilitate working capital and trade finance needs, Murabaha contracts generally involve a bi-partite agency-purchaser relationship between the Islamic Finance institution and the end purchaser under 2 distinct capacities. The purchaser initially enters into an agency relationship with the financial institution for buying the required asset on behalf of the financier and then enters into a purchase agreement (usually on deferred payment contract basis) with the financier. Similar contractual agreements are also observed wherein the financial institution buys a product desired by the purchaser from the seller and in-turn sells the same to the buyer on cost plus profit basis. The financial institution retains the title to goods until the customer makes his final payment, thereby obliging the financial institution to perform maintenance and major repairs on the asset. Since the mark-up or profit is usually linked to conventional interest rate indexes or likewise, this forms a major point of debate amongst various schools of Islamic thoughts.

**Ijarah:** Ijarah contracts are another form of debt-based contracts widely used to finance capital assets required by Enterprises. Primarily used to finance assets of high value, Ijarah financing is based on transfer of Usufruct of an asset to the business customer at an agreed consideration. Financial Institution, on agreed terms with the Customer, purchases required asset and rents its usufruct to the customer. Though this form has often drawn simile to conventional leasing structure, a major differentiating factor remains that in accordance to the Islamic concept of risk ownership, the lessor or the financial institution remains the owner of the asset under the lease terms and bears the risk associated to the asset ownership during the life of asset. Lessee remains free from ownership and continues to pay the rent till the expiry of the contract with

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27 Usmani, M. T. (2010a). Post-Crisis Reforms: Some Points to Ponder. Retrieved 07 February 2010, from World Economic Forum: <http://www.weforum.org/pdf/faith/UsmaniPostCrisisReforms.pdf>

28 Farooq, Mohammad Omar, 2007, "Review of Islamic Economics" (special issue), Vol. 11, pp. 67-88, link : [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1415239](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415239) last accessed on 03/July/2012

general responsibility of regular day to day upkeep of the asset. At the end of the basic Ijarah contract, the financial institution regains the possession of the used asset.

Istisna: As described by Chong (2007), Istisna contracts are based on the concept of commissioned or contract manufacturing whereby a party undertakes to produce a specific good for future delivery at a pre-determined price.<sup>29</sup> Commonly used in financing of infrastructure and development projects, under Istisna contract the financial institution owns and develops a large scale facility and then either leases the project to the lessee with profit mark-up or sells the entire project to the buyer with profit mark-up on deferred basis. However eligibility and usage of Istisna contracts are permitted only by few schools of Islamic thought with several restrictions on contracting. Relevant to highlight is that Istisna and Bai'Salam contracts are the only exceptions to the general principles of Shariah based trades where the asset under consideration are sold before the asset is in possession and ownership of the seller.

Qard: Qard in form of Qard al-hassan (benevolent loan) is a true Islamic form of lending transaction wherein the lender lends capital or asset to the borrower in order to support the welfare or short term needs of the borrower without any levy of additional charges or collaterals. In Quran-E-Sharif, this form of lending is highly recommended by Allah (s.w.t) as righteous and has promised the lenders with increase in wealth and forgiveness of sins.<sup>30</sup> Micro financing in its original forms is partly related to such kind of Qard-al-hassan relationship.

**2.2.3. Fee based Contracts:** Simple to understand, Fee based contracts are basically service contracts aimed at facilitating trade. With aims and efforts to promote trade in ethical way, Islamic Financial Institutions offer various fee-based services like Kifalah (trade Guarantees), Joalah (service and other trade facilitation fees), Amanah (custody and safe keeping fees), Wakalah (agency or representation fees), etc. Such contracts are not a product of innovation but emanated from the very existence of the idea of trade and promoting Muslims to venture into faraway lands for trade.<sup>31</sup>

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<sup>29</sup> Chong, Beng Soon and Liu, Ming –Hua, October 2007, "Islamic Banking : Interest Free or Interest Based?"

<sup>30</sup> Refer Quran - Sura Taghabun: 16-17

<sup>31</sup> Refer Q 62 : 10

**2.2.4. Hybrid Contracts:** Shariah law prohibits amalgamation of several contracts into one. However current practices by various banks, with due approval from their respective Shariah boards, have successfully created a host of financial products that involve multiple layered contracts, in essence but amalgamated and sold as an individual piece of contract, in form. These hybrid products as well as derivative contracts, discussed later, are increasingly at the heart of controversies surrounding Islamic Banking offerings and hence it becomes imperative to understand some of these variants while supporting the need for paradigm shift.

**Musharaka Mutanaqisah:** As highlighted by Rosylin et al (2011), Musharaka Mutanaqisah contracts are commonly used to finance various assets like houses, properties, etc.<sup>32</sup> Predominantly regarded as diminishing partnership model, under this contract, the parties agree to enter into a Musharaka agreement for buying an asset with major share of investment being made by the financial institution. The customer agrees to pay regular returns linked to rental index or house price index alongwith a share to buy-out banks share of investment over a specified period of time until the property is completely owned by the client.

**Ijarah-wa-Iqtina:** Ijarah with final purchase agreement, a variant of Ijarah contracts, have features similar to traditional Ijarah product but with an added option for the Lessee/buyer to purchase the asset under Ijarah contract for an agreed pre-determined residual value. Importantly it needs to be noted that such an option is binding on the Lessor while Lessee retains the option of returning the asset to the Lessor / owner much similar to Call options in traditional derivative structures.

**Bai'Muajjal:** A variant of Murabaha contract, Bai'Muajjal contracts allows the bank or financing institution to buy an asset with contract of subsequent sale, on deferred basis, to the customer. The goods are delivered to the customer on immediate basis while repayment is customized on deferred basis in several pre-agreed payments over a specified period of time or in lumpsum at a fixed future date.

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32 Rosylin Mohd Yusof, Salina H. Kassim, M. Shabri A. Majid and Zarinah Hamid, 2011, "Determining the viability of rental price to benchmark Islamic home financing products", *Benchmarking: An International Journal* Vol. 18 No. 1, 2011 pp. 69-85; Emerald Group Publishing Limited 1463-5771, DOI 10.1108/146357711111109823

Bai'Salam: Bai'Salam or Future Sale contracts are structured based on forward sale concept wherein price for a specific good is paid in advance with contractual binding of receiving the goods at a specified future delivery date.<sup>33</sup>

Bai'al-wafa: As described by Netzer (2004), Bai'al-wafa is a typical contract of sale and repurchase wherein the borrowers who owns an asset or a property sells the asset to the bank or lender, enters into a rental or leasing agreement for the said property with the bank and a final right to repurchase the property at any time from the lender.<sup>34</sup>

**2.2.5. Derivative Contracts:** Derivatives as the name defines is a contract the value of which is derived from the value of the underlying asset. Much of debate in current literature on Islamic Finance revolves around promotion of derivatives trading as a resolve to risk mitigation. One such existing form of contract widely referred as derivatives options contracts permissible in Islam and worth mentioning is Bai'Urbun contracts. Bai'Urbun is a sale contract wherein the buyer deposits, in advance, a part of the total sale consideration in form of earnest money and agrees to complete the transaction within stipulated period of time. During the deposit of earnest money, the buyer agrees to the terms that incase he fails to ratify the contract; the seller can forfeit the earnest money deposited with him bringing its simile to the conventional call options. While use of derivative is strictly prohibited in Islam based on revealed guidance to enter into trade and prohibit from entering into prohibitive practices involving Riba, Maysir, Gharar and Jahalah, more and more efforts are evidently witnessed to frame Islamic values to suit and promote traditional derivative contracts. Such financially re-engineered products try to frame and exploit the mutsabah contents of Islamic principles and are packaged to promote their adaptability in providing risk mitigation alongwith enhanced risk-return solutions within Islamic Finance framework. Several scholars have expressed their views, criticisms and justifications on use of such products based on Islamic concepts of Khiyar,<sup>35</sup> W'ad<sup>36</sup> and Tawarruq.<sup>37</sup>

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33 Gamal endorses permissibility of Bai'Salam trade, with reference to acknowledgement by several scholars, to have been a practice endorsed by Prophet (s.a.s). As noted earlier, Bai'Salam and Istisna contracts are two exceptions to the general Shariah principle that asset must be in existence and the seller must be in possession and ownership of the commodity. - [El-Gamal, Mahmoud Amin, 2000, "A Basic Guide to Contemporary Islamic Banking and Finance", June 2007, Rice University].

