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Muhammad Mahmood Shah Khan

iib.dir@umt.edu.pk
Director, Institute of Islamic Banking
University of Management and Technology
Johar Town, Lahore-54770, Pakistan

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معهد المصارف الاسلامية

مجلة تعنى بالشوؤن المصرفية الاسلامية

Islamic Banking and Finance Review

Volume 1, Number 1, 1435H/2014

وَلَا تَأْكُلُوٓا۟ أَمْوَٰلَكُم بَيْنَكُم بِٱلْبَٰطِلِ وَتُدْلُوا۟ بِهَآ
إِلَى ٱلْحُكَّامِ لِتَأْكُلُوا۟ فَرِيقًا مِّنْ أَمْوَٰلِ ٱلنَّاسِ بِٱلْإِ
ثْمِ وَأَنتُمْ تَعْلَمُونَ

And eat up not one another's property unjustly (in any illegal way e.g. stealing, robbing , deceiving, etc.) nor give bribery to the rulers (judges before presenting your cases) that you knowingly eat up a part of the property of others sinfully.

Surah al-Baqarah* 2:188

ٱلَّذِينَ يَأْكُلُونَ ٱلرِّبَوٰا۟ لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ ٱلَّذِى
يَتَخَبَّطُهُ ٱلشَّيْطَٰنُ مِنَ ٱلْمَسِّ ۚ ذَٰلِكَ بِأَنَّهُمْ قَالُوٓا۟ إِنَّمَا ٱلْبَيْعُ
مِثْلُ ٱلرِّبَوٰا۟ ۗ وَأَحَلَّ ٱللَّهُ ٱلْبَيْعَ وَحَرَّمَ ٱلرِّبَوٰا۟

Those who eat *Riba* (usury) will not stand (on the day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is only like *Riba* (usury)." Whereas Allah has permitted trading and forbidden *Riba* (usury).

Surah al-Baqarah* 2:275

هذه المجلة تحتوي على آيات قرآنية كريمة
لذلك يجب احترام صفحاتها وعدم وضعها في مكان غير لائق بعد قراءتها

The publication carries quotations form al-Qur'an al-Karim and ahadith (traditions) of the prophet (blessings of Allah and peace be on him). Please ensure their sanctity. The pages on which such quotations appear should be disposed of in the proper Islamic manner.

*****Al-Hilali, Muhammad Taqi-ud-Din, and Muhammad Moshin Kahn. *Translation of the Meanings of the Noble Qur'an in the English Language.* King Fahd Complex for the Printing of Holy Qur'an. Madinah al-Munawwarah, 1419AH/1998CE.

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Rector's Message

The University of Management and Technology (UMT) has come a long way over a short span of time as a wide-ranging disciplines providing university on most modern lines. The university is set on the threshold of breaking in to a new era of growth and success with the aim to be among the best seats of higher learning. With the award of W4 category by the Higher Education Commission (HEC) of Pakistan, UMT is in right direction to take place among the institutions of higher learning and has won privileged distinction both in the country and abroad. UMT offers quality yet accessible higher education not only in the traditional fields but also in the emerging disciplines to meet current and future national needs.

The Institute of Islamic Banking (IIB) is one of the best examples of such emerging area of present needs. The IIB is an educational research oriented institute with the objective of promoting intellectual, logical and scientific thoughts and discussions on principles of Islam in application of Islamic banking and finance. The institute construes the Islam teachings in the framework of conventional banking development of the modern world and the foundation of such institute will give us an opportunity to pay tribute to the wealth of knowledge that comes with Islamic visualization and will help us translate it in action. The institute opens its doors to the scholars and bankers who wish to pursue academic Islamic studies at wide and are eager to know the true teachings of Islamic religion. The institute has a conducive environment that enables researchers to carry out a broad survey of the fundamentals of Islamic banking studies and ethics.

My primary concern, as Rector, is to ensure that IIB maintains its high standards and academic status and that we continue to attract the best students and staff from around the world. I congratulate all and specially the team of IIB for the initiative and wish them success in the running of institute. I hope that you will find it interesting and informative. Come join us on this exciting journey into the future to share our enthusiasm of introducing Islam in conventional financial and economic systems.

Dr. Hasan Sohaib Murad

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EPISTEMOLOGICAL FOUNDATION OF FINANCE: ISLAMIC AND CONVENTIONAL*

Abbas Mirakhor
First Holder, INCEIF Chair of Islamic Finance
International Centre for Education in Islamic Finance (INCEIF)
Kuala Lumpur, Malaysia
abbasmirakhor@inceif.org

Edib Smolo
Coordinator of Islamic Capital Market Unit
International Shari'ah Research Academy for Islamic Finance
(ISRA), Kuala Lumpur, Malaysia
edib@isra.my or hfz.edib@gmail.com

Abstract

The main purpose of this paper is to trace epistemological roots of conventional and Islamic finance. Based on an extensive literature review, this paper aims to highlight, explain, and discuss an ideal conventional and Islamic financial system. The ideal conventional financial system is discussed in light of various writings by Smith and Arrow, plus based on Arrow-Debreu model. On the other hand, the Islamic financial system is discussed in light of *Qur'anic* verses based on which the system is built. The findings show that the present Islamic finance industry evolved from conventional finance to address a market failure in conventional finance in terms of unmet market demand for Islamic finance products. However, since most practitioners in Islamic finance were bankers and market players from the conventional background, they developed, more often than not, products that are similar to conventional ones albeit with *Shari'ah* compatibility. Hence, the focus was primarily on avoiding *riba* while ignoring the first part of the verse 275 of *surah al-Baqarah* which first ordains exchange contracts. A way forward, hence, would be to move towards more risk-sharing products which indicate a robust link between the strength of the financial system and economic growth.

Keywords: Epistemology, Arrow-Debreu, Conventional finance, Islamic finance, *Shari'ah*-compliant, Risk-sharing, Uncertainty, Debt, Interest

*An earlier, longer version of this paper was presented at the Second Foundation of Islamic Finance Conference: "Islamic Banking Products: Theory, Practice and Issues." Organized by Universiti Putra Malaysia, Kuala Lumpur, Malaysia, 8-10 March 2011.

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Introduction

Simply stated, epistemology deals with the question of what we know about a phenomenon and how do we know it. For precision, it is helpful to clarify terms used currently in discussions of Islamic finance. The practitioners use the term Islamic finance industry to refer their activities in designing and trading "*Shari'ah*-compliant" ways and means of financing. Taxonomically, industries in an economy belong to a sector and sectors belong to subsystems which in turn belong to a larger system. For example, airplane manufacturing industry belongs to airline-industry sector which, in turn, belongs to the transportation subsystem and this belongs to an overall system. Similarly, a bank belongs to a banking industry which belongs to the financial sector which belongs to the financial subsystem which belongs to the larger economic system which, finally, belongs to an overall socio-political-economic system. What then of Islamic finance industry?.

Before the inception of Islamic finance industry, there was what could be called a "market failure" in the conventional financial system. There was substantial unmet demand for *Shari'ah*-compliant financial products. Islamic finance industry grew out of the conventional finance to meet this demand. Muslim scholars writing mostly since the 1970s about Islamic finance focused on development of an Islamic finance system; they not only emphasized elimination of *riba* contracts but urged their replacement with risk-sharing contracts. The practitioners, most of whom had been operating in the conventional finance, were however interested in developing ways and means of finance that, while *Shari'ah*-compatible, would be familiar to and accepted by market players in the conventional finance. The former emphasized Profit-Loss Sharing (PLS), the latter focused on traditional methods of conventional finance centered on risk transfer and risk shifting. In doing so, all financial instruments of conventional finance became subject to replicating, retrofitting and reverse engineering for *Shari'ah* compatibility. This paper argues that there are two ideal financial systems based on risk sharing, conventional and Islamic, and one actual conventional system focused on risk transfer. There are two industries within the actual system; conventional and Islamic finance industries. The paper then proceeds to discuss the epistemology and the main characteristics of each of the two ideal systems. Finally, the paper will discuss the present state of Islamic finance, challenges it faces, and prospects for the future.

Epestimology of Conventional and Islamic Finance

An overall socio-political-economic system gives rise to an economic system out of which grows a system of financing to facilitate production, trade and exchange. The idea of the contemporary conventional economic system is usually traced to Adam Smith's conception of an economy as envisioned in his book, *The Wealth of Nations*. What has been ignored until recently, however, is the fact that, from an epistemological point of view, Smith's vision of the economy is embedded in his vision of a moral-ethical system that gives rise to the economy envisioned in *The Wealth of Nations*. That moral-ethical system was well-described in Smith's book: *The Theory of Moral Sentiments* which preceded his *Wealth of Nation* by a decade (Mirakhor & Askari, 2010; Mirakhor & Hamid, 2009).

Whereas conventional economics considered Smith's notion of "invisible hand" as a coordinator of independent decisions of market participants, in both *The Theory of Moral Sentiments* and in The *Wealth of Nations* the metaphor refers to the design of the Supreme Creator "who arranged the connecting principles such that the actions of all those seeking their own advantage could produce the most efficient allocation of resources, and thus the greatest possible wealth for the nation. This is indeed a benevolent designer" (Evensky, 1993, p. 9). Smith contended that the objective of the Devine Design must have been the happiness of humans "when he brought them into existence. No other end seems worthy of that supreme wisdom and divine benignity which we necessarily ascribe to him ..." (Smith, 2006, pp. 186-189). Major contribution of Smith in his *Theory of Moral Sentiments* is to envision a coherent moral-ethical social system consistent with the Supreme Creator's design and how each member of society would enforce ethical positions. Recognition of human frailties led Smith to recognition of need for an organic co-evolution of individual and society in a stage-wise process of accumulation of ethical system of values from one generation to next. While it is possible for any given society to move forward or stagnate and even regress, the benevolence of the invisible hand of the "Author of nature" guides the totality of humanity in its movement toward the ideal human society. Compliance with and commitment to a set of values – virtues of prudence, concern for other people, justice and benevolence – would insure social order and cohesion (Askari, Iqbal, & Mirakhor, 2010; Askari, Iqbal, Mirakhor, & Krichenne, 2010; Mirakhor & Hamid, 2009; Smith, 2006).

Smith and Arrow

It was not until the second half of the last century when attempts were made to present a particular conception of Smith's vision of the economy. This conception saw the economy as a market system guided by the "invisible hand" toward smooth functioning, coordinating "authonomous individual choices in an interdependent world" (Evensky, 1993). Two such attempts were the works of Arrow and Debrau (1954)(1954)(1954) and Arrow and Hahn (1971) that sought to show "that a decentralized economy motivated by self-interest" would allocate resources, such that it "could be regarded, in a well-defined sense, as superior to a large class of possible alternative dispositions …" (Arrow & Hahn, 1971, pp. vi-vii). These attempts focussed primarily on Smith's idea of a decentralized market economy but in the process it abstracted from much of the well-spring of his thoughts represented by the societal framework emphasizing moral-ethical values envisioned in *The Theory of Moral Sentiments*.

The work of Arrow-Debreu (1954) is fundamentally about optimal risk sharing in a decentralized market economy. It addresses the question of how best to allocate risk in an economy. The answer is that risk should be allocated to those who can best bear it. The work abstracted from the underlying institutional structure envisioned by Adam Smith in *The Theory of Moral Sentiments* and *The Wealth of Nations*. It appears that Arrow-Debreu took for granted the existence of such institutions as property rights, contracts, trust, rule of law, and moral-ethical values. Two key assumptions of this work were complete contracts and complete markets. By the former it was meant that it was possible to design contracts such that all contingencies were covered. The latter assumption meant that there was a market for every conceivable risk. Crucially, all future payoffs were contingent on specific outcomes. Arrow-Debreu model did not include fixed, predetermined rates of interest as payoffs to debt contracts. Subsequent to his seminal work with Debreu, Arrow made it clear that, while not stated explicitly in his work with Debreu and with Hahn, he envisioned it "possible that the process of exchange requires or at least is greatly facilitated by the presence of several ... virtues (not only truth, but also trust, loyalty and justice in future dealings ... The virtue of truthfulness in fact contributes in a very significant way to the efficiency of the economic system …

ethical behaviour can be regarded as socially desirable institution which facilitates the achievement of economic efficiency in a broad sense" (Arrow, 1971, pp. 345-346). For example, if the institution of trust is strong in an economy, the universe of complete contracts can be replicated by simple contracts entered into by parties stipulating that terms and conditions of the contracts would be revised as contingencies arise. Arrow himself was to place emphasis on trust as the lubricant of the economy (Arrow, 1974). Despite Arrow's attention to some important elements of the institutional structure that were integral to Smith's vision of an economy, such as its value system, the economics profession developed its own vision of that economy focusing primarily on two concepts of "invisible hand" and "self interest." The first was mentioned only once in *The Wealth of Nations* (see Smith, 1976, p. 456) and the manner in which the second was used by economists has been referred to by Vivian Walsh (2000) as "vulgar … misunderstanding" of what Smith meant by "self interest". This "narrowing" of Smith's view has been subject to rather sharp criticism by Amartya Sen (Sen, 1977, 1987) who suggests that: "Indeed, it is precisely the narrowing of the broad Smithian view of human beings in modern economics that can be seen as one of the major deficiencies of contemporary economic theory. This impoverishment is closely related to the distancing of economics from ethics" (Sen, 1987).