34 Netzer, Miriam. "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> (Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>).

35 Mohammed Obaidullah, 2002, "Islamic Risk Management : Towards Greater Ethics and Efficiency", International Journal of Islamic Financial Services, Vol.3, No. 4, Jan-Mar 2002.

While it is necessary to state that most of these prohibitions and practices form the basis of wide criticism for Islamic Finance Industry, it is however necessary here to understand the role of Authority and plurality of the said authority that play substantial role, driving inherently, in most of these criticisms.

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36 Muhammad Ayub, 2011, "Use of W'ad and Tawarruq for Swaps in the framework of Islamic Finance", paper presented at 8th International Conference on Islamic Economics and Finance, link - <http://www.iefpedia.com/english/wp-content/uploads/2011/12/Muhammad-Ayub.pdf> last accessed on 03/July/2012

37 Dr. Asyraf Wajdi Dusuki and Shabnam Mokhtar, 2010, "The Concept and Operations of Swap as a Hedging Mechanism for Islamic Financial Institutions", ISRA Research Paper : 14 / 2010.

### 3. Authority in Islam

Most of the issues highlighted while discussing Islamic Finance are mainly due to partial, incomplete and often conflicting interpretation of Shariah Laws within diverse structures of authority in Islam. As such it becomes imperative to understand the origination of hierarchical structure in Islam and the diverse authority structure that surfaced within Islamic Society. The need to highlight the history of authority in Islam is mainly to develop an understanding on the most contentious issue of Authority faced by Islamic Finance Industry and if there exists any solution to the growing concerns on authority issues.

The issue of Authority and interpretation in Islam, and Islamic Finance in specific, is not an issue restricted to doctrines established by various schools of thought in Islam alone. One of the common misperception held about Islamic Finance, by majority of people, is the word “Islam” used in the verbiage of Islamic Finance. It is often considered to be financial system catering only to the needs of Muslims (followers of religion, “Islam”, established by Prophet (s.a.s)). However the origin of Islamic Finance goes much beyond the era of establishment of Islam associated with the birth of Prophet Muhammad (s.a.s). The word Islam is derived from the root word “Sa-le-ma” meaning peace, purity, submission and obedience. Thus Islam means submission to the will of God and obedience to his laws. These principles of submission to the will and laws of God were reinforced by Prophet Muhammad (s.a.s) as were reinforced by Prophets associated with other scriptures like Torah (revealed on H. Musa (a.s) or Moses), Injil (revealed on H. Issa (a.s) or Christ) and Zabur (revealed on H. Dawood (a.s) or David). The applicability of divine laws can be traced to various prohibitions emphasized in these scriptures. These laws were enforced to govern all aspects of human life including social equity and economic dealings. However much of the variances can be attributed to the growing influences of various forces, especially capitalist forces, in interpretation of divine laws and effecting changes in policy administration. A subtle reference can be made to the administrative history of institution of Roman Catholic Church during 5th to 19th century that witnessed growing influence of capitalist desires on performance of religious duties along with several issues including but not limited to biblical prohibitions of Riba.<sup>38</sup> As highlighted by Stern (1982), Heter isqa contracts (silent profit-sharing partnership arrangement) also witnessed such dilution

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38 Noonan J. and De.Roover, 1957, *The Scholastic Analysis of Usury* . Cambridge: Harvard University Press. 1957, p. 192 as cited by Clyde G. Reed and Cliff T. Bekar, 2002, “Religious Prohibitions Against Usury”, Elsevier - Explorations in Economic History, Volume 40, Number 4, October 2003 , pp. 347-368(22), [http://dx.doi.org/10.1016/S0014-4983\(03\)00039-1](http://dx.doi.org/10.1016/S0014-4983(03)00039-1)

primarily to circumvent the Biblical prohibition of ribit<sup>39</sup> and to bring Maslaha to inherent moral hazard inconsistencies arising in profit sharing arrangements.

Islamic Finance has not been an exception to such diverse interpretations of religious laws. A synopsis of various literary works on Islamic Finance portray the severity of growing criticism about lack of common interpretative authority on Islamic Laws. Gamal (2003, op cit) accounts for one such widely criticized fundamental argument underlying the December 2002 ruling of Al-Azhar's Islamic Research Institute that revolves around the issue of fixing the silent-partner's profit percentage to solve moral hazard problems. A common man interested in ethical investment is often lost in these financial debates of religious importance. These problems raise a central question on who bears authority to interpret religion and religious laws in Islam?

Authority in Islam to guide the religious and social lives of Muslims has primary source in revelations of the almighty Allah (s.w.t). All that is revealed and compiled in Quran-E-Sharif has the foremost authority in ruling the application of law and practices. However since the standard text of Quran-E-Sharif in itself allows multiplicative interpretations, Allah (s.w.t) has directed people to refer all matters of disagreements and guidance to his beloved prophet.<sup>40</sup> As such there is no dispute across Muslim society, that the primary source of reference and authority lies in words of Allah through revealed holy Quran-E-Sharif and in his beloved Prophet (s.a.s) through his Hadiths and Sunna.

Despite a clear revelation and authority in Prophet (s.a.s), the influential class of the so-called Muslim population, who had accepted Islam by mere act of words and always rendered the message of Allah and Prophet to interpretations that were supportive to their very cause of interest, became much more vocal and evident after the death of Prophet (s.a.s). Infact in Quran-E-Sharif itself, Allah (s.w.t) has prophesized such ingenuity by clearly laying reference to Mutashabihat Ayats which shall be the source for mischief creation by these perverse people and who shall be after that which is ambiguous and shall seek to mislead by their interpretation.<sup>41</sup> As evidently narrated by Daftary (1998), the sectional disintegration of authority

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39 Stern, J. (1982) "Ribit: A Halachic Anthology", Journal of Halacha and Contemporary Society, 46, as cited by Mahmoud A. El-Gamal, 2003, "Interest and the Paradox of Contemporary Islamic Law and Finance," Fordham International Law Journal 27(1), December 2003, pp. 108 -149.

40 Refer Q 4:59, 3:31-32, 33:21

41 Refer Q 3:7



in Islamic society appeared immediately after the death of Prophet (s.a.s)<sup>42</sup> and the above Ayat lays testimony to the division of authority observed in the Muslim community after death of beloved prophet. In one of the assertive statements made by 48th Imam of Shia Ismaili Nizari Muslim sect of Islam, Aga Khan 3 (1958), “ The Shi’a school of thought maintains that while direct divine inspiration ceased at the Prophets death, the need of Divine guidance continued and this could not be left merely to millions of mortal men subject to the whims and guts of passion and material necessity, capable of being momentarily but tragically misled by greed, by oratory or by the sudden desire for material advantage. These dangers were manifest in the period immediately following our Holy Prophet’s death.”<sup>43</sup>

With the death of Prophet (s.a.s) in AD 632, Daftary (1998, *ibid*) categorically remarks that the once unified and nascent Muslim community (Umma) of the prophet's time was soon, after the sad demise of prophet (s.a.s), divided into numerous rival communities and groupings. Muslims now disagreed on a number of fundamental issues concerning the Islamic way of life. The succession crisis led to 2 major distinct subdivisions in Islamic society, i.e., Sunni and Shia traditions of Islam and can be referred as first major separation of authority structure in Islam.

While there was no doubt about the need of potentially rightful authority to guide Muslims after the death of prophet, the choice was resolved in Sunni tradition by a group of leading Muslim Ulema’s in election of Khulfa-e-Rashid-al-din as successors to the messenger of Allah. This was believed to be in line with one of the Hadith, recorded in Ibn Majah - (2:1303 #3950), where prophet had asked Muslims to obey Quran-E-Sharif, Hadith and Sunna of Prophet and in case of any divergence in views, to follow the greater consensus (Ijma). This founded, in the words of Daftary,<sup>44</sup> the distinctive Islamic institution of the Caliphate which received authority by mass selection to lead the political as well as religious aspects of Islam for its followers. The authority to interpret the divine message of Allah and to guide the lives of Muslim ummah soon became a process of selective Choice within majority of believing Sunni community of Islam. However with passing times, several myriad groups engaged in formulating differing conceptions of religio-political and moral authority of Caliphs towards the community. The formative period of Islam

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42 Daftary, Farhad (1998), “A Short History of The Ismailies - Traditions of a Muslim Community”, 1998 Edinburgh University Press, ISBN 0748606874

43 Aga Khan 3, 1954, “The Memoirs of Aga Khan : World Enough and Time”, 1954 Simon And Schuster, New York, (pp-28)

44 *Ibid.* pp 23-24

was essentially characterized by such multiplicity of communities of interpretation and schools of thought leading to various sources of Furu al'fiqh in Islamic world.<sup>45</sup>

The Interpretive and authority structure in Sunni Islam confirms that subjugate to the word of God and the Hadith and Sunnah of Prophet (s.a.s), the next in authority to legal discourse is laid in the process of decisions based on Ijma or general consensus.<sup>46</sup> Alongside the process of Ijma, there is a heavy reliance on the process of Qiyas or analogy in deriving meaning and application out of the Mutashabihat Quranic revelation. Based on the qualified Ijma and Qiyas, the mujtahids certify the application of Shariah laws or fiqh for the law abiding Muslim society. However relevant to quote here is a word of caution derived from Quran-E-Sharif where Allah (s.w.t) directs believers on the way interpretations need to be arrived so as to avoid sin and revolt and disobedience.<sup>47</sup> In order to sustain a definitive delivery of interpretation process relevant to growing challenges faced by Muslim society, the mufti's study the fiqh, apply analogy and deliver fatwa's for these problems faced by the society and solutions are aimed at resolving their issues within the premise of Usul-al-fiqh. These fatwas represent an individualistic opinion or solution on the issue under consideration and they need to receive a general consensus by majority of schools of thought in Islam. However commenting on the possibility of imperfection existing in these fatwa's, Gamal (2003, op cit) makes a subtle remark by stating that no matter how prominent the issuers of fatwa may be, they are human.

On other hand, the minority Shi'is believed that the seal of prophethood was ordained by Allah in revelation of a continuing authority in H. Ali and his family succession (nass) through various clear ayats of Quran-E-Sharif<sup>48</sup>. Shi'is maintained that Allah (s.w.t) declared the perfection of religion<sup>49</sup> immediately after the notable declarations (Hadith-e-Saqlain) made by Prophet (s.a.s) at Ghadir-e-Khumm thereby declaring H. Ali (a.s) and his progeny as rightful successors (Ahlul-Baiyat and nass) after him on the command of Allah (s.w.t).<sup>50</sup> The Shia belief in Imamah and continuing Imamah has held the authority of Imam as a rightful single individual, from the lineage

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45 Daftary, Farhad (1998), "A Short History of The Ismailies - Traditions of a Muslim Community", 1998 Edinburgh University Press, ISBN 0748606874 - (pp 21)

46 Hadith - Ibn Majah - (2:1303 #3950)

47 Refer Q 108 : 9

48 For instance refer Q 36:12, Q 2:124,Q 3:33

49 Refer Q5:3

50 Refer Q 17:71, Q33:33)

of H.Ali (a.s) and H. Bibi Fatima (a.s), appointed by the divine command instituted in the preceding Imam, as the only rightful authority to guide each and every aspect of human life and the only source for understanding the esoteric meaning of Quran-E-Sharif in changing times. Alongwith the divine authority in Imam, the Shi's believe in the role of wisdom ("aql") omnipresent in humans that can, with the guidance from Imam, act as a guide to all matters of life. Despite the uniformly held belief of Shi'is in divine authority instituted in Imam, the passing time has revealed differences in precise definition and composition of Ahlul-Baiyat thereby leading to sectarian divide within the Shi'i sect of Islam as well.

According to Daftary, Islam from early on represented a monolithic phenomenon with a well-articulated doctrinal basis. As such those who did not follow the majority of Sunni population were accused of Ilhad or Heresy. A history of Islamic civilization provides evidence of how these Shi'i principles were grossly rejected by the ruling majority of influential Sunni rulers. Islamic principles of authority has since developed and nurtured around the majority driven ideologies of Sunni Islam and thereby in conformation to selective choice in authority.

The concept of authority in Islam in both Shi'i and Sunni tradition marked another notable development in the period of post colonial rule, when the concept of authority in major sects of Islam developed around the influential role of Siyasa. The ruling authority and its laws governing society formed the book of rule that would provide distinctive guide for Qadi's to give judgements. This authority had derived its powers from the need to find a greater Maslaha for its subjects and avoiding any dichotomy with the primary revelations. The Siyasa law on finding Maslaha consisted of securing benefits by preserving and preventing from harm, the five essential values namely life, religion, lineage, property and intellect within the objectives of Shariah. However over a sustained period of time, the rising quest to find maslaha especially in Islamic Finance, aimed to exploit the ambiguous sources of Islamic laws to appease the capital sensitive sections of administration. It won't be a mis-statement here to say that liberalization of economies had created a greater hoard at finding maslaha to complement and bring Islamic principles in line with the contemporary functioning of civil societies. Infact Netzer (2004) goes a step further in claiming how Siyasa law has gradually encroached the territories of Fiqh law?<sup>51</sup> Such practices are quite evidently observable in Islamic republic of Malaysia, where Siyasa law

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51 Netzer, Miriam. "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>

has allowed multiple innovations in fields of Islamic Finance and are often condemned as anti-Shariah by other Islamic countries.

The issues faced by modern Islamic Society is not only in the diversity of authority existing within Islamic society but mainly arise from partial references derived from Shariah Laws to provide evidences that support their schools of thought and at times their individualistic arguments. It has taken forms either based on direct references to the primal sources of authority or based on ijtihads on Mutashabihat contents of guidance. This inturn has created intellectual conflict between nations of different sects of Islam thereby widening the gap in understanding and deriving a meaningful message from the commonly referred revelation of Allah (Quran-E-Sharif) and traditions of beloved prophet (s.a.s). Though plurality of authority serves the purpose of generating more wider interpretation and understanding of Shariah Laws, the effectual problem gets accentuated when one discipline of authority tries and claims superiority over other and tries to enforce their thoughts as the only legitimate interpretation of Shariah Laws. Several scholars from these schools form decisive members of Islamic Finance Institution's Board and take part in approving innovative products based on exploitation of the mutashabihat contents of primary sources of guidance. A subtle case in near times and discussed even today has been a debate on need of indexation and compensation for loss of value being discussed at Fiqh Academy of the organization of Islamic conference held at Bahrain on September 22-23, 1999. Approvals from eminent scholars often lead to blind following by associates of these schools without being actually questioned for the rationales.

While the debate on rightful authority remains an unresolved parable in Islam, a seemingly constructive source of direction can be construed from the discussion on authority existing in Islamic world that interpretations those strictly adhere to prohibitions laid in divine revelation and traditions of prophet (s.a.s), may at the least provide a periphery for innovations and limitations of financial engineering in Islamic Finance. Much of these limiting principles shall help in critical evaluation of several issues and criticisms highlighted in existing scholarly deposition on Islamic economic system and shall justify the rationale suggested for a paradigm shift in approach towards Islamic Finance.