A careful reading of Moral Sentiments and The Wealth of Nations provides immense support for Sen's position. Even beyond Sen's spirited criticism of economists' misunderstanding of Smith's self-interest motive is the latter's insistence on the need to comply with "general rules of conduct" that "are the commands and laws of the Deity, who will finally reward the obedient, and punish the transgressor of their duty … When the general rules which determine the merit and demerit of actions comes thus to be regarded as the laws of an all-powerful being, who watches over our conduct, and who, in a life to come, will reward the observance and punish the breach of them – they necessarily acquire a new sacredness from this consideration. That our regard to the will of Deity ought to be the supreme rule of our conduct can be doubted of by nobody who believes his existence. The very thought of disobedience appears to involve in it the most shocking impropriety. How vain, how absurd would it be for man, either to oppose or to neglect the commands that were laid upon him by infinite wisdom and infinite power. How unnatural, how impiously ungrateful not to reverence the precepts that were prescribed to him by the infinite goodness of his Creator, even though no punishment was to follow their violation! The sense of propriety, too, is here well supported by the strongest motive of self-interest. The idea that, however, we may escape the observation of man, or be placed above the reach of human punishment, yet we are always acting under the eye and exposed to the punishment of God, the greatest avenger of injustice, is a motive capable of restraining the most headstrong passions, with those at least who, by constant reflection, have rendered it familiar to them" (Smith, 2006, pp. 186-189).

Consideration of the above quotation as well as the rest of *The Moral Sentiments* leads to, at least, three observations. First, this is the Smith that has been ignored by the economics profession. The Smith of economics is the author of the self-interest motive that is the basis of utility and profit maximization at any cost to the society, including the impoverishment and exploitation of fellow human beings. Even his most ardent of supporters, Amartya Sen, has ignored the Smith of the above quotation. Second, Smith makes clear in his *Theory of Moral Sentiments* that compliance with the rules prescribed by the Creator and with the rules of the market was essential to his vision. Third, it is also clear that Smith considers the internalization of rules – being consciously aware of ever-presence of the Creator and acting accordingly - as crucial to all human conduct, including economics. Smith succinctly and clearly shares some of the fundamental institutional scaffolding of Islam: belief in One and Only Creator; belief in accountability of the Day of Judgement; belief in the necessity of compliance with the rules prescribed by the Creator; and belief that justice is achieved with full compliance with rules. To paraphrase Sen, no space need be made artificially for justice and fairness; it already exists in the rules prescribed by the Law Giver.

Arrow-Debreu Economy

An economy in which there are contingent markets for all commodities – meaning that there are buyers and sellers who promise to buy or sell given commodities "if and only if" a specified state of the world occurs – is called an Arrow-Debreu economy. In such an economy, it is the budget constraint of the participants that determines how much of each contingent commodity at prices prevailing in the market they can buy. Since these commodities are contingent on future states, they are risky. Therefore, the budget constraint of individuals determines the risk-bearing ability of each market participant. Arrow himself recognized that requiring such a market is unrealistic. "Clearly, the contingent commodities called for do not exist to extent required, but the variety of securities available on the modern markets serve as a partial substitute" (Arrow, 1971). Such securities, referred to as Arrow Securities whose payoffs could be used to purchase commodities, would reduce the number of markets required while replicating the efficiency of risk allocation of complete contingent markets. Associated with complete markets are complete contracts. These are agreements contingent on all states of nature. In the real world, not all contracts can cover all future contingencies. Therefore, they are said to be incomplete contracts and may indicate inefficiencies in exchange. However, as suggested above, optimal contracts can be devised provided there is mutual trust between the parties to the contract. That would be a simple contract with provisions for modification of terms and conditions should contingencies necessitate change.

A compelling case can be made that in so far as the financial instruments are Arrow Securities, i.e., their payoff is contingent on the "state of nature", that is, depend on the outcome, not fixed, predetermined, and represent risk sharing, this ideal system would have many characteristics of an ideal Islamic system (Mirakhor, 1993). However, not all Arrow Securities would satisfy *Shari'ah* requirements as some may well represent contingent debt contracts to deliver a fixed predetermined amount of money if a given state of world occurs. These may not, therefore, represent an ownership claim either. Shares of common stock of open corporations do meet these requirements. They are residual ownership claims and receive a returns contingent on future outcomes; they are "proportionate claims on the payoffs of all future states" (Fama & Jensen, 1983). These payoffs are contingent on future outcomes. Stock markets that are well-organized, regulated and supervised are efficient from an economic point of view because they allocate risks according to the risk-bearing ability of the participants. In essence, this is the contribution of Arrow-Debreu model of competitive equilibrium (Arrow, 1971; Arrow & Debreu, 1954), according to which, efficient risk sharing requires that the risk of the economy are allocated to market participants in accordance with their "respective degree of risk tolerance" (Hellwig, 1998).

From Ideal to Actual: Conventional Finance

As mentioned earlier, what Arrow-Hahn and Arrow-Debreau set out to do was analytically rigorous demonstration of the proposition that an "imposing line of economists from Adam Smith to the present have sought to show that a decentralized economy motivated by self-interest … would be compatible with a coherent disposition of economic resources that could be regarded, in a well-defined sense, as superior to a large class of possible alternative disposition …" (Arrow & Hahn, 1971, pp. vi-vii). But, as Evensky suggests, "the Smithian story told by Arrow and Hahn – and they are representative of modern economists – is an abridged edition. The spring that motivates action in Smith's story has been carried forward, but much of the rest of his tale has been forgotten" (Evensky, 1987, 1993). It can be argued, as Arrow (1971) himself seems to imply, that the "rest of" Smith's "tale" would have been his vision of the institutional infrastructure (rules of behaviour) that is envisioned in *The Theory of Moral Sentiments*, and, as such, abstracting from them would be unlikely to change the outcome of the mathematical analysis of Arrow-Debreu and/or Arrow-Hahn. Furthermore, had actual finance developed along the trajectory discernible from these works, i.e., steps taken toward completion of markets and of contracts, keeping in mind the overall institutional framework for the economy as envisioned by Adam Smith, the result might have been emergence of conventional finance different from the contemporary system. That system would instead be dominated by contingent, equity, risk-sharing financial instruments.

Perhaps the most influential factor in derailing that trajectory is the existence and the staying power of a fixed, predetermined rate of interest for which there has never been a rigorous theoretical explanation. All, so called, theories of interest from the classical economists to contemporary finance theories explain interest rate as the price that brings demand for and supply of finance into equilibrium. This clearly implies that interest rates emerge only after demand and supply forces have interacted in the market and not *ex ante* prices. In fact, in some theoretical models there is no room for a fixed, *ex ante* predetermined rate of interest. For example, introducing such a price into the Walras or Arrow-Debreu-Hahn models of general equilibrium (GE) leads to the collapse of the models as they become over determined. As Cowen suggests: "since the prices of all goods, whether present or future, are already specified by our set of Arrow-Hahn-Debreu equations, to now impose a discount rate on the economy (however derived) would over determine our system of equations. Hence, the interest rate is not the prices of capital goods or durable consumption goods. Instead, the own rates of return are given by the intertemporal price ratios we examine. Not only can there be no explanation of own interest rates that are not dependent upon our explanation of relative prices, but there can be no explanation of own interest rates which are not identical to our description of intertemporal relative prices ... However, if the goods are located in different time periods, then they must be considered different goods … The logical status of a theory of interest across different goods is rather dubious – how is it any different from a theory of "interest" which compares the price of apples to price of oranges? … Once we define the interest rate as the set of intertemporal price ratio percentages, GE (general equilibrium) theory losses its ability to tell us anything specific about the magnitude of interest rates. These rates may be positive, negative, or even zero. Most likely, our system of equations will simultaneously contain all three possibilities as solutions" (Cowen, 1983, pp. 609-611).

Even though no satisfactory theory of a positive, *ex ante* fixed rate of interest exists, all financial theory development post Arrow-Debreu-Hahn assumed its existence in the form of a risk-free asset, usually Treasury Bills, as a benchmark against which the rates of return of all other assets, importantly equity returns, were measured. These include theories such as the Capital Asset Pricing Model (CAPM), Modern Portfolio Theory (MPT); and the Black-Scholes option pricing formula for valuing options contracts and assessing risk. For all practical purposes, the assumption of a risk-free rate introduced an artificial floor into the pricing structure of the real sector of the economy, and into all financial decisions. It can be argued that it is the existence of this exogenously imposed rate on the economy that transformed Arrow-Debreu vision of a risk-sharing economy and finance. The resulting system became one focused on transferring or shifting of risk rather than sharing it. Such a system needed strong regulation to limit the extent of both. However, further developments in finance theory provided analytic rationale for an ideologically aggressive deregulation. One was the Modigliani-Miller Theorem of neutrality of capital structure of firms. In essence this theorem asserted that the value of a firm is independent of its capital structure. This implied that since firms want to maximize their value and since Modigliani-Miller showed that the value of the firm is indifferent whether the firm debt finances or equity finances its capital structure, firms would prefer to incur higher debt levels for the firm rather than issue additional equity. Hence, the risk of additional debt would be shifted to other stakeholders (Jensen & Meckling, 1976).

Another was the development of the Efficient Market Hypothesis (EMH) claimed that in an economy similar to that of Arrow-Debreu, prices prevailing in the market contained all relevant information such that there would be no opportunity for arbitrage. The implication was that if market efficiency is desirable, then markets should be allowed to move toward completion, through innovation and financial engineering, in order to create a financial instrument to allow insurance against all risks. For this to happen, it had to be demonstrated that it is possible to develop such a wide array of instruments, and that regulation had to become passive or even regressive to allow an incentive structure to induce innovation. The latter was initiated in almost all industrial countries in the '80s and continued with an accelerated pace until the 2007-2008 crisis. The former had already been demonstrated by the theory of spanning developed in late 1960s and early 1970s showing that one basic financial instrument can be spanned potentially into a infinite number of instruments (Askari, Iqbal, & Mirakhor, 2010; Askari, Iqbal, Mirakhor, et al., 2010). These developments coupled with the high magnitude of leverage available from money-credit creation process characteristic of a fractional reserve banking system represented an explosive mix that reduced the vision of Adam Smith to the rubble of post crisis 2007-2008. The Arrow-Debreu vision of an economy in which first transformed risk was shared into an economy in which the focus became risk transfer but which quickly transformed into one in which risks were shifted, ultimately, to tax payers (Mirakhor & Krichene, 2009).

An Ideal Islamic Finance System

The ideal Islamic finance points to a full-spectrum menu of instruments serving a financial sector imbedded in an Islamic economy in which the institutional "scaffolding" (rules of behaviour as prescribed by Allah swt and operationalized by the Noble Messenger, including rules of market behaviour prescribed by Islam) is fully operational (Chapra, 2000; Iqbal & Mirakhor, 2007). The essential function of that spectrum would be spreading and allocating risk among market participants rather than allowing it to concentrate among the borrowing class. Islam proposes three sets of risk-sharing instruments:

(i) *mu'amalat* risk-sharing instruments in the financial sector;

(ii) redistributive risk-sharing instruments which the economically more able segment of the society utilize in order to share the risks facing the less able segment of the population; and

(iii) inheritance rules specified in the *Qur'an* through which the wealth of a person at the time of passing is distributed among present and future generations of inheritors.