## 4. Critical Review of existing dialogues on Islamic Finance

One of the commonly held belief about Islamic Finance in financial fraternity is that Islamic Finance is a system of banking and finance developed to cater to the needs of only followers of Islam. As such, even after being the second largest religion followed across the world, reach of Islamic financial institution has been to a dismal 2-4% in many markets. Faced with challenges of finding *maslaha* to align with the changing needs of society and competition faced from conventional financial system, Islamic scholars have given diverse views and justifications to promote understanding on Shariah laws. However several views and justifications from these scholars are often guided according to their personal understanding or influence of their respective schools of thought. Off-late these guidance have found issuances in favor of their employers, who hire them to promote their business needs. The lack of clarity and often partial referencing of these laws by many scholars have created circles of questionability on relevance to many of its dependant structures. An attempt is made below to highlight some of these issues that pivot around the identity of Islamic Finance and form a reasonable base to highlight the necessity to effect a paradigm shift in future scholarly dialogue on Islamic Finance.

**4.1. Issue of lack of adequate and proper knowledge about Shariah laws:** Islamic Finance delves on the tenets of Shariah Laws. However as emphasized by several researchers like Netzer (2004)<sup>52</sup>, Obaidullah (2002)<sup>53</sup>, lack of competent authority in Islam to interpret revealed guidance alongwith increasing interference of *Siyasa* law have added complexity for customary participants at understanding of Shariah framework. Scholars have expressed their views and interpretations on Shariah Laws based on incidental interpretations of the Shariah texts rather than the wholistic and objective meaning behind the law. An interesting conflict referred by Netzer (ibid. 2004) & Gamal (2003)<sup>54</sup> in Shariah interpretation is evident from one of the scholarly debates on fatwa issued by Sheikh Tantawi on accepting pre-fixed returns on funds on the basis of establishing relationship dimension between a bank and its depositors. Such generic approach to revealed guidance, especially in finance, has led to informational

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52 Netzer, Miriam. "Riba in Islamic Jurisprudence: The Role of 'Interest' in Discourse on Law and State." 2004. Tufts University. Digital Collections and Archives. Medford, MA. <http://hdl.handle.net/10427/9434> Available from Tufts Digital Library, Digital Collections and Archives, Medford, MA. <http://hdl.handle.net/10427/9434>

53 Mohammed Obaidullah, Jan-Mar 2002, "Islamic Risk Management : Towards Greater Ethics and Efficiency", International Journal of Islamic Financial Services, Vol.3, No. 4

54 Mahmoud A. El-Gamal, 2003, "Interest and the Paradox of Contemporary Islamic Law and Finance," Fordham International Law Journal 27(1), December 2003, pp. 108 -149.

dissymmetry and lack of clear understanding of fundamental nature of Shariah principles governing finance. As noted by Montgomery (2010), there remains a persistent lack of knowledge amongst investing Muslims about the products offered by Islamic financial Institutions. Instead of investigating the underlying practices of Islamic banks, many Muslims simply assume that the investment vehicles are Shariah-compliant either because of their Islamic names or by word of the eminent scholars empanelled on Shariah board of these financial institutions.<sup>55</sup> These partial interpretations have led to adoption of various modes of investment and financing that conform to the Form rather than substance of Shariah Law.

**4.2. Window dressing arguments in Sale of Islamic Financial products :** Several researchers like Rahman (1999 op cit), Gamal (2000 & 2003 op cit), Jaman (2011)<sup>56</sup>, Ayub (2011)<sup>57</sup> have observed growing trend in numerous Islamic Economies, to lure participants of Islamic finance Industry to avail so called Islamic products primarily sold on aegis of its conventional variants. As noticed by Chong & Liu (ibid. 2007), Islamic banking, as is practiced in economies like Malaysia today, is not very different from conventional banking and the alleged benefits of Islamic banking exist in theory only.<sup>58</sup> Structured on derived and partial interpretations of Shariah Laws, increasing number of innovated Islamic finance products are sold to match risk-return requirements of Islamic Investors. Citing such practices, Gamal (ibid 2003) analysed how despite restriction on amalgamation of contracts, Islamic financial institutions sold Islamic products using innovative ideas of creating one degree separation between different contracts available within Shariah framework. As highlighted by Montgomery (op cit. 2010), Proponents of modern Islamic financial products justify use of several window-dressed products mainly conforming to Shariah form as best alternative in absence of better Islamic options of financing.<sup>59</sup> To exemplify the extent of window dressing existing in Islamic Finance industry, Ayub (2011 op cit) notes that despite the recent crisis of 2009 mainly resulting

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55 Montgomery, John, 2010, "Ethics, "Practice, and Future of Islamic Banking and Finance", Senior Thesis, link - <http://dukespace.lib.duke.edu/dspace/bitstream/handle/10161/2523/Senior%20Thesis.pdf?sequence=1>.

56 Bashir Uj Jaman, 2011, "Benchmarking in Islamic Finance", paper submitted at Markfield Institute of Higher Education (Mihe), University of Gloucestershire accessible at <http://uaelaws.files.wordpress.com/2011/09/benchmarking-in-islamic-finance-and-banking.pdf>

57 Muhammad Ayub, 2011, "Use of W'ad and Tawarruq for Swaps in the framework of Islamic Finance", paper presented at 8th International Conference on Islamic Economics and Finance, link - <http://www.iefpedia.com/english/wp-content/uploads/2011/12/Muhammad-Ayub.pdf> last accessed on 03/July/2012

58 Beng Soon Chong and Ming-Hua Liu, October 2007, "Islamic Banking : Interest Free or Interest Based ?"

59 One such reference of argument against window dressing can be found by Natalie Schoon - Schoon, Natalie, 2008, "Islamic Finance – An Overview." *European Business Organization Law Review* 9 (2008): 621-36

from CDS fallout on global economies as well as default of atleast 10 sukuk issues during this period, calls were still being made to promote Islamic forms of CDS.

**4.3. Issue of Misrepresentation** : Many Scholarly articles and Islamic Financial Institutions while promoting Islamic Finance products knowingly or unknowingly misrepresent the very foundation of Islamic Finance. Often their scholarly depositions, as noted by Montgomery, have misrepresented Islamic Finance as a mere adjunct of Islamic revivalism and not as an independent area of study. Western publishers, as noted by Noman (2002) have remarked the emergence of Islamic banking as an innovation under the category of religious innovation or ethical investment.<sup>60</sup> In a critical evaluation and portrayal of Islamic Finance as a mere adjunct of conventional banking, Jobst (2007), has drawn parallels of Islamic modes of finance to some of the conventional ones like resembling the permitted Salam trades to conventional futures contract, Istisna trades to pre-financed project financing, Ijarah wa-Iqtina to debt-based synthetic loans with imbibed put option, Musawama to Negotiable sales contract, etc.<sup>61</sup> Such literary exposition on Islamic financial products have created a detrimental damage to the visibility of Islamic Finance Industry thereby lending an impression of subjugation of Islamic Finance to the forces of proponents of conventional finance. The use of nomenclatures like **“Mudarabah TIME DEPOSITS”** itself exhibits how sale of mudarabah contracts are advertised to the investing public. Such critical misrepresentation lead to an added uncertainty and doubt in the minds of believers about Islamic Finance and its products thereby significantly hampering growth of Islamic Finance Industry.