As will be argued here, the second set of instruments is used to redeem the rights of the less able in the income and wealth of the more able. These are not instruments of charity, altruism or beneficence. They are instruments of redemption of rights and repayment of obligations.

The spectrum of ideal Islamic finance instruments would run the gamut between short-term liquid, low-risk financing of trade contracts to long-term financing of real sector investment. The essence of the spectrum is risk sharing. At one end, the spectrum provides financing for purchase and sale of what has already been produced in order to allow further production. At the other end, it provides financing for what is intended or planned to be produced. In this spectrum there does not seem to be room provided for making money out of pure finance where instruments are developed that use real sector activity only as virtual license to accommodate what amount to pure financial transactions. There are *duyun* and *Qard Hasan* that are non-interest based debt but only to facilitate real sector transactions in terms of consumption smoothing for those who have experienced liquidity shock. This is a case when a financier shares liquidity risk with the firms or consumers for whom the risk is materialized or who use non-interest borrowing as an insurance against liquidity shocks.

It may be argued plausibly that in a modern complex economy, there is need for a variety of ready-to-use means of liquidity, and so long as instruments – being developed – are, in the judgement of *Shari'ah* scholars, permissible where is the harm? Usually, this argument starts with the reasoning that financial instruments that serve short-term, trade-oriented transaction contracts, such as *murabahah*, are permissible. From there, the argument goes that any instrument with connection, no matter how tenuous, to the real sector transactions is also permissible. It is worth noting that transaction contracts permissible in Islam and the financial instruments intended to facilitate them are not the same thing. Islamic real sector transactions contracts (*'uqud*) that have reached us are all permissible. However, it is possible that a financial instrument designed to facilitate a given permissible contract may itself be judged non-permissible. As the proliferation of derivative instruments in the period of run up to the global financial crisis demonstrated, the number of financial instruments that have some relation, even if only nominal, to a real sector transaction is limited only by the imagination of financial engineers. This is the essence of the theory of spanning developed in finance in the late 1960s and early 1970s which led to the design and development of derivatives (see Askari, Iqbal, & Mirakhor, 2010; Askari, Iqbal, Mirakhor, et al., 2010). It is possible that a financial instrument may have weaker risk-sharing characteristic than the Islamic transaction contract it intends to serve.

Since Islamic finance is all about risk sharing, then the risk characteristics of a given instrument needs to become paramount in decisions. One reason, *inter alia*, for non-permissibility of the contract of *al-riba* is surely due to the fact that this contract transfers all, or at least a major portion, of risk to the borrower. It is possible to imagine instruments that on their face are compatible with the no-*riba* requirement, but are instruments of risk transfer and, ultimately, of shifting risk to tax payers. An example would be a sovereign *ijarah sukuk* based on the assets subject of *ijarah* but credit-enhanced by other means, say collateral. All costs taken into account, such a *sukuk* may well be more expensive and involve stronger risk transfer characteristic than a direct sovereign bond (see Mirakhor & Zaidi, 2007). Clearly, a judgement call needs to be begged of the financiers and financial engineers when they design and develop an instrument to consider its risk-sharing characteristic. This is a call with which *fiqh* alone should not be overburdened. Financiers and financial engineers should assure of the risk-sharing characteristics of instruments they present to *fuqaha* for approval. *InshaAllah*, *fiqh* will catch up with modern finance as well as with the intricacies of risk and uncertainty.

It appears that at the present, the energies of financiers and financial engineers are focused on the design and development of instruments to accommodate the low-end of time and risk-return, liquid transactions. Without effort at developing long-term investment instruments with appropriate risk-return characteristics, there is a danger of emergence of path-dependency where the market will continue to see more – albeit in greater variety – of the same. That is more short-term, liquid and safe instruments. This possibility should not be taken lightly. After all, as mentioned earlier, since early 1970s finance has been quite familiar with the theory of spanning. According to this idea, an infinite number of instruments can be "spanned" out of a basic instrument. This is what led to the explosion of derivatives which played an influential role in the recent global financial disasters. At one point it was estimated that in 2007, the total financial instruments, mostly derivatives, in the world was 12.5 times larger than the total global GDP. Similar development could be awaiting Islamic finance if the ingenuity of financial engineers and the creative imagination of *Shari'ah* scholars continue to serve the demand-driven appetite for liquid, low risk, and short-term instruments. In that case, the configuration of Islamic finance would have failed to achieve the hopes and aspirations evoked by the potential of the ideal Islamic financial system.

Epistemology of an Ideal Islamic Finance System

The fountainhead of all Islamic thought is the *Qur'an*. Whatever the theory of Islamic knowledge may be, any epistemology, including that of finance, must find its roots in the *Qur'an*.

The starting point of this discussion is therefore Verse 275 of Chapter 2 of the *Qur'an*, particularly the part of the Verse that declares contract of *al-Bay'* permissible and that of *al-riba* non-permissible. Arguably, these few words can be considered as constituting the organizing principle – the fundamental theorem as it were – of the Islamic economy. Most translations of the *Qur'an* render *al-Bay'* as "commerce" or "trade". They also translate "*at-Tijarah*" as "commerce" or "trade". Consulting major lexicons of Arabic (see among others Al-Isfahani, 1992; Al-Mustafaoui, 1995; Ibn Mandhoor, 1984; Lane, 2003) reveals that there is substantive difference between *al-Bay'* and *at-Tijarah*. Relying on various verses of the *Qur'an* (e.g. verse 254: chapter 2; 111:2; 29-30:35; 10-13:61) these sources suggest that trade contracts (*at-Tijarah*) are entered into in the expectation of profit (*ribh*). On the other hand, *al-Bay'* contracts are defined as "*Mubadilah al-Maal Bi al-Maal*": exchange of property with property. In contemporary economics it would be rendered as: exchange of property rights claim.

These sources also suggest a further difference in that those who enter into a contract of exchange expect gains but are cognizant of probability of loss (*khisarah*).

It is worth noting also that all Islamic contractual forms, except spot exchange, involve time. From an economic point of view, time transactions involve a commitment to do something today in exchange for a promise of a commitment to do something in the future. All transactions involving time are subject to uncertainty and uncertainty involves risk. Risk exists whenever more than one outcome is possible. Consider for example a contract in which a seller commits to deliver a product in the future against payments today. There are a number of risks involved. There is a price risk for both side of the exchange; the price may be higher or lower in the future. In that case the two sides are at risk which they share once they enter into the contract agreement. If the price in the future is higher, the buyer would be better off and the price risk has been shed to the seller. The converse is true if the price is lower. Under uncertainty, the buyer and seller have, through the contract, shared the price risk. There are other risks that the buyer takes including the risks of non-delivery and quality risk. The seller, on the other hand, also faces additional risks including the risk that the price of raw material may be higher in the future, and transportation and delivery cost risk. This risk may also be lower. Again, these risks have been shared through the contract. The same argument applies to defer payment contracts.

Second, it may appear that spot exchange or cash sale involves no risk. But price changes post-completion of spot exchange are not unknown. The two sides of a spot exchange share this risk. Moreover, from the time of the classical economists it is known that specialization through comparative advantage provides the basis for gains from trade. But in specializing, a producer takes a risk of becoming dependent on other producers specialized in production of what he needs. Again, through exchange the two sides to a transaction share the risk of specialization. Additionally, there are pre-exchange risks of production and transportation that are shared through the exchange. It is clear that the other contracts at the other end of the spectrum of Islamic contracts, i.e. *mudarabah* and *musharakah*, are risk sharing transactions. Therefore, it can be inferred that by mandating *Al-Bay'*, Allah swt ordained risk-sharing in all exchange activities.

Third, it appears that the reason for the prohibition of the contract of *al-riba* is the fact that opportunities for risk sharing are non-existence in this contract. It may be argued that the creditor does take risk – the risk of default. But it is not risk taking per se that makes a transaction permissible. A gambler takes risk as well but gambling is *haram*. Instead what seems to matter is opportunity for risk sharing. *al-riba* is a contract of risk transfer. As Keynes emphasized in his writing, if interest rate did not exist, the financier would have to share in all the risks that the entrepreneur faces in producing, marketing and selling a product (see Mirakhor & Krichene, 2009). But by decoupling his future gains, by loaning money today for more money in the future, the financier transfers all risks to the entrepreneur. Fourth, it is clear that by declaring the contract of *al-riba* non-permissible, the *Qur'an* intends for humans to shift their focus to risk sharing contracts of exchange.

It appears – and Allah knows best – that it can be inferred from the above discussion that there are two types of contracts involving time;

(i) contracts over time (or on spot) involving trade in which there is expectation of gain (*ribh*); and

(ii) contracts over time involving exchange in which there is expectation of gain or loss (*khisarah*).

The latter must refer also to contracts of investment with uncertain outcome in terms of gain or loss. This, of course, does not mean that *mudarabah* and *musharakah* could not be used for longer-term trade in expectations of profits to be shared and for long-term investment as was the case for centuries in the Muslim world as well as in Europe in the Middle Ages. Borrowed from Muslims and known as *commenda* in Western Europe, *mudarabah* became quite popular as means of financing long-term trade and investment (Al-Hassani & Mirakhor, 2003; Brouwer, 2005; Fischel, 1933; Mirakhor, 1983; Udovitch, 1967, 1970a, 1970b). Lopez (1976) suggests that there is a consensus among Medieval historians that the *commenda* was of the highest importance and contributed greatly to the fast growth of trade and investment which led to economic change and growth in Europe. *Commenda*'s contribution to industrial development of Ruhr Valley in Germany and in building railroads in Europe were particularly pronounced (Mirakhor, 1983). Therefore, what needs emphasis is that *al-bay'* covers long-term investment contracts that allow the growth of employment and income and expansion of the economy. The focus of *at-tijarah* and all its financing instruments is trade of commodities already produced. In effect, Islam meets the financing needs of trade as well as the requirements of resource allocation, investment, production, employment, income creation, and risk management.

Given the above, major economic implications follow. First, as the definition of *al-bay'* indicates, it is a contract of exchange of property. This means that the parties to exchange must have property rights over the subjects of contract antecedent to the exchange. Second, parties must have the freedom not only to produce what they wish but also with whom they wish to exchange. Third, parties must have freedom to contract. Fourth, there must be means of enforcing contracts. Fifth, exchange requires a place for the parties to complete their transactions, meaning a market. Sixth, markets need rules of behaviour to ensure an orderly and efficient operation. Seventh, the contract of exchange requires trust among the parties as to commitments to perform according to the terms and conditions of exchange. Eighth, there must be rules governing the distribution of proceeds. Ninth, there must be redistributive rules and mechanisms to correct for pattern of distribution emerging out of market performance. These are rules that govern the redemption of the rights of those who are not parties to the contract directly but who have acquired rights in the proceeds because, one way or another, they or their properties have contributed to the production of what is the subject of exchange. These implications are discussed below.

Property Rights

Briefly, the Principles of Property rights in Islam include:

(i) Allah swt has created all property and He is the ultimate owner;

(ii) Resources created by Allah swt are at the disposal of all humans to empower them to perform duties prescribed by the Creator;

(iii) While the ultimate ownership is preserved for the Creator, humans are allowed to combine their physical and intellectual abilities with the created resources to produce means of sustenance for themselves and others;

(iv) The right of access to resources belongs to all of mankind universally;

(v) Humans can claim property rights over what is produced through their own labour or transfers through gift giving, exchange, contracts, inheritance or redemption of rights in the produced property;

(vi) Since created resources belong to all humans, the inability of a person (physical, mental or circumstances) to access these resources does not negate the individual's right to these resources;

(vii) These rights have to be redeemed – this establishes the rule of sharing with the less able;

(viii) Sharing is implemented through redistributive mechanisms, such as *zakah*, which are redemption of rights and not charity;

(ix) Since work and transfers are the only sources of property rights claims, all sources of instantaneous property rights creation, such as theft, bribery, gambling and *riba* are prohibited;

(x) Unlike, the conventional system of property rights, Islam imposes strict limits on the freedom of disposing of property; there is no absolute freedom for the owner to dispose of property as there are rules against extravagance, waste, destruction of property or its use in prohibited transactions;

(xi) Property rights must not lead to accumulation of wealth as the latter is considered the life blood of the society which must constantly circulate to create investment, employment, income and economic growth opportunities; and

(xii) Once the principles governing property rights are observed, particularly the rule of sharing, the owner's right to the remaining property, cleansed of others' rights, is inviolate.