**4.4. Issue of generalization in applicability of Islamic thought** : A related issue to issue of misrepresentation is the issue of generalization applied to the Islamic Finance. Due to lack of centralized decision making authority in Islamic world, financial products offered by certain Islamic Republics like Malaysia or fatwa's or decrees often made by schools of thought is generalized as universally proposed by the entire Islamic society in financial literature. Critical claims like benefits of Islamic banking exist in theory only severely dent the image of entire Islamic Finance industry.<sup>62</sup>

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60 Abdullah M Noman, Oct-Dec 2002, “Imperatives of Financial Innovation For Islamic Banks”, International Journal of Islamic Financial Services, Vol.4, No. 3

61 Andreas A. Jobst, 2007, “The Economics of Islamic Finance and Securitization”, IMF working Paper WP/07/117, Monetary and Capital Markets Department

62 Beng Soon Chong and Ming-Hua Liu, October 2007, “Islamic Banking : Interest Free or Interest Based ?”

**4.5. Issue of Self Identity** : As expressed earlier, Islamic banking is considered by many researchers as a mere window-dressed tool of conventional financial system. A closer look at regulatory, monetary and legal framework where these institutions operate also demands Islamic Institutions to adhere to more generalized conventional norms like Basel accord, fiat money system, etc. Standing by the history of Islamic Economics, Gamal (2003 op cit) quotes views of Nasr (1991)<sup>63</sup> on how Islamic banking got caught in centripetal pull of western economic thoughts and quickly lost the emphasis of being an independent Islamic Social science, while trying to replace the intellectual web of this very western economic system. Often the ideas of implementing a change in economic system is influenced and hampered by policies drafted by a couple of developed economies dominating the world economic system. This is well illustrated in banning of gold standards being used as a medium of currency by IMF way back in 1978. According to Dali and Ahmad (2005), such disqualifications have restricted Financial Institutions, especially amongst OIC countries, in promoting a sustainable medium of exchange.<sup>64</sup> In effect, global financial institutions are forced to accept controversial benchmarking standards like LIBOR<sup>65</sup> for pricing of many of their products. This is quite evident today when Islamic republic's and their so-established Islamic regulatory system accommodate products like sukuks with guaranteed percentage returns, Islamic derivatives, etc. As observed by Nasr (2011), large numbers of key financial institutions worldwide redraft and sell their conventional products as Shariah-compliant products.<sup>66</sup> Such practices severely hamper the identity and growth of Islamic Finance that in essence remains deeply intertwined with divine revelation and prophetic traditions of Shariah practice and a more unbiased form of ethical economic system.

**4.6. Issue of maslaha prioritized over Shariah Laws** : Islamic Finance does not discriminate material and spiritual aspects of human life and as such Islam advocates provision of Maslaha to the changing needs of society but within the peripheries of guidance from Allah (s.w.t) and his prophet. Prophet (s.a.s) had laid strict prohibitions on several nature of Islamic financing based on amalgamation of contracts, inclusions of elements of Gharar and Maysir, etc. However as

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63 Nasr, S-H. (1991) "Islamization of Knowledge: A Critical Overview", Islamic Studies, 387-400

64 Nuradali Ridzwan Shah Mohd Dali and Dr. Sanep Ahmad, "A Review of Forward, Futures, and Options From The Shariah Perspective. "From Complexity to Simplicity"", paper presented at Seminar Ekonomi & Kewangan Islam (SEKI 2005) conference, ESSET Bangi, August 29-30 2005

65 Financial Times, "Rate-rigging at Barclays was 'pervasive'" published on June 27, 2012, Link - <http://www.ft.com/intl/cms/s/0/dd46517e-c072-11e1-9372-00144feabdc0.html#axzz1z9cWtp20>, last accessed on February 7, 2014.

66 Dr. Sahar Nasr, 2011, "Islamic Finance in the Arab World : Challenges and Prospects", 2011 Cambridge Business & Economics Conference (CBEC), ISBN 9780974211428



pointed by Dusuki and Mokhtar (2010), the issue of provision of Maslaha has taken a form wherein modern scholars have given views to allow the same but with certain conditions.<sup>67</sup> As noted by Gamal (2003), Islamic Institutions have promoted Islamic Finance and hedging products using Shariah arbitrage by creating an environment wherein jurists on the industry payroll denounce conventional financial products as subject of severest prohibition in Islam, while at the same time facilitating the creation of twin products based on one degree of separation principle and juristic fiction about nature of structured Islamic Finance products.<sup>68</sup> Evidently there are growing instances of such financial solutions being provided by Islamic arms of conventional financial institutions and followed by Islamic banks in general. Terming the current pragmatic approach as internationalization of capitalist desires into Islamic Finance, Rahman (2007) asserts that such contentious views amongst scholars as well as countries to which they belong further complicate and complement the growing criticism and the way Islamic Finance is looked upon not only by Muslims but also by other societies of the world<sup>69</sup>. Concepts of *W'ad* and *Tawarruq* are increasingly used to promote derivatives transactions without actually involving any real assets (that forms the basis of Islamic economics) in their settlement deals thereby bringing it at par with conventional derivative products. Despite ban by apex Shariah bodies on use of *Tawarruq* to facilitate derivatives trading, financial institutions have created their own ways of increasingly using it in providing top-up facilities, mezzanine financing, liquidity management and working capital finance.

**4.7. Issue of mis-selling and improper marketing :** Believers in Islam advocate selective use of debt instruments based on Quranic ordinance from Allah (s.w.t) and traditions of his beloved prophets (s.a.s). However mis-selling and improper marketing of Islamic financial products can be evidently judged from balance sheets of these financial institutions where more than 80% of bank's assets are still financed through debt and mark-up products. As observed by Haneef and Solo (2010), Islamic banks still entrap and entice customer to enter debt transactions by skillfully playing upon their impulsive desires.<sup>70</sup> They cite an example of how Islamic banks induce

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67 Dr. Asyraf Wajdi Dusuki and Shabnam Mokhtar, 2010, "THE CONCEPT AND OPERATIONS OF SWAP AS A HEDGING MECHANISM FOR ISLAMIC FINANCIAL INSTITUTIONS", ISRA Research Paper : 14 / 2010

68 Mahmoud A. El-Gamal, 2003, "Interest and the Paradox of Contemporary Islamic Law and Finance," Fordham International Law Journal 27(1), December 2003, pp. 108 -149

69 Abdul Rahim Abdul Rahman, 2007, "Islamic Banking and Finance : Between Ideals and Realities", IIUM Journal of Economics and Management 15, no. 2 (2007): 123-141

70 Rafe Haneef & Edib Solo, 2010, "Reshaping The Islamic Finance Industry : Applying The Lessons Learnt From The Global Financial Crisis", available at <http://www.isra.my/publications/research-paper/research-paper-2010/item/47-research-paper-no-11/2010.html?tmpl=component&print=1> last accessed on 15/June/2012)

customer borrowings by slashing interest rates on personal finance during the Ramadan period. As cited by Rahman (2007)<sup>71</sup>, Dusuki and Abozaid claimed that the current trend of selling conventional products excellently fitted in forms of Shariah principles has indirectly lent higher priority to providing Maslaha than the ethical requirements of adherence to Shariah.

**4.8. Behavioral inconsistencies of financial clients** : As statistically observed by Zahir (2007), about 27% of world population now constitute Muslims.<sup>72</sup> However the penetration rates of Islamic Finance has just been a mere 2-4% in many markets. This implicitly conveys that still majority of Muslim population are either forced to resort to conventional sources of financial contracts or they do not have adequate knowledge to enter into Islamically permitted financial contracts. The hurdles of savings and investment to realize future value of money for various purposes like retirement planning and other longer term financial planning has often convinced Muslim investors to replace uncertainty in returns from Islamic contracts and resort to interest based assured financial planning products advocated by conventional finance system. Muslims face the dilemma of choice between the lucrative rates and far wider range of financial products offered in conventional financing vis-a-vis the limited range and the predominant PLS based contracts in Islamic Finance. Ismal (2010) supports these views by pointing towards several behavioural aspects of Islamic investors and identifies that one of the prime issues faced by Islamic investors is their lack of understanding about financing instruments in general and the dominant preference amongst majority of Islamic Finance investors to seek higher and assured profits.<sup>73</sup> Another behavioural aspect noted by Dusuki and Abdullah (2007), with reference to Investors in Islamic republic of Malaysia, is that Investors choose IBF based on their reputations and the services they provide rather than any perceived moral benefits.<sup>74</sup>