It is through its rules of property rights that Islam envisions economic growth and poverty alleviation in human societies. The latter is accomplished through the discharge of the obligation of sharing derived from the property rights principles which envision the economically less able as the silent partners of the more able. In effect, the more able are trustee-agents in using resources created by Allah swt on behalf of themselves and the less able. In contrast to property rights principles of the conventional system, here property rights are not means of exclusion but of inclusion of the less able in the income and wealth of the more able as a matter of rights that must be redeemed. In the conventional system, rich help the poor as a demonstration of sympathy, beneficence, benevolence and charity. In Islam, the more able are required to share the consequences of the materialization of idiosyncratic risks – illness, bankruptcy, disability, accidents and socio-economic disadvantaged – for those who are unable to provide for themselves. Those who are more able diversify away a good portion of their own idiosyncratic risks using risk-sharing instruments of Islamic finance. The economically well off are commanded to share risks of those who are economically unable to use the instruments of Islamic finance. It can be argued plausibly that unemployment, misery, poverty and destitution in any society are prima facie evidence of violation of property right rules of Islam and/or non-implementation of Islamic instruments of risk sharing. In Islam the risks that would face the future generations are shared by the present generation through the rules of inheritance. These rules break up the accumulated wealth as it passes from one generation to another to enable sharing risks of a larger number of people.

Contracts and Trust

Basically, a contract is an enforceable agreement. Its essence is commitment. Islam anchors all socio-political-economic relations on contracts. The fabric of the *Shari'ah* itself is contractual in its conceptualization, content and application. It's very foundation is the primordial covenant between the Creator and humans (see verses 172-173: chapter 7). In an unambiguous verse (152:6), the *Qur'an* urges the believers to fulfil the covenant of Allah. This is extended to the terms and conditions of all contracts through another clear verse (1:5) in which believers are ordered to be faithful to their contracts. They are ordered to protect faithfulness to their covenants and what has been placed in trust with them as a shepherd protects sheep (8:32; also 34:17; 172:2; 91-92:16). Thus, believers do not treat obligations of contracts lightly; they will take on contractual obligations only if they intend fully to fulfil them. Hence, their commitments are credible.

Contracts are means of coming to terms with future risks and uncertainty. They allocate risks by providing for future contingencies and set obligations for each party and each state in the future as well as remedies for breach of contracts. Generally, there are three motives for entering into a contract: to distribute risk (via sharing of risk, transfer of risk or shifting of risk), to align incentives, or to minimize transaction costs. *Mudarabah*, *musharakah*, and the purchase of equity shares are examples of risk sharing. Entering into an insurance contract is an example of transferring risks for a fee to those who can better bear them. Risk shifting occurs when the risks of a transaction or a contract between two parties are shifted to a third party. This concept was discussed by Jensen and Meckling (1976)(1976)(1976)(1976)(1976)(1976) in the context of corporate managers resorting to debt finance instead of issuing additional equity, thus shifting the risk of debt burden to other stakeholders. To align incentives, one party (usually the principle) enters into a contract with another (an agent) through which incentives are created for the latter to take actions that serve their joint-surplus maximization objective (Hart & Holmstrom, 1987). Contracts that are designed to reduce transaction costs are usually aimed at establishing stable, long-term relationship between parties in order to avoid *ex ante* information, search and sorting costs as well as *ex post* bargaining costs (Goldberg, 1985).

There is an organic relationship between contract and trust. Without the latter, contracts become difficult to negotiate and conclude and costly to monitor and enforce. When and where trust is weak, complicated and costly administrative devices are needed to enforce contracts. Problems are exacerbated when, in addition to lack of trust, property rights are poorly defined and protected (Sheng, 2009). Under these circumstances, it becomes difficult to specify clearly the terms of contract since transaction costs – that is search and information costs, bargaining and decision costs, contract negotiations and enforcement costs – are high. Consequently, there is less trade, fewer market participants, less long-term investment, lower productivity and slower economic growth. Weakness of trust creates the problem of lack of credible commitment which arises when parties to an exchange cannot commit themselves or do not trust that others can commit themselves to performing contractual obligations. Empirical research has shown that where the problem of lack of commitment exists and is significant, it leads to disruption in economic, political and social interaction among people. Long-term contracting will not be possible and parties to exchange opt for spot market or very short-term transactions (see for example Keefer & Knack, 2005). Considering these issues, one can appreciate the strong emphasis that the *Qur'an* [as well as the Messenger (sawaws)] has placed on trust, trustworthiness (see Verse 27, Chapter 8 and 57:4) and on the need to fulfil terms and conditions of contracts, covenants, and promises one makes. These rules solve the problem of credible commitment and trust, thus facilitate long-term contracts. To illustrate the importance of trust, consider the role of complete contracts in the neoclassical theory of competitive equilibrium (Arrow, 1971). A complete contract fully specifies all future contingencies relevant to the exchange. In the real world a vast majority of contracts are incomplete. This requirement, therefore, is considered too stringent and unrealistic. Not only ignorance about all future contingencies make writing complete contracts impossible, even if all future contingencies are known, it would be nearly impossible to write a contract that can accommodate them all. However, if the parties to a contract trust each other, they can agree to enter into a simple contract and commit to revising its terms and conditions as contingencies arise.

Markets

A major reason for a contract of exchange is that the parties to the contract wish to improve upon their own pre-contract welfare. For this to happen, parties must have the freedom to contract. This, in turn implies freedom to produce which calls for clear and well-protected property rights to permit production and sale. To freely and conveniently exchange, the parties need a place to do so, i.e., a market. To operate efficiently, markets need rules of behaviour and clear unambiguous rule-enforcement mechanisms to reduce uncertainty in transaction. Markets also need free flow of information. To reinforce the efficiency of market operations, trust has to be established among participants, transaction costs to be minimized, and rules established to internalize externalities of two-party transactions. Andrew Sheng (2009, p. 9) suggests that: "Successful markets all share three key attributes: the protection of property rights, the lowering of transaction costs and the high transparency." To achieve these attributes, preconditions and infrastructures are needed including:

(i) freedom of market participants to enter and exit the market, to set their own objectives within the prescribed rules, to employ ways and means of their own choosing to achieve their goals, and to choose whomever they wish as their exchange partner;
(ii) an infrastructure for participants to access, organize and use information;
(iii) institutions that permit coordination of market activities;
(iv) institutions to regulate and supervise the behaviour of market participants; and
(v) legal and administrative institution to enforce contracts at reasonable costs.

Both the *Qur'an* and *Sunnah* place considerable emphasis on the rules of behaviour. Once instated in *Madinah*, as the spiritual and temporal authority, the Messenger (sawaws) exerted considerable energy in operationalizing and implementing the property rights rules, the institutions of the market, the rules of exchange and contracts as well as rules governing production, consumption, distribution and redistribution. He also implemented rules regarding the fiscal operations of the newly formed state as well as governance rules. Specifically regarding markets, before the advent of Islam trade had been the most importanteconomic activity in the Arabian Peninsula. A number of dynamic and thriving markets had developed throughout the area. Upon arrival in *Madinah*, the Messenger of Allah organized a market for Muslims structured and governed by rules prescribed by the *Qur'an*, and implemented a number of policies to encourage the expansion of trade and strengthen the market. Unlike the already existing market in *Madinah*, and elsewhere in Arabia, the Prophet prohibited imposition of taxes on individual merchants as well as on transactions. He also implemented policies to encourage trade among Muslims and non-Muslims by creating incentives for non-Muslim merchants in and out of *Madinah*. For example, travelling non-Muslim merchants were considered guests of the Muslims and their merchandise were guaranteed by the Prophet against (non-market) losses. The market was the only authorized place of trade. Its construction and maintenance was made a duty of State. As long as space was available in the existing one, no other markets were constructed. The Prophet designated a protective area around the market. No other construction or facility was allowed in the protective area. While trade was permitted in the area surrounding the market in case of overcrowding, the location of each merchant was assigned on a first-come, first-served basis but only for the duration of the trading day (Mirakhor & Hamid, 2009).

After the conquest of Mecca, rules governing the market and the behaviour of participants were institutionalized and generalized to all markets in Arabia. These rules included, *inter alia*, no restriction on inter-regional or international trade, including no taxation on imports and exports; free movement of inputs and outputs between markets and regions; no barrier to entry to or exit from the market; information regarding prices, quantities and qualities were to be known with full transparency; every contract had to fully specify the property being exchanged, the rights and obligations of each party to the contract and all other terms and conditions; the state and its legal apparatus guaranteed contract enforcement; hoarding of commodities were prohibited as were price controls; no seller or buyer was permitted to harm the interests of other market participants; for example, no third party could interrupt negotiations between two parties in order to influence the outcome in favour of one or the other party; short changing, i.e. not giving full weights and measure, was prohibited; sellers and buyers were given the right of annulment depending on circumstances. These rights protected consumers against moral hazard of incomplete, faulty or fraudulent information. Interference with supply before market entrance was prohibited as they would harm the interests of the original seller and the final buyer. These and other rules – such as trust and trustworthiness as well as faithfulness to the terms and conditions of contracts – reduced substantially transaction costs and protected market participants against risks of transactions (Mirakhor & Hamid, 2009).

Achieving the Ideal: Uncertainty, Risk and Equity Markets

Now that we have discussed epistemologies of both conventional and Islamic finance and that we discussed briefly about recent financial crisis and its relevance to the Islamic finance industry, it is time to discuss how we can achieve the ideal having in mind the uncertainty and risks involved in everyday life.

Uncertainty is a fact of human existence. Humans live on the brink of an uncertain future. Uncertainty stems from the fact that the future is unknown and therefore unpredictable. If severe enough, it can lead to anxiety, decision paralysis and inaction. Lack of certainty for an individual about the future is exacerbated by ignorance of how others behave in response to uncertainty. Yet, individuals have to make decisions and take actions that affect their own as well as others' lives. Making decision is one of the most fundamental capabilities of humans; it is inexorably bound up with uncertainty. Facing an unknown, and generally unknowable future, individuals make decisions by forming expectations about payoffs to alternative courses of action. They can do so using subjective estimates of payoffs to actions based on personal experiences. Alternatively, the person can use known probability techniques to form an expectation of returns to an action. Either way, the expected outcomes will form an expression in terms of probability of occurrence of consequences to an action. In other words, uncertainty is converted into risk. Risk, therefore, is a consequence of choice under uncertainty. Generally, "even in the most orderly societies the future is by no means certain. Even if an individual or organization has defined goals they must reflect their attitude toward risk. In some cases risk may be evaluated statistically … when a population is large enough, some odds can be calculated with fair accuracy as is exemplified by some calculations in life insurance area. In general, however, many of the aspects of uncertainty involve low probability or infrequent events" (Shubik, 1978, p. 124). This makes decisions difficult and actions risky. Risk exists when more than one outcome is possible. It is uncertainty about the future that makes human lives full of risks.

Risk can arise because the decision maker has little or no information regarding which state of affairs will prevail in the future, the person, nevertheless, makes a decision and takes action based on expectations. Risk can also arise because the decision maker does not or cannot consider all possible states that can prevail in the future. In this case, even if the decision maker wants to consider all possible states of the future, there is so much missing information that it is impossible to form expectations about payoffs to various courses of action. This situation is referred to "ambiguity." If severe enough, this type of uncertainty too leads to reluctance or even paralysis in making decisions. People adopt various strategy of "ambiguity aversion." One strategy is to exercise patience and postpone making decisions until passage of time makes additional "missing" information available. The *Qur'an* has many references to the need for patience so much so that in a number of verses it is said that: "*Allah is with those who are patient*" and "*Allah loves those who are patient*."