**4.9. Issue of lack of uniform code of conduct and distinct regulatory mechanism** : As noted by Nasr (2011 op cit.), Islamic Finance faces numerous challenges in the areas of regulation, supervision and international harmonization. Multiplicity of Shariah boards and diverse judgements across jurisdictions impede homogeneity of Islamic products thereby

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71 Abdul Rahim Abdul Rahman, 2007, "Islamic Banking and Finance : Between Ideals and Realities", IIUM Journal of Economics and Management 15, no. 2 (2007): 123-141

72 Zaher T.S and Kabir, Hassan M. (2001), A Comparative Literature Survey of Islamic Finance and Banking. Financial Markets, Institutions & Instruments, 10: 155–199. doi: 10.1111/1468-0416.00044

73 Ismal, Rifki (2010), The Management of Liquidity Risk in Islamic Banks: The Case of Indonesia. Doctoral thesis, Durham University. Available at Durham E-Theses online : <http://etheses.dur.ac.uk/550/>

74 Dusuki, Asyraf Wajdi and Nurdianawati Irwani Abdullah, 2007, "Why Do Malaysian Customers Patronise Islamic Banks?" International Journal of Bank Marketing 25:3 (2007): 142-60

creating uncertainty and doubt in the minds of common investors. Though there are a couple of research being conducted on liquidity and risk management in Islamic Finance, there is still a greater need on integrated crisis management framework distinct and recognized universally across jurisdictions. As noted by Karim (2001), Islamic contracts are unique in terms of accounting and regulatory treatment and imposition of general regulatory provision of Basel norms and standard accounting treatments like considering Murabaha financing under general category of Loans, Ijarah muntahia bittamleek as in substance capital lease, etc hamper the very substance of Shariah principles in these contracts and as such these provisions are not always applicable to Islamic banking.<sup>75</sup> As currently can be seen, several countries and International agencies do not allow some of the basic structures of Islamic banking like PLS sharing in deposit structures, zero-interest structures on savings scheme, permissibility of gold-standards being used as a medium of exchange, etc. Apart from these issues, PLS contracts also suffer from unfair treatment in taxation as compared to interest based financing. In conventional financing, interest is treated as a cost to the company and as such is exempt from tax while profits from PLS contracts are taxable at higher rates thereby disincentivizing people from enter into PLS contracts. Farooq (2007) also points to the fact that there is a lack of secondary market for trading of Islamic financial instruments which negatively impacts the financial resources mobilizing capacity of the Islamic Finance Institutions.<sup>76</sup>

**4.10. Inherent inconsistencies in Islamic Financing :** Apart from several external issues surrounding Islamic Finance, there are several inherent inconsistencies that deprive effective marketing and sale of Islamic financial products. Islamic Finance lays great emphasis on PLS contractual relationships like Mudarabah and Musharaka contracts. As noted by Chong (2007), PLS financing encounters severe principal-agent problems directly related to moral hazard problems like attempts to artificially manipulate cost and/or under reporting of profits from the projects, inclination to undertake high risk projects due to limited downside financial risk on part of Mudarib, requirement of costly monitoring for Rabb-ul-maal to safeguard their financial interests, lack of management and control rights especially in case of Mudarabah contracts, etc.<sup>77</sup>

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75 Rifaat Ahmed Abdel Karim, 2001, "International Accounting Harmonization, banking regulation and Islamic Banks", *The International Journal of Accounting* 36 (2001) 169-193

76 Mohammad Omar Farooq, 2007, "Partnership, Equity Financing and Islamic Finance : Whither Profit-Loss Sharing", *Review of Islamic Economics* (special issue), Vol. 11, pp. 67-88, link : [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1415239](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415239) last accessed on 03/July/2012

77 Beng Soon Chong and Ming-Hua Liu, "Islamic Banking : Interest Free or Interest Based ?", October 2007

As highlighted in some of the issues severely affecting the identity of Islamic society, in general and Islamic finance in particular, there is a dire need to bring a paradigm shift in the perceived identity of Islamic economics and an attempt is made in succeeding part to suggest some ways to achieve the said objective and to provide an even opportunity for growth of Islamic finance industry.

## 5. A Paradigm Shift in dialogue on Islamic Finance

Paradigm shift is generally defined as a fundamental change in approach or underlying assumption. As reflecting through several issues highlighted above, Islamic Finance has found severe criticism from various scholastic fraternity. Some of these criticisms are very systemic in nature and require solutions through greater consensus from diverse authority existing in Islamic Society. However there are many issues which emanate due to misrepresentation and willful desires of market participants to benefit from existing ambiguity in Shariah Framework. Such exploitations have severely affected the identity of Islamic Finance Industry and hence an attempt is made below to suggest a paradigm shift based on merits of running a sound socio-ethical banking system built on firm Islamic foundations of equity, transparency and growth.

A prologue to the need for paradigm shift can well be supported by a word of caution expressed by Siddiqui (1983) that “we cannot claim, for an interest-free alternative not based on sharing, the superiority which could be claimed on the basis of profit-sharing. What is worse, if the alternative in practice is built around predetermined rates of return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provided in the modes of finance based on murabaha, bay' salam (a forward sale, whereby payment is made at time of contract and item is delivered at later), leasing and lending with a service charge, are all predetermined as in the case of interest. Some of these modes of finance are said to contain some elements of risk, but all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around these modes of financing can hardly claim superiority over an interest-based system on grounds of equity, efficiency, stability and growth”.<sup>78</sup>

To establish the process of paradigm shift, the first and foremost attempt needs to be garnered towards enhancing the suitability and acceptance of Islamic finance. There is a need to change the way Islamic Finance is being discussed by scholastic society and being influenced by a couple of ardent supporters of Riba based financial system. Most of the articles on Islamic Finance delve around how Islamic Finance lags in terms of providing financial solutions to

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78 Siddiqui, Mohammad Nejatullah (1983), “Issues in Islamic Banking”, The Islamic Foundation, Leicester, ISBN 0860371174, as cited by Mohammad Omar Farooq, 2007, “Partnership, Equity Financing and Islamic Finance : Whither Profit-Loss Sharing”, Review of Islamic Economics (special issue), Vol. 11, pp. 67-88.

society in comparison with the conventional finance. While products of Islamic Finance are always compared and simile are drawn with conventional finance, there is a dire need to portray the differentiation in essence and substance of these Islamic products from the conventional parallels. Islamic Finance has its own segment of customer loyalty strictly banking within ethical frameworks of Shariah laws and distinctly disconnected from generalized conventional finance system. Infact the recognition of the said fact itself is necessary to reduce comparison and conflicting interest generated by these two systems. The socio-ethical merits of Islamic finance products through proper communication and marketing shall create the required differentiation and appeal to the market participants. To avoid futile comparison between the two systems, each trying to replace or oust each other, It is relevant to quote a reference from Quran-E-Sharif where Allah guides believers to avoid indulging in meaningless arguments over things and leave them (critics) to practice what they deem suitable to them.<sup>79</sup>

Another area that demands a paradigm shift and requires a serious effort is in managing the scathing disapproval of Islamic economics, created by supporters of conventional system, through enunciation of limitations of age old traditions of Shariah in delivering financial solutions, absence of uniform jurisdictional and legal authority, static and limited availability of financial contract system, etc. Notably, It remains an accepted fact that Islam does revolve around the Shariah framework established in 6<sup>th</sup> century, laying highest degree of emphasis on adherence to revelation of Allah followed by traditions of prophet. Having said this, different sects in Islam derive their time relevant and continuous guidance through established process of either Ijma amongst Ulemas or reference to fiqh literatures or as seen in Ismaili sect, through the guidance of Imam's of their time considered as rightful and declared progeny of Prophet (s.a.s). Whatever is the belief, Islam as a faith, inspires believers to lead their lives and ways of living in conformation to these principles of Shariah and does not create a divide between material and spiritual aspects of life. It is from this integrated perspective that Islamic Finance does not exclusively deal with only financial aspect of human life but inexplicably deals financial relationships within the moral and ethical framework of social life. This socio-ethical financial framework is often mis-represented by western researchers, so influenced by capitalistic paradigm, that it forms an area of condemnation towards Islamic finance as being outdated and not a forward looking financial system. Infact the inter-twining relationship between material and spiritual aspects of life, within the so-called old prohibitive frameworks of Shariah, offers a sound base for creation of an ethically and fundamentally strong financial system. A financial system,

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79 Refer Q 109:1-6

that can help its stakeholders to avoid the current vices of inequity and rash speculative adaptations of modern financial system.