Question may arise how can existence of uncertainty and its overwhelming influence in human life be explained within the context of Islamic thought? Why is life subjected to so much uncertainty necessitating risk taking? Since Allah swt is the Creator of all things why create uncertainty? A full discussion of possible answers is beyond the task of this paper. Suffice it to say that in a number of verses the *Qur'an* makes reference to the fact that this temporary existence is a crucible of constant testing, trials and tribulations (see for example verse 155: chapter 2 and 2:76). Not even the believers are spared. In verse 2 of chapter 29 the *Qur'an* asks: "*Do humans think that they will be left alone when they say: we believe, and they therefore will not be tested?*" The fact that this testing is a continuous process reflected in verse 126 or chapter 9: "*Do they not see that they are tried every year once or twice? Even then they do not turn repentant to Allah, not do they remember*" (see also verse 155: chapter 2). To every test, trial and tribulation in their life-experience, humans respond and in doing so they demonstrate their measure of being self-aware and Allah-conscious. If the response-action is in compliance with the rules of behaviour prescribed by the Supreme Creator, that is it is "*Ahsanu 'Amala*", the "best action" (verse 7: chapter 11), meaning completely rule compliant, then the trial becomes an occasion for self development and strengthened awareness of Allah swt. Even then, uncertainty remains. No one can be fully certain of the total payoff to one's life within the horizon of birth-to-eternity. Muslims are recommended not to ever assume they are absolutely certain of the consequences of their action. They are to live in a state of mind and heart suspended between fear (*khawf*) of consequences of their actions and thoughts, and the hope (*raja'*) in the Mercy of the All-Merciful Lord Creator. All actions are risky because the full spectrum of future consequences of action is not known. The *Qur'an* refers to this idea of uncertainty by suggesting that " *… at times you may dislike a* *thing when it is good for you and at times you like a thing and it is bad for you. Allah knows and you do not*" (verse 216: chapter 2).

Risk Sharing

It follows from the above discussion that it would be difficult to imagine the idea of testing without uncertainty and risk. Statistician David Bartholemu asserts that: "It could be plausibly argued that risk is a necessary ingredient for full human development. It provides the richness and diversity of experience necessary to develop our skills and personalities" (2008, p. 230). He speculates that: "The development of human freedom requires sufficient space for that freedom to be exercised. Chance seems to provide just the flexibility required and therefore to be a precondition of free will" (2008, p. 200). Further, he suggests that: "… we value our free will above almost everything; our human dignity depends upon it and it is that which sets us apart from the rest of the creation. But if we are all individuals free, then so is everyone else, and that means the risks created by their behaviour, foolish or otherwise, are unavoidable. To forgo risk is to forgo freedom; risk is the price we pay for freedom" (2008, pp. 239-240). While life and freedom are gifts of the Supreme Creator to humans, and uncertainty and risk are there to test and try humans to facilitate their growth and development, humans are not left unaided to face the uncertainty of life to suffer its consequences. Books, Prophets and Messengers have brought guidance on how best to make decisions and take actions to mitigate the risks of this life and to improve the chances of a felicitous everlasting life. Islam, in particular, has provided the ways and means by which uncertainties of life can be mitigated. First, it has provided rules of behaviour and taxonomy of decisions/actions and their commensurate payoffs in the *Qur'an*. Complying with these rules reduces uncertainty. Clearly, individuals exercise their freedom in choosing to comply or not with these rules. That rules of behaviour and compliance with them reduce uncertainty is an important insight of the new institutional economics. Rules reduce the burden on human cognitive capacity, particularly in the process of decision making under uncertainty. Rules also promote cooperation and coordination (Mirakhor, 2009). Second, Islam has provided ways and means by which, those who are able to, mitigate uncertainty by sharing the risks they face by engaging in economic activities with fellow human beings through exchange. Sharing allows risk to be spread and thus lowered for individual participants. However, if a person is unable to use any of the market means of risk sharing because of poverty, Allah swt has ordered a solution here as well: the rich are commanded to share the risks of the life of the poor by redeeming their rights derived from the Islamic principles of property rights. Islam's laws of inheritance provide further mechanism of risk sharing.

Individuals in a society face two types of risks. The first is the result of the exposure of the economy to uncertainty and risk due to external and internal economic circumstances of the society and its vulnerabilities to shocks. How well the economy will absorb shocks depends on its resilience which will in turn depend on the institutional and policy infrastructure of the society. How flexibly these will respond to shocks will determine how much these risks impact individual lives when they materialize. The second type of risk individuals face relates to the circumstances of their personal lives. These include risks of injuries, illness, accidents, bankruptcies or even change of tastes and preferences. This kind of risk is referred to as idiosyncratic and when they materialize, they play havoc with people's livelihood. This is because often the level of their consumption that sustains them is directly dependent on their income. If their income becomes volatile so will their livelihood and consumption. Engaging in risk sharing can mitigate idiosyncratic risk and allow consumption smoothing by weakening the correlation between income and consumption that should materialize these risks, and the shock reduce income, consumption and livelihood of the individual do not suffer correspondingly.

It is important to note a nuanced difference between risk taking and risk sharing. The former is an antecedent of the latter. The decision to take risk to produce a product precedes the decision on what to do with the risk in financing the project. The decision to share the risk in financing does not increase the risks of the project but reduces the risks for individuals involved in financing as it is spread over larger number of participants. It is also to be noted that the Islamic contract modes that have reached us are all bilateral real sector contracts. What the contemporary Islamic finance industry has accomplished is to:

i. multilateralize the bilateral contracts as the latter move from the real sector to the finance sector, and
ii. employ instruments of risk transfer available in the conventional finance but made them *Shari'ah*-compatible.

Instruments of Islamic finance allow risk sharing and risk diversification through which individuals can mitigate their idiosyncratic risks. On the other hand, mandated levies, such as *zakah*, are means through which the idiosyncratic risks of the poor are shared by the rich as an act of redemption of the former's property rights in the income and wealth of the latter. Other recommended levies, beyond those mandated, such as *sadaqat* and *qard hasan*, too play the same role. They help to reduce the poor's income – consumption correlation. In other words, the poor are not forced to rely on their low (or no) level income to maintain a decent level of subsistence living for themselves and their families. It is possible that at some point in time even these levies can be instrumentalised to be included in the full-spectrum Islamic finance menu of instruments for risk sharing. In the event, Islamic finance becomes a risk manager of the society. Its instruments of risk sharing will help blunt the impact of economic shocks, disappointments and suffering on individuals by dispersing their effects among a large number of people. It will have instruments of finance available for all classes of people to allow them to reduce their idiosyncratic risks and smooth their consumption. It will ensure that innovators, entrepreneurs, small and medium size firms have access to financial resources without the need to take all risks on themselves or, alternatively, abandon productive projects altogether. It will have instruments of insurance that not only provide protection against health and accident risks but also insure against risks to livelihood and home values to protect people's long-term income and livelihood. Such a full-spectrum Islamic finance can then truly be said to have "democratized finance" without transferring risks of any venture to a particular class or to the whole society. This would be in sharp contrast to the results of the "democratization of finance" project which led to the recent global financial crisis of the conventional system in which the risks of financial innovations were shifted away from financiers. Consequence was that while the gains of this "democratization of finance" project were privatized, its pains were socialized (Sheng, 2009).

Summary and Conclusion

This paper has sought to trace the epistemological roots of conventional and Islamic finance. The reason for interest in the two fields is that, the paper contends, the present Islamic finance industry evolved over the past three decades from conventional finance to address a market failure in conventional finance in terms of unmet market demand for Islamic finance products. Most practitioners of Islamic finance were bankers and market players well familiar and often well established in conventional finance sector. Their focus was, and is, to develop financial instruments familiar to conventional finance market albeit with *Shari'ah* compatibility as an objective. Their ingenuity combined with active and creative imagination of leading *Shari'ah* scholars has managed to develop a rich array of synthetic and structured products all of which, in one form or another, are replicated, retrofitted or reverse engineered from the conventional finance. This vast array – composed of simple instruments such as lease-purchase to exchangetraded funds (ETFs) to leverage buy outs (LBOs) – are Islamic in so far as attempt is made to ensure avoidance of *riba*. This paper contents, however, that this is only meeting the second half of the part of verse 275 of chapter 2 of the *Qur'an* in which Allah swt first ordains exchange contracts and, second, He swt prohibits *al-riba* contracts. The paper argues that this approach has further entrenched the present Islamic finance industry within the conventional financial system rendering Islamic finance industry a new asset class within the conventional system. The Islamic finance industry could have taken a different course as a number of pioneer scholars had defined a trajectory for its development based on risk sharing (profit-loss sharing or PLS.) In the event, it was the conventional finance that gave Islamic finance industry its take-off platform, thus making the study of the epistemology of conventional finance relevant.

It was argued that it is an economic system that gives rise to a financial system. Therefore, to understand the knowledge of the origin of a financial system one needs to understand the epistemology of its economic system. In case of the conventional economy, the practitioners in the field of economics trace its epistemology to Adam Smith. It was the genius of Kenneth Arrow and his principle co-authors, Gerard Debreu and Frank Hahn, who attempted to provide an analytically rigorous proof of what they saw as the vision of Smith for an economy. However, numbers of contemporary scholars, including Amartaya Sen, consider the neoclassical understanding of Smith's vision as distorted and an inadequate representation of the latter's works. The paper argued that Smith's vision of the institutional infrastructure of the economy, i.e. moral-ethical rules governing behaviour prescribed by "the Author of nature" echoes some of the important rules prescribed by Allah swt in the *Qur'an* and operationalized by His Beloved Messenger. There is some tantalizing evidence from Arrow in the mid-70s that suggest that he had thought those ethical-moral rules are crucial to the efficient operation of the economy.

The economy-finance nexus defined by Arrow-Debreu-Hahn general equilibrium models were risk-sharing conceptualizations in which securities represented contingent financial claims on the real sector. Equity share claims represent first best instruments of risk sharing and satisfy characteristics required of Arrow Securities. It would appear that had the financial markets in industrial countries developed their financial sector along the lines suggested by Arrow-Debreu-Hahn model, they could have had much more efficient risk sharing and, perhaps, avoided the crises that have plagued conventional financial system. A number of post-mortem analyses of the recent crisis have developed constructive insights that may help steer the conventional system away from high credit, high leverage, and high debt which are the ultimate causes of all financial crises (Reinhart & Rogoff, 2009). Almost all of the many recommendations for reform of the conventional system – from the *Stiglitz Report* (Stiglitz, 2010), at one end, and *The Squam Lake Report* (The Squam Lake Group, 2010), at the other end of the spectrum of thought among financial-economic scholars and practitioners – include some form of control, direct or indirect, on credit, debt, and leverage within the financial system, including higher capital adequacy requirement. Some have gone beyond these recommendations and have suggested reform of the fractional reserve banking system and deposit insurance (Kotlikoff, 2010). It is likely that if such reforms are implemented reliance on debt-creating flows within the conventional system will decline in favour of greater equity. Basel III has already taken steps – albeit not as significant as scholars such as Stiglitz or Hellwig demanded – to enhance capital adequacy requirements, impose limits on leverage and curtail proprietary trading of the banks. Whether these changes are sufficient to induce the conventional system to move away from its overwhelming dominance by interest-based debt contracts, risk transfer and risk shifting or it will take a more severe bouts with crises before it does so remains to be seen.

A healthy debate is in progress regarding the future direction of Islamic finance. This paper suggests a way forward that all countries would have to follow anyway to develop an effective financial system. The paper has argued that risk sharing is the objective of Islamic finance. Theoretical and empirical research has shown a robust link between the strength of the financial system and economic growth (Askari, Iqbal, & Mirakhor, 2010; Askari, Iqbal, Mirakhor, et al., 2010).

The progress of Islamic finance over the last three decades is well recognized. In the course of its evolution thus far, the market has developed an array of short-term, liquid, low-risk instruments. While instruments of liquidity are needed in the market so are instruments of long-term investment. What is of concerns is that very little or no effort is spent developing instruments that can serve the long-term, less liquid, higher-return investments that have greater potential for generating employment, income and economic growth. There is a strong perception that Islamic finance is focusing on developments of relatively safe instruments with debt-like characteristics promising maximal return with minimal risk in the shortest possible time. It is thought that this is what is driving Islamic finance. Currently, this is a major apprehension. Concentrating market energies on these types of instrument has possible detrimental effects. There is the possibility of repeatedly reinventing the same short-term, liquid, safe instruments with only a small difference in fine tuning, slicing and dicing risk for purpose of product differentiation. Theory of spanning which provided the analytic basis for development of the derivatives market assures that this process can be never ending. The theory argues that one basic instrument can be spanned into an infinite number of derivatives. If the resources of the market are taken up by investment in these types of instruments, the economy is deprived of financing for long-term investment on risk-sharing basis.

There is a perception that the demand-driven market values safety and this is the reason why longer-term riskier Islamic finance instruments are not being developed. While the market should have instruments to meet short-term, low risk, and liquid trade financing demand, it would be unfortunate if the future evolution of Islamic finance focuses only on short-termism at the cost of neglecting investment needs of the real sector. While instruments developed so far emphasize safety, the recent crisis in the conventional system as well as the turmoil in the *sukuk* market demonstrate that no one instrument is immune to risk and that it is unrealistic to perpetuate a myth that safety with high returns in financial markets is possible. There is always risk. The question is how to allocate it to those who are in the best position to bear it and how to build system resilient to absorb shocks emanating from materialization of risk. The answer must surely lie in a system that provides full-spectrum menu of risk sharing instruments.

A related concern is that by focusing solely on short-termism, there is the possibility of emergence of path dependency. Economic changes generally occur in increments. Growth of markets and capital formation are path dependent. That is, later outcomes are partly a function of what has inspired in the earlier rounds of economic and financial exchange (Sheng, 2009). Once path-dependency sets in, change becomes difficult. At times, path dependency is exacerbated by insularity and silo mentality generated by a perception that all is well with established way of doing things therefore no change is required. There is a concern that such path dependency may well emerge that conveys a message that short-termism, safety and liquidity, as well as no *riba*, are all there is to Islamic finance. The thrust of this paper is that this is not so. Islamic finance is more about risk spreading and risk sharing. It suggests that, for those who are able to participate in the financial sector, Islamic finance provides risk sharing through *mua'malat*. For those unable, due to poverty, to utilize instruments of Islamic finance to mitigate risk, financially able are commanded to share the risks of the less able through the redistributive instruments prescribed by Islam. Thus the financially more able have to share the risks to the life of the poor not as an act of charity but as a duty of redeeming a right of the less able; a right that is a direct result of the property rights principles of Islam. Finally, inheritance laws are also means of risk sharing.

It can be argued that one must not lose sight of the fact the Islamic finance is a new industry. After centuries of atrophy, it has begun operating at a noticeable level of commercial significance only recently. In the process, it is competing against a path-dependent financial system centuries old. It is making a serious attempt to return to its roots but systematically and within the framework of present day economic, social and financial reality. This would suggest that in time, Islamic finance will develop a full-spectrum menu of instruments to serve all risk-return appetites.

The global financial crisis revealed the weaknesses of the global financial architecture on one side and provided an opportunity for Islamic finance to show its inherent strengths and qualities on the other. Notwithstanding the limited impact of the global financial crisis on IFI, there are many lessons from the crisis that should be learned and commensurate steps taken within the IFI in order to make it more resilient to similar shocks. This is an opportune time when IFI should reduce reliance on debt-like products and move closer to equity-based, risk-sharing instruments.

Having said that, the paper suggests that lack of available equity instruments within the menu of Islamic finance instruments is akin to a market failure; creating a strong ground for government intervention. Additionally, the paper suggests that the introduction of Islamic finance at the global level represents a remedy for the failure of financial markets to meet a strong demand for Islamic instruments. It took a top-down, government commitment, dedication, and investment of resources, particularly in the case of Malaysia, to correct this market failure. Once again, government intervention can remedy the current failure of the market to develop long-term, more risky, higher return equity instruments. Some 65 years ago Domar and Musgrave (1944) argued that "if the government fully shared in gains and losses, it can actually encourage risky investment" (Stiglitz, 1989, p. 65). *InshaAllah Ta'ala!*

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MICRO-MONEY AND REAL ECONOMIC RELATIONSHIP IN THE 100 PERCENT RESERVE REQUIREMENT MONETARY SYSTEM

Masudul Alam Choudhury
Professor of Economics
College of Commerce and Economics
Sultan Qaboos University
Muscat, Sultanate of Oman
and
The School of Business
University College of Cape Breton
Sydney, Nova Scotia, Canada
masudc@squ.edu.om

Abstract

The structure of Islamic transformation into 100 per cent reserve requirement monetary system is explained in terms of the foundational epistemology of the unity of divine knowledge (*tawhid*). In this, the role of micro-money and real economic exchange relations is shown to arise by a natural causality. A comparative study of endogenous money in the quantity theory of money points out significant differences between the endogenous theory of money in Islam and mainstream methodologies (Choudhury, 1997). A formal model of micro-money and its endogenous relationship with the real economy is formulated with the objective goal of realizing well-being, economic stabilization and sustainability of development regimes. Policy recommendations for *ummatic* transformation into a 100 per cent reserve requirement monetary system with the gold-backed micro-money as currency in relation to real economic transaction vis-a-vis *shari'ah* are given towards the end of the paper.

The principal objective of this paper is to derive a simulation model explaining the interrelationships between money, real economy, prices, economic growth and social well-being. We argue that such a relationship between money and the real economy cannot be explained by the existing macroeconomic conception of monetary relations, and thereby, by the institutional structure of monetary policies in the macroeconomic framework. Substantial changes that follow by redefining the money-real economy relations in view of market forces and institutional structure bring forth the study of specific linkages between money and resource mobilization within the market order. Here a substantive study of micro-money appears. Furthermore, in the Islamic framework of reference we find that the substantive nature of the model of money and real economy relationship is derived from the Islamic epistemological foundations. We will elaborate upon this epistemological derivation to establish our money-real economy model. We will show thereby, that the most appropriate monetary system that results in the case of the micro-money and real economy interrelations is the 100% reserve requirement monetary system backed by the gold standard (Dinar).

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This paper is divided into the following sections: Section 1 gives a brief review of the literature on the gold standard from which we derive the evolution of micro-money in the history of economic thought. In Section 2 we derive our own specification of micro-money concept after noting its context within the quantity theory of money. In Section 3 we formulate the general epistemological background in the light of which our model of micro-money and its real economic relations is established. In Section 4 we explain some of the glaring methodological contrasts in the concept of micro-money between Islamic political economy and mainstream economic thought. In Section 5 we connect the micro-money concept with a 100 per cent reserve monetary system backed by the gold standard (Dinar). In Section 6 we point out other kinds of endogenous micro-monetary *numeraire* suggested in recent times (Choudhury, 1998). In Section 7 we conclude with certain policy recommendations in favour of micro-money within the context of 100 per cent reserve requirement monetary system.

Section 1: A Brief Review of the Literature: Gold Standard and the Nature of Relationship between Money and Market Exchange

Within the economic argument of the classical type the gold standard was thought of as any similar commodity that could be freely transacted in the market system setting its own prices without government intervention, and thereby, causing a trend in the general price level in goods and services in exchange (Block, 1999). The gold standard was thus thought to be behind the social philosophy of a free market and private ownership economy in which most importantly the individual made free choices without a statist intervention. It is pointed out that over the long-run trend in prices and real transactions determined by the gold standard there existed a profound stability in the gold price level despite certain short-run exceptions.

Consider the disaggregate version of the equation of exchange (Friedman, 1989, pp.1-40),

$$M_1V_1 + M_2V_2 = PT = Py \quad \ldots\ldots\ldots\ldots\ldots \quad (1)$$

Where, M_i is the money in circulation in the ith goods basket;
V_i is the velocity of money in circulation;
P is the general price level of goods and services transacted in the economy;
T is the number of transactions performed by the circulation of the quantity of money, M_1+M_2;
y is per capita national income;
i =1,2 goods or markets.

The identity (1) can be generalized to any number of specific transactions including the market for securities. The resulting quantity of money expressed as the demand for money, M_i^D, then is,

$$M_i^D = P.D(y,w,i_1, i_2, u), \quad \ldots\ldots\ldots\ldots\ldots \quad (2)$$

where, w denotes the capitalized wealth;

i_1 denotes interest rate on money assets;

i_2 denotes interest rate on securities;

i_1 and i_2 can be furthermore considered as term structures of interest rates over different kinds of assets over time.

u denotes all other variables, most importantly non-bank preferences, as in the 'real bills' hypothesis;

Section 2: Definition and Analytics Concerning Micro-money

A generalization of the disaggregate forms of the expressions (1) and (2) brings us to the definition of micro-money. Micro-money is the money in circulation specific to particular goods, services, assets, also clientele and thus multimarkets. Now to understand the meaning of micro-money we must turn firstly to the specific markets for real transactions and to the preferences of the non-banking agents to determine the quantity of money that needs to be in circulation to finance such real transactions.

Our definition of micro-money requires a broader deconstruction of the expressions (1) and (2) of the quantity theory. The resulting specification appears as follows:

$$\Sigma_i M_i V_i = \Sigma_i P_i y_i \qquad \ldots\ldots\ldots\ldots\ldots \quad (3)$$

Where, P_i denotes price in the ith market;
y_i denotes per capita income in the ith market;
$i = 1,2, \ldots, n$.

The expression like (3) has not appeared in the equation of exchange particularly due to the inability in defining the right hand side in terms of a total quantity of money in circulation. However, by allowing for a large number of multimarkets with borrowing in the Walrasian sense of the entire economy being viewed as the sum total of such equilibrium multimarkets, an equilibrium in the micro-monetary sector will cause a simultaneous equilibrium in the corresponding real goods market (Henderson & Quandt, 1971). Expression (3) now devolves into,

$$M_i V_i = P_i y_i, \text{ for each } i = 1,2,\ldots,n \qquad \ldots\ldots\ldots\ldots\ldots \quad (4)$$

We re-write (4) as, $M_i V_i / P_i y_i = M_j V_j / P_j y_j$.

That is, $M_i V_i / M_j V_j = P_i y_i / P_j y_j = (P_i/P_j)(y_i/y_j) \qquad \ldots\ldots\ldots\ldots\ldots \quad (5)$

Expressions (4) and (5) convey the meaning that for the total volume of micro-money in financing the nominal value of transactions in the ith market, relative prices in money terms between the markets must remain stable and the markets must be in equilibrium. This result would assume well determination of the agent-specific preferences as in the case of the 'real bills' hypothesis. But the same result on the existence of pre-determined stable and equilibrium relative prices negates the complex nature of intertemporal price and quantity relations as explained by Hayek's (1990, 1999 reprints) analysis of intertemporal resource allocation. Consequently, the above kind of deconstruction of the exchange equation of the quantity theory of money does not contribute to any fresh understanding of interaction in multimarkets with the presence of money prices affecting exchange prices in terms of the influence of micro-monies in those markets.

From the above discussion we note that in the quantity theory of money both the analytical as well as the institutional contexts of micro-money fall short of their proper definition with respect to real economic transactions. The analytical perspective shows a serious problem of aggregation in the micro-money model of the quantity theory. The institutional perspective points out the need for a new arrangement between the central bank, the commercial banks and markets within a gold standard and with the full force of market exchange determining the micro-money and real economic interrelationships. We now turn to these issues.

Section 3: An Epistemological Model of Micro-money and Real Economic Transactions in Islamic Perspective

The institutional and analytical problems of micro-money in the quantity theory of money lead us to investigate whether these problems can be addressed by received mainstream economics or is another methodology required. The quantity theory as formulated being an identity, it cannot answer the following question: Does money affect price level or does the price level affect money stock in circulation through the output effect? (Laidler, 1989)

Between the contending approaches we find that money is treated in the mainstream literature either as an exogenous asset created by the central banking authority to establish price and output stabilization or when there exists endogenous feedback between money and economic activities the exact nature of the price-money causality is not determined. Furthermore, in all such feedback a model there exists the permanent prospect for inflationary pressure, as spending can forever cause upward pressure on output and prices. In the end, the question of stable price and output effects in relation to the feedback between money and real economic transactions remains unanswered.

A return to the gold standard with micro-money in a 100 per cent reserve requirement monetary system must analytically answer and realize this very missing phenomenon of the money-real economy linkages in the quantity theory of money and prices. Our critical project is now explained by the building blocks of an alternative methodology and its institution-economy consequences.

Section 4: The Tawhidi Epistemological Worldview of Unity of Knowledge in World-Systems

Our epistemological premise commences from the following argument. Unity of systemic knowledge as a relational worldview can be realized by means of extensive interaction, linkages, complementarity and their dynamic sustainability according to certain precise economic instruments and preferences (behaviour) that are formed within a political economy that recognizes unity of knowledge as its epistemological premise. Parting away with this critical foundational assumption of unity of knowledge and its attributes in terms of specific instruments, behaviour and methodology will leave any system of money-real economy relations to evolve by the force of uncontrolled anomie, thus leaving indeterminate the money-real economy feedback unchecked.