Quran-E-Sharif inspires believers to be dynamic and industrious members of the society and to carry trade to faraway lands for growth and development.<sup>80</sup> Islamic economics has its roots as a predominantly trade based economic system with emphasis on involvement of capital contributors to be a part of the business not only in terms of profits but also losses from the business. Thus engagement of individual members of society and their ownership of business forms the basis of most of the contractual relationships promoted by Islamic Finance. This creates a conflicting separation from currently practiced Riba-based financial system that offers risk-free returns to its affluent capitalist class without participating in the negative outcomes of the venture. Islam condemns these forms of risk-less returns as main source of increasing the social divide in the society and also for laying the very foundation of avarice commonly observed and substantiated as causes of crisis-like situation promoted by Riba-based economic system. The risk-less return to capital providers often directs a capital scarce entrepreneur, striving on these high cost funding, to venture their resources in demand driven economic sectors that tend to produce matching higher returns for the entrepreneur. Scarce economic resources as such get diverted to create demand and supply of irrational luxuries rather than prudential allocation to increase supplies of essentials and real growth oriented economic activities. To avoid fallouts of such reprehensible economic system, there is a definite need to shift to PLS structures of Islamic economics that shall provide sufficient resources for entrepreneurs to venture into promising economic activities without any apprehensions of entering into vicious cycles of debt emanating from probabilities of failure of businesses. This shall also promote entrepreneurial efforts towards innovations in productions aimed at collective improvement in quality of life of entire society and not just being a mere conduit of materialistic system.

Another misrepresented criticism and cause for paradigm shift is the lack of flexibility expressed in Islamic contractual relationship. It needs to be emphasized here that Islam, as a religion or Shariah as a law, has never refrained its followers to set their own terms of trade and finance. However emphasis on trade in Islam involves obligation of ensuring transparency, fairness and equity amongst the trading parties. As expressed by Noman (2002 op cit.), there are evidences from well known traditions of prophet's life that allows believers to agree on their own terms and condition in trade so long as they do not contradict the explicit Shariah rules and principles.

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80 refer Q 62:10

Apart from agreement between contracting parties, it also emphasizes on taking care of interest of any other parties not directly related to trade but shall be affected by such trade. This creates an inbuilt moral responsibility on parties entering into trade to consider the effects of any such transactions on the socio-economic framework of the society. Rather than criticizing these principles as outdated and needing innovation, an ethical understanding of the contractual systems in Islamic finance can help to get rid of several ruses of current financial system. Marred by excessive leverage, information asymmetry and ambiguously complex transactions, 2008 financial crisis had left rogue capitalists amassing enormous wealth at the cost of thousands of lay-offs, small business closures and a greater extent of loss of faith amongst the investors in this very complex economic system. This had also resulted in loss of real value to millions of small savers as a result of horrid cycles of distressed sale of assets, heightened market volatility, falling asset prices and acute liquidity crisis. The adverse effect of the said crisis has not only effected millions of individuals but also several nations who are yet to come out from the ripples of this crisis even till date. There has been a phenomenal increase in expenditure on regulatory supervision and dispute redressals. Such implacable fall-outs inadvertently calls for a certain paradigm shift towards a more transparent and ethical financial system, readily available in form of existing Islamic Finance system.

Another important aspect of Shariah principles that create a structure of sound financial system and warrants for a paradigm shift in current financial activities is the selective use of debt. Balance sheets of most of the Islamic Financial Intermediaries show heavy reliance on debt based products that correspond to the balance sheet structures of Riba based banks. As analyzed by researchers, debt-alike instruments form more than 80% of balance sheets of Islamic banks. This is in stark contrast to Islamic principles those lay strong emphasis on selective use of debt and limits its acquisition only in case of stark necessity. Ample examples are highlighted from the life of holy prophet on how all transactions involving Riba were strictly condemned on the basis of its consequences to create an inequitable and unjust society that on one hand provides effortless income to the creditors while at same time laying heavy burden of servicing on debtors, irrespective of his ability to pay, forcing them to fall in vicious circles of debt and poverty. As rightly prophesized in Quran-E-Sharif, Injustice ultimately leads to destruction.<sup>81</sup> To avoid such fallouts of debt, Shariah strictly forbids any excessive increase on unpaid debts and inspires creditors to extend the term of debt to enable debtors to pay their debts or to forego debts in circumstances where debtors are permanently not in a position to

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81 Refer Q 57:25



pay. Such deferment of debt without increase and acts of altruism shall protect debt burdened sections of the society from being exploited and restart their lives. Additionally, Shariah also creates a self-disciplinary structure to avoid possible misuse by debtors. It lays moral responsibility on debtors to avoid willful defaults in payment of debt and persuades debtors to pay their debts before any income is used for purposes other than basic necessities of sustaining life.

A related exemplar of indiscriminate practices that calls for paradigm shift is the extensive use of Riba based benchmarks like LIBOR to ascertain asset and liability financing in financial system. Though it is established to be one of the stable sources of references based on demand and supply of money, the problem is the very basic debate on intrinsic value of underlying fiat currency and the value it derives from an unknown and speculative future expectation of the financial institutions primarily involved in setting these benchmark rates. Without any real asset attached to these interest based benchmarks, speculations and frauds are inevitable as seen in the recent LIBOR fixing scam exposed by leading newsprints.<sup>82</sup> Such referencing shall not only create artificial benchmarking but also a complex web of inflated prices of assets and liabilities dependant on these benchmarks. If Islamic framework of referencing based on real value of assets is followed, though costly in implementation and monitoring, it can link all products to real factors of economy and price them accordingly. Such a change in paradigm needs a major overhaul in practices adopted by entire financial fraternity and as such its feasibility shall be cast in shadows of irrationality from advocates of long established Riba based benchmarking systems.

One more area where paradigm shift is required and needs to be specifically highlighted is the heightened criticism and growing innovation in the use of derivative instruments in Islamic financial markets. Patrons of derivative markets, especially Islamic banking arms of large financial MNC's, in order to tap huge potential wealth of Islamic republics, try to sell these instruments to Islamic fraternity on basis of various combinations of W'ad ,Tawarruq and alike. The elite members of Shariah board justify them with partial reference to the traditions of prophet (s.a.s). Often lack of financial alternatives within Shariah framework is also used as an alibi to sell the prohibited contracts through Islamic modes of financing. The idea of derivatives

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<sup>82</sup> An article from The Financial Times, "Rate-rigging at Barclays was 'pervasive'", By Kara Scannell, Caroline Binham and Brooke Masters, June 27, 2012 8:39 pm, link - <http://www.ft.com/intl/cms/s/0/dd46517e-c072-11e1-9372-00144feabdc0.html#axzz1z9cWtp20> last accessed 29/June/2012

trading has found stiff resistance within Islamic fraternity with exception of Islamic economies like Malaysia which supports such transactions on the grounds of Maslaha and often attempts at re-designing these forms of derivatives transactions to meet the Shariah requirements. Such innovative ideas, on backdrop of providing Maslaha to Investing communities, have become popular areas of criticism in several Islamic republics. While Shariah practices does not reject innovations in totality but it definitely limits them within the extant framework of Shariah Laws which are aimed at preventing vices like Riba, Gharar, Maysir and all of that which is considered Haram. Ownership and control of assets in line with two well-known maxims from prophets (s.a.s)'s hadith, i.e., Al-kharaj bil-daman and al-ghunm bil-ghurm fundamentally practiced within Islamic fraternity, govern the nature of transactions permitted to the believing community. If observed meticulously and ethically, these fundamentals themselves provide a strong financial framework that justify avoidance of transactions like Derivatives and its pseudo types that are not Halalan tayyiban (lawful and good).