In this paper, instead of divulging the details of the process model of interaction, integration and creative evolution (IIE-process) premised on the unity of divine knowledge that has been developed in details elsewhere (Choudhury, 1995), we will briefly delineate and use it for formulating our money-real economy model. Our focus now is on formalizing a process model of generalized systems as shown below:

Primal stock of knowledge → Derivation of primal knowledge flows → Process of deriving knowledge flows by → Post-evaluation by means of the social wellbeing function

↓

Closure in the very large scale universe ← Continuity ← Evolution of similar processes(IIE-process of the shuratic process)

In the above string the primal stock of knowledge is the *tawhidi* epistemology. It explains the fundamental *Qur'anic* axiom of divine oneness and assumes a formal relation in the system (Choudhury, 1995, 1999, 2000a). From the *tawhidi* premise is derived fundamental *shari'ah* knowledge as primal knowledge-flows. Knowledge-flows so derived at once unravel the spontaneous and pervasive unveiling of divine oneness in the all experiential systems. This is the start of the process of deriving knowledge in relation to the unity of the experiential systems. We will denote the knowledge-flows by$\{\theta\}$ and is derived by the exercise of the discursive IIE process, which in accordance with Qur'anic terminology is also termed as the *shuratic* discourse at the level of deriving *shari'ah* rules from the episteme of *Qur'an* and *sunnah*. From the organization of the world-system in relation to the unity of knowledge-flows comes about the post-evaluation of this unity of knowledge by means of the well-being criterion used by the discursive system. We call this criterion as the social well-being function. From the post-evaluation of unity of knowledge in the context of the specific problems at hand follow similar relations in continuity until the completion of the original stock of knowledge is realized in the Hereafter. Thus we realize closure in the very large scale universe.

Now to specify, we can imagine two similar strings of relations similar to (6), one for money and the other for real economic activities. This means that in the epistemological sense money is a creation of Allah for the purposeful use in attaining well-being of individuals and society. Likewise, the economic order is patterned for the same purpose according to ethical values that are to be found in the Islamic Law, *shari'ah*. These two together, namely money-real economy relationship along with institutional guidance as complementary pairs follow from the *Qur'anic* principle of the 'paired universe' in the good things of life. The IIE-processes (*shuratic* processes) within and between the money-real economy relations would now proceed in the way explained by expression (6).

The functional mappings existing between extensive interactions between money and real economy now generate compound functions (Choudhury, 2000a). The social well-being criterion function resulting from pervasive interaction across the interactive, integrative and evolutionary branches of (6) in the two interconnected levels of money and the real economy is represented by non-linear and complex aggregation of the separate well-being functions belonging to these branches at their nodes.

The inter-systemic interactions, integration and evolution between money and the real economy generates a circular causation and continuity model of unified reality. Such an IIE-worldview makes risk-diversification, product-diversification, institutional development and participation among the agents, variables, resources and their relations to acquire permanent consequences of evolutionary learning. Knowledge augmentation by means of new learning constantly reduces the risk and unit cost of production and investment through product-, risk- and economic- diversification in the framework of the unity of knowledge as signified by the principle of universal complementarily across diversity.

Section 5: The Epistemologically Derived Specific Model of Money-Real Economy Relations

It is noted that every variable of the well-being function is of the micro-type. Aggregation to higher levels of ethical decision-making is explained by IIE-type compound mappings that result in non-linear multiplicative indexes. Although the IIE-expression (6) is now generalized to all types of socio-scientific problems in the framework of the *tawhidi* unity of knowledge, its specificity to the money-real economy interrelationship is now formulated. The simulative form of the money-real economy relationship is explained by the following system of relationships:

Simulate $\{\theta_{ikl}\}$ $[W([\theta_{ikl}],[X_{ikl}(\theta_{ikl})]]$ …………… (7)

Subject to the *circular causation recursive relations*,

$X_{ikl}(\theta_{ikl}) = f_{jkl}(X_{jkl}(\theta_{jkl}))$, …………… (8)

$\theta_{ikl} = g_{jkl}([\theta_{jkl}],[X_{jkl}(\theta j_{kl})])$ …………… (9)

i,j $(i \neq j) = 1,2,\ldots$;

k = monetary system; l= real economy.

All variables, $\{X_{ikl}, \theta_{ikl}\}$ are to be taken in vector notation. f_{jkl} and g_{jkl} are recursive relations of the circular causation model over interactions (i) within and between the k,l-systems.

Specifically, we can write for money and two markets both endowed with a limiting consensual value of $\theta_i = \theta^*$ over k and l,

$X_{ikl}(\theta^*) = (M_{k1}, p_{k1}, y_{k1})[\theta^*]$, …………… (10)

k,l =1,2 as k = micro-money specific to two categories of spending and valuation in markets, l = 1,2.

The nature of complementarity across diversity and dynamic evolution in the well-being function is causally linked with complementary relations between every one of the variables in the vector (10). This means that ethicizing markets emerge by complementary spending in real goods and services, whose valuation is shown in terms of micro-money supporting such complementary spending patterns. Likewise, the existence of regimes of dynamic basic needs as life-fulfilling goods cause complementary outputs in the two sets of goods and services. There is no substitution now, only relative choice within a discursive framework interlinking money and real economy through the medium of the *shuratic* process, as explained earlier.

Such unifying relations among the variables require appropriate development and policing of money-market linking instruments. Examples of such instruments are valuation in the absence of interest-based discount factors, equity and profit-sharing joint venture instruments revolving around economic cooperation, trade financing and secondary instruments that revolve around these principal ones. Above all, there is the central role played by human resource development along the lines of the *ummatic* transformation in the light of the *tawhidi* worldview. All of these knowledge-inducing factors and instruments are comprised in the θ-induced policies and preference changes determined in and by the IIE-process.

When an evolution from lesser to higher regimes of micro-money and real economy linkages are being established in the knowledge-inducing systemic change, θ-induced policies and preference changes determined in and by the IIE-process are once again active in progressively reducing the 'marginal substitutions' between the goods and services and thus creating greater complementary relation between them. The unwanted goods and services are thus phased out by the θ-induced policies and preference changes determined in and by the IIE-process. In this way, the progressive evolution of the interactive and integrative processes reflect growing unification and responsiveness between the variables in a regime of change characterized by convergence between the growth rates of spending and the quantity of micro-money. This is a sure sign of progressive reduction of instability and inflationary pressure in the economy with pervasive money-real economy linkages. With gains in output arising from the side of technological change, organizational efficiency and accentuated mobilization of resources (spending) the money-economy interrelationship would yield the growth rate of output to exceed the growth rate of spending and price level. Thereby, a sustained increase in real output growth is maintained both by the endogenously allocative and the X- efficiency conditions of the money- real economy interrelationships.

We can now write down the complete form of the money-real economy relationship in the light of the simulative well-being goal of the knowledge-centered worldview of Islamic political economy. Because of the nonlinear aggregation due to interaction and relational complementarity that are embodied in the well-being function, we take it in the multiplicative form denoted by intersection $\cap_{jkl}$ over j variables interacting across (k,l)-systems.

$$\text{Simulate } \{\theta\}\ W(\theta) = \cap_{jkl} X_{jkl}^{aj}, \qquad \text{……………} \quad (11)$$

k, l = 1,2 are the money and economy as the two interactive and co-determining systems. $X_{jkl} = \{M_1,M_2,p_1,p_2,y_1,y_2\}$ is the vector of various variables pertaining to markets that are interconnected with the micro-money flows. Because of the knowledge-inducing process of the IIE-kind all variables including the a_j coefficients are θ-induced. We have taken this θ-value in the limiting form. X_{jkl}^{aj} are thus the indexed variables $\{M_1,M_2,p_1,p_2,y_1,y_2\}$ by the elasticities a_j , j ranges over the given variables. The recursive relations according to the circular causation system are,

$$M_1 = f_1 (M_2,p_1,p_2,y_1,y_2) \qquad \text{……………} \quad (12)$$

$$M_2 = f_2(M_1,p_1,p_2,y_1,y_2) \qquad \text{……………} \quad (13)$$

$$p_1 = f_3(M_1,M_2,p_2,y_1,y_2) \qquad \text{……………} \quad (14)$$

$$p_2 = f_4(M_1,M_2,p_1,y_1,y_2) \qquad \text{……………} \quad (15)$$

$$y_1 = f_5(M_1,M_2,p_1,p_2,y_2) \qquad \text{……………} \quad (16)$$

$$y_2 = f_6(M_1,M_2,p_1,p_2,y_1) \qquad \text{……………} \quad (17)$$

$$\theta+ = f_7(\theta,M_1,M_2,p_1,p_2,y_1,y_2) \qquad \text{……………} \quad (18)$$

All of the above variables are recursively θ-induced through the IIE circular causation processes. The sign '+' indicates a forward recursive value upon the lagged values of both the institutional *shuratic* policies and preferences and the socioeconomic variables. The recursive lag indicated by '-' is shown to govern all the variables inside the bracket. All the functions denoted by f's are nonlinear.

In a progressively transforming Islamic money-real economy complementary system the coefficients of the relationships are expected to be either positive or tending towards positive signs out of progressively weakening negative relations. This signifies the passage from a non-learning system, such as the one characterized by the neoclassical marginal substitution methodology (Shackle, 1972), to increasingly pervasive complementarity as signified by the *shuratic* process or equivalently the IIE-process methodology.

The above trends translate into the following analytical results. In the evolutionary life-fulfilling regimes of development promoted by the *shari'ah* preference changes and use of instruments selected out of discourse and extensions, p_i and y_i denote prices and outputs of such goods, respectively. Thereby, ($p_i y_i$-cost of production) are distributed among participants in a cooperative Islamic political economy. This implies that the cost of production is also shared and no opportunity cost of production concept can therefore remain.

Spending in the production and consumption of y_i at prices p_i is financed by M_i. Thereby, some of the spending flows between production value and consumption value of interrelated goods and services. The equations (12)-(18) bring out this kind of interdependence. Such an interdependence follows the circular causation methodology as epistemologically derived from the extended form of expression (6).

Equations (12) and (13) are the micro-money equations for the quantity of money in circulation in multimarkets. Note that interest rates are logically ruled out in this system of relations by the absence of the opportunity cost of money and real goods and services as is otherwise expressed by their relative prices in neoclassical economic theory. Marginal substitution hypothesis is replaced by the endogenous nature of micro-money pursuing spending in interconnected multimarkets. The circular causation process in simulation by the IIE-methodology sustains the evolution of the system of diversity leading to pervasively complementary relations through the *shuratic* process.

We note from the system of complementary relations (11)-(18) that well-defined circular causation exists between money and the real economy. That is to say money is truly micro in nature as it is in pursuit of financing the *shari'ah* recommended life-fulfilling basket of goods and services by means of specified instruments that promote ethical values and complementarity between ethical possibilities. This makes money the valuation medium for multimarket spending. Subsequently, new rounds of multimarket spending become the springboard for further quantity of micro-money in the economy.

The concept of demand and supply of money now loses significance. There is simply a quantity of currency as money available from the central authority to match up a reflective spending demand in *shari'ah*-recommended life-fulfilling goods and services. Our old ideas of money as medium of exchange and store of values lose meaning in this case. Since money has no market of its own it cannot be a commodity or a factor of production. Money has no intrinsic use price. It simply comes into use after the demand signals are provided from the spending side. Consequently, money stock cannot be formed by savings in such a micro-money and real transactions linkages. Monetary policies in this system cannot logically promote savings. Interest-based instruments and speculation cannot occur because of the absence of short-term rates of interest. Spending is a source for making production a diversity resulting in the ultimate reduction of cost of production by means of risk and product diversification. Uncertainty is thereby controlled and the spending variable causes the growth of money-real economy variables. Stabilization and sustainability are realized by the principal action of the circular social causation of the knowledge-induced process model across the 'wider field of valuation' in dynamic life-fulfilling regimes of development (Myrdal, 1968; Choudhury, 1997).

Section 6: From Methodology to Methods: Contrasting the Islamic Micro-money and Real Economy Simulation from the Mainstream Economic Methods

Apart from the causality and aggregation problems of the equation of exchange in the quantity theory of money and the consequential inability to use this equation for developing the idea of micro-money, there are other problems that fly from the epistemological side of this body of theory into its methods. We will consider one such other problem below.

Equation (1) is revisited in the form,

$$MV = Py, \qquad \text{……………} \quad (19)$$

$$\text{Giving, } g_M + g_V = g_P + g_y. \qquad \text{……………} \quad (20)$$

Now consider the micro-money version of equation (1). Can this be put in the form (20)? No. Consequently, the method of quantity theory of money in the disaggregate exchange equation does no match up the growth rates of money and of the velocity of money circulation with the growth rate of spending in multimarket. One cannot therefore either aggregate from (1) into (19) or disaggregate from (19) to (1), no matter how appealing this would appear in the linear form. Consequently, we cannot derive micro-money stability and well-being results from the methodical conclusion as shown above.

The same question when inquired in the IIE-version of micro-money and real economy relations yields the following result: There is no concept of macroeconomic disaggregation of a stock of money M into its micro-monies equating to multimarket spending. It is possible only to aggregate the micro-monies by the spending formula in particular markets. However, this would not yield the concept of the macroeconomic money stock.

For the ith multimarket,

$$M_i = Sp_i \text{ (spending in ith multimarket)} = p_iy_i + r_ic_i. \qquad \text{……………} \quad (21)$$

The intrinsic θ-value is subsumed. Besides, $r_ic_i = p_iy_i\text{-}\pi_i$, …………… (22)

where, r_i denotes quantity of productive factors, ci denotes unit cost of factor use.

$$\text{Thereby, } M_i = 2p_iy_i\text{-}\pi_i. \qquad \text{……………} \quad (23)$$

Since π_i is a proxy for well-being at the level of the firm or market, it is a simulated target function attaining a given value at the end of every completed *shuratic* process, as explained earlier. This kind of simulation is shown in figure 1. We can differentiate the variables in (23) primarily with respect to θ-values. The resulting equation is, $g_{Mi} = g_{pi} + g_{yi}$ …………… (24)

This is the result corresponding to rates of change *with respect to the changes in θ-values* in any given completion of process according to the circular causation model explained in expression (6) or (10). With respect to both time variable and θ-values we must invoke the epistemological meaning that time is created by knowledge and only momentarily they are the same. This is authenticated by the *Hadith al-Qudsi* (divinely inspired Prophetic saying) in which Allah declares, "Sons of Adam inveigh against [the vicissitudes] of Time, and I am Time, in my hand is the night and day."(Al-Bukhari & Muslim). Expression (24) can thus be aggregated to maintain the equivalence between total micro-money and multimarket spending.

Section 7: Policy Conclusion

Today, in the eve of a post-modernist epoch that is dawning before us, the old socio-scientific order is up for questioning and rejection in many ways. This is giving way to new epistemological roots of intellectual inquiry, discovery and innovative applications. The Muslim World today is to assess its station in this spectrum of novelty according to her own episteme of knowledge and life. Thus far she has failed miserably in all fronts and the aftermath of a global political economy of disorder and fragmentation is upon her.

Among the many issues that assume center stage in new perspectives of the globalization scene for the Muslim World, that which we refer to here as *ummatic* transformation, will be the nature of money, monetary policy and institutions and their relationship with the real economic transactional basis of sustainable development. In this regard, keeping in view the micro-money and real economic interrelationships, the automatic stabilization, sustainability and well-being effects of such an interactive, integrative and dynamically evolutionary order and the challenging new methodology and methods premised on the unity of *tawhidi* worldview, the ensuing critique of the mainstream economic order in this paper has opened up new dimensions for serious investigation.

To attain such an *ummatic* transformation we offer the following policy recommendations that emanate from this study.

1. The OIC with its membership is to galvanize the intellectuals, practitioners, public and private sectors and governments to establish a think tank or center/institute enabling discourse on the ways and means of putting into action a human resource development program (Choudhury & Korvin, 2001) that would develop the pragmatic understanding of the *shuratic* process of decision-making and put that into action.

2. The Human Resource Development Center on the understanding and application of the *shuratic* process methodology for *ummatic* change in all fronts but with a focus on the interactive and unifying dynamic relations between trade, development and real money, must be prominent. This calls for a policy on getting the banking systems of the Muslim World to enact a program that will incrementally change the existing banking relations based on fractional reserve requirements into a 100 per cent reserve requirement monetary system with the backing of the gold standard. This monetary policy change calls for a program of establishing a monetary system that looks at the function of micro-money in terms of its direct relationship with real economic transactions.

3. The banking community along with the national decision-makers, Muslim intellectuals and private sector practitioners are to assign a program promoting linkages between money and the real economic sectors and markets within the Muslim World over a stipulated period of time, within which a reasonable transformation into the endogenous monetary system with 100 per cent reserve requirement monetary system would be realized. During this process of change growing linkages between effective sectors and activities should be subjected to the trading and developmental patterns on the basis of the on-going monetary transformation.

4. The Muslim World should then be developing a regional trading bloc of the Muslim countries that would ultimately enact a common monetary transformation based on 100 per cent reserve requirement with the gold standard. This would cause the exchange rates and the common tariff value of the Islamic customs union to be based on the economic and social productivity of the integrating economies and in view of their complementary resource endowments. Thus the exchange-rate setting in such a case of the 100 per cent reserve requirement monetary system would be converted into a productivity driven indicator rather than be determined by a monetary policy of the fractional reserve requirement system as the latter is conventionally treated exogenously in exchange-rate and interest-rate mechanisms.

5. Islamic banks, other banks and financing development intermediaries in concert with the national planning departments are to establish programs to jointly fund such complementary projects as an accepted focus of trade and development in the Muslim World. Such programs for developing and executing complementary projects should aim at vitalizing the private sector in co-ordination with the public sector and governments toward facilitating such developments that build on programs of linkages along lines of the dynamic life-fulfilling needs of development (Huq, 1997).

6. The dynamic basic needs regimes of development would correspondingly define the development and trade patterns of the Muslim bloc. This kind of *dynamic basic needs regime* vis-a-vis its linked manufacturing/service sectors would be a good sign in capturing today's global trend towards green industry and to keep the gaze of technological transformation on its appropriateness in this age of 'ecological revolution' (Korten, 1995). The commodity sector would then realize improving terms of trade, which is an important pre-condition for establishing the complementary relations between economic efficiency and distributive equity and between trade and development with the 100 per cent use of money in real economic activities.

7. The financing modes of the Islamic transformation process must of course be based on co-operative joint ventures (Choudhury, 2000b). *Mudarabah* and *Musharakah* instruments cannot continue to be understood simply as the financing instruments for specific project financing alone as they presently are. Rather, their broader meaning and effectiveness are to be realized within the foundational meaning of Islamic socioeconomic co-operation. M&M must thus be changed into policy instruments by the financial sector in concert with the central and commercial banks and the planning departments of members of the OIC. The same M&M instruments would determine the co-operative character of all other Islamic trade instruments and secondary financial instruments. This transformation can be realized through the use of a 100 per cent reserve requirement monetary system in determining the productivity driven values of exchange rates and common tariffs outside an integrating Muslim World.

8. In every area of institutional and policy changes recommended above the OIC with her sister organizations such as the IDB with the Islamic Research and Training Institute, Islamic Chamber of Commerce, Islamic Corporation for the Development of the Private Sector and SESRTCIC with its COMCEC must play catalytic roles in collaboration with the governments, public sector, private sector and development financing organizations of the OIC membership. The *shuratic* process model of *ummatic* change must become the human resource foundation (epistemology) for guiding the progressive *ummatic* transformation. The progress of the Islamic transformation in the years to come would then see the effective interactive, integrative and dynamic evolution of the echelons of interlinked *shuratic* processes and their complementary relations in terms of policies, programs and economic transactions on all fronts.

9. The centers/institutes implied above for facilitating the *shuratic* transformation in the areas of trade, development, money and the real economy vis-a-vis the central role of human resource development in all of these, respecting the understanding of the *shuratic* process in action, can be housed in IRTI and SESRTCIC or they can be launched in major Islamic universities.

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ISLAMIC FINANCE: FROM NICHE To MAINSTREAM In The ACADEMIC WORLD

Abdul Azim Islahi
Professor of Economics
Islamic Economics Institute
King Abdulaziz University
Jeddah, Kingdom of Saudia Arabia
aaislahi@hotmail.com, aaislahi@kau.edu.sa

Abstract

Not very long ago the practicability of Islamic banking and finance was not taken seriously, and writing on such topics was considered simply a mental exercise in vain. Opportunity of teaching and learning Islamic economics, banking and finance was unheard. But the situation at present has completely changed. At present it is the most discussed and practiced area of Islamic economics. **It** has received global recognition. Now there is a vast variety of degree programmes in the Western universities, with different specializations. The present paper aims to shed light on the rapid development of Islamic finance in the academic circle all over the world. At the concluding note it strongly recommends for keeping close tie between its theoretical development and practical advancement.

Keywords: Islamic Banking, Islamic Finance, History of Islamic Banking and Finance, Objectives of Islamic Finance, Islamic Economics.

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Introduction

There is very close relation between academic and research activities of a discipline on the one hand and its practical experiments on the other hand. While practice provides a case for study and a lab for experiments, theoretical and intellectual exercises offer testing material and work as corrective measures. Not very long ago people scoffed at the practicability of Islamic banking and finance, and writing on such topics was considered simply a mental exercise in vain. Opportunity of teaching and learning Islamic economics, banking and finance was unheard. In fact, it was considered a negative element in ones career. But the situation at present has changed. One must be very cautious to show such a reaction now as it would reveal his/her sheer ignorance from the latest developments in theory and practice of the discipline. In the past it was considered almost impossible to run a baking and financial system without interest. At present, this is the most practiced part of Islamic economics. The present paper aims to shed light on the fast development of Islamic finance in the academic circle all over the world. At the concluding note it strongly recommends for keeping close tie between its theoretical development and practical advancement. Any divergence between the two is bound to have detrimental effect and tear down the usefulness and relevance of the Islamic finance.

Earliest Practice of and Writing on Modern Islamic Finance

There has always been an urge among the Muslims to avoid interest based financing. The modern history of Islamic finance starts from the 19th century. According to Dr. Muhammad Hamidullah, the first known step in this direction was taken in 1891 in Hyderabad. He gives a detailed account of it in his article “Haiderabad’s Contribution to Islamic Economics” He notes two more developments in this direction in early 20th century, one in 1902 and the other in 1913 (Hamidullah, 1957).

The credit for producing first exclusive work related to Islamic finance also goes to Hyderabad. It was authored by a professor of Osmania University Dr. Anwar Iqbal Qureshi during 1940s. It would be interesting to know its context. It was in December 1938 that the annual conference of the Indian Economic Association was held at Nagpur. One of the subjects of discussion was 'the theory of interest'. Dr. Anwar Iqbal Qureshi, the head of Economics Department, Osmania University at that time, participated in the discussion and pointed out defects of the prevailing theories of interest and ventured to suggest that interest has done more harm than good to society as a whole, and the world would be better if interest was altogether prohibited. At this Mr. Findlay Shirras, a participant in the conference, was annoyed and alleged him that Dr. Qureshi was influenced by the "orthodox Muslim point of view" on the subject of interest. Dr. Qureshi responded him saying that he was speaking at the conference in his capacity as academic economist but he would be prepared to present the Islamic point of view with regard to interest at some later occasion. This event led him to author his famous pioneering work *Islam and the Theory of Interest* (Qureshi, 1945). It took another ten year to give a clear concept of Islamic banking based on *mudarabah* (participatory financing). This time credit went to another scholar of Indian origin, Uzair Ahmad, a graduate of Allahabad University (Uzair, 1955).

The above story is enough to refute those who say that the development of Islamic banking and finance was resultant of pan-Islamic movement or it was an outcome of oil discovery in the Middle East.[1] The first Islamic bank established in the Middle East was not in an oil rich country. It was established during 1960s in a village of Egypt called Mitt Ghamr having agricultural economy. Earlier in Pakistan in late 1950s rural landlords created an interest free credit network (Wilson, 1983). These events took place much before the oil boom. There is no doubt that prosperity in the Middle East has provided a boost to the Islamic banking and finance in its later stages.

Pace of Publications

Like any other discipline, works on Islamic economics, banking and finance began with individual initiative and personal interest