Another supplementary call for a definite paradigm shift is from the perspective of market participant's attitude towards understanding of Islamic ethos and supporting sustainable growth of Islamic Finance Industry. Study in Malaysian market by Ismal (2010 op cit.) shows that large number of participants due to lack of proper knowledge of Islamic products, deal with Islamic banks just by the Islamic names to their banking products or on words of prominent figures in bank's Shariah board, without relevant understanding of these products being halal in essence. Also large numbers of depositors tend to withdraw from Islamic Banking Institutions if they are made to believe that their banks are not-Shariah compliant. Such practices not only substantiate liquidity crisis within the system but also tend to increase confidence crisis amongst various stakeholders of the organization thereby rendering these institutions in long run, less accountable to its participants, mainly depositors and shareholders, who transact with belief of dealing with Shariah driven institutions. There is a definite need to create proper consumer education amongst investors to assist them to understand some of the basic tenets of Shariah law and practices. This shall help them to analyze products offered by Islamic Institutions and importantly imbibe a culture of PLS ownership, as a way forward to creating equitable opportunities. Also at institutional level, more efforts needs to be directed towards achieving greater market penetration by creating adequate consumer education and reaching untapped markets to promote Islamic banking. An interesting findings by Baba and Lang (2012), on acceptability of Islamic banking by non-Muslims in one of the states of Malaysia having more than 75% of population as non-Muslims, reveal that given the ethical structures of Islamic banking and superior quality of products and services offered by these banks, non-Muslims are

ready to patronize Islamic banks and are even confident that Islamic banks can offer performances that can compete with the conventional banks.<sup>83</sup>

There is also a larger need of paradigm shift in role of various stakeholders involved in the financial system. Shareholders need to effectively monitor actions of the banks board and its managing committee and needs to ensure that banks actions are truly within the precepts of Shariah principles. The role gets even more crucial at regulatory and supervisory level to ensure Islamic Finance gets recognized as a financial system that aims to create ethical financial relationships with long term view of facilitating the need based production functions within the society. Supervisory efforts needs to bring in more discipline in ethical functioning of system and accountability within the financial industry to avoid crisis like situations that shake the entire framework of financial system and inturn depleting consumer confidence in the very system. Legislative frameworks need to be supportive rather than trying to create conflict with the nature of Islamic offerings. Central banks of many influential economies do not accept sale of interest free products resulting in denunciation and non-recognition of alternate Riba free socio-ethical banking models as a viable financial industry option. Adding impair to ethical banking structures, dispute resolution mechanism through Shariah supervisory boards are frequently overruled by the democratic laws of non-Islamic republics. Such legislative and regulatory roadblocks calls for a concentrated effort in persuading these participants at understanding the merits of maintaining and supporting an ethical financial and regulatory structure so provided by Islamic Finance. These bold initiatives may also require flexibility and serious consensus on restructuring of existing authority structures existing within the Islamic worlds as well.

In addition to several approaches highlighted above, there is also a genuine need to effectively look at some solutions that exist within areas of finance but are seldom recognized and promoted to allow its growth to true potentials. One such commonly known and vastly discussed solution is the role of micro-finance institutions and micro-finance products in providing a sustainable and equitable opportunity for growth and development. Islam has always emphasized on creating equitable opportunities in the society by providing generous support to all weaker sections of the society. It has encouraged Muslims to co-operate and explore potential sources of income generation without compromising the ethical values of Islam. Micro-finance, if implemented within precincts of Shariah, can contribute as a true Islamic source of financing. Smaller amounts may be lent as Qard al-hassan to economically weaker sections of

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83 Baba, Ricardo and Lang, Ricky (2012), "Perception of non-Muslims towards Islamic Banking", Bankers Journal Malaysia – The Journal of the institute of Bankers Malaysia, Issue No. 138 – June 2012, KDN PP 3781/05/2013 (032406) ISSN-0126-9536.

society to enable them to collectively work together and in turn generate employment and growth opportunities. Allocation of resources can be made with responsibility on borrower to return from the profitable outcomes of venture, principal lent alongwith voluntary payment of fair share of returns on investment. These micro-finance ideas, once adopted within Islamic PLS structures of Mudarabah or Musharaka, shall provide ethically sound, sustainable, halalan and growth oriented development of all sections of the society. This shall also provide real sources of PLS returns for the investors, thereby replacing the current pseudo conventional fixed returns offered by several so called Islamic and Micro Financial Institutions. An alternative to reinvest may also be provided to promote further growth of entrepreneurial venture itself. Similarly Insurance models based on Takaful ways of risk sharing needs to be promoted to ensure promotion of goodwill and sense of security and protection to members of society aiming to achieve common goals but are hesitant to accept challenges of uncertainties in their ventures.

Apart from above suggested reforms, there is a need for paradigm shift on several contentious practices existing within Islamic societies. Aligned to the discussion on charities and economic alleviation, one such contested matter is the utilization of Zakah fund. While charitable funding and altruistic acts in form of Zakah by members of society promote adherence to Shariah requirements for a Muslim, decentralized Shariah authorities differ in their verdict on utilization of Zakah funds. Many authorities promote use of Zakah fund to advance religious cause and to support basic necessities of needy members of society. However wider outcomes of such approaches terminate in creation of dependency and lack of commitment to uplift human honor. Some schools of thought also suggest the use of Zakah funds to write-off bad debts from balance sheets of Islamic Finance Institutions, consequences of which inturn fall in line with evils of bailouts promoted by existing conventional financial systems. Instead, a paradigm shift may be proposed at utilization of these funds to support several micro finance institutions and not for profit organizations that play crucial role in supporting socio-economic activities that create integrated and sustainable development of these less privileged members of the society. Such efforts remain strictly in adherence to the guiding principles of Islam.

Within the peripheries of moral and ethical framework of Shariah, Islamic finance can provide a growth oriented and forward looking financial system to the world economy. However the success of the proposed system shall only be possible if there is a desire and serious commitment on part of each and every stakeholder to accept and effect necessary paradigm shift beneficial to strengthen the foundations of the proposed Islamic finance framework. There are several inherent inconsistencies and issues that require further research and consensual

approach by various stakeholders and the current study can provide distinct guidance in marking a difference to these efforts.

## 6. Conclusion

While critics of Islamic banking and innovators of conventional financial framework are attempting to bring the framework of Islamic banking in lines with the conventional financial framework, there is a need to understand and portray the true essence of ethical financial structure based on Islamic principles. There is a need to create a paradigm shift in the way Islamic Finance is perceived and a need for wider understanding of Shariah laws which form quintessence of Islamic economics. There are issues of authority and so framed lack of innovative thinking that lag Islamic banking vis-a-vis conventional banking framework. Having claimed that, there is a genuine need for Islamic Finance Industry to stop mis-selling and disguising investors by luring them to invest in innovated Islamic financial products merely wrapped in Islamic form but in essence are mere replications of conventional financial products. Also there is a dire need to provide equal opportunity and adequate regulatory framework to support the growth of socio-ethical financial structure promoted by Islamic financial system. Such an effort shall require active co-operation and support from developed economies, which have frequently bailed avarice of the capitalist conventional system. Rather than wasting costly resources at bailing the existing inequitable capitalist system mainly held responsible for most of the financial crisis in the world, It shall be more prudent to invest in promoting ethical financial structures that can develop the roots of prosperity and opportunity for sustainable development of entire society. This is indeed a long term solution that shall require serious efforts from all stakeholders without prejudices. Unless there is a serious effort being made to create a desired paradigm shift in deriving proper understanding of financial framework based on Islamic principles of ethics and equity, deepening of ethical banking model derived through Shariah principles is a dream far from realization.

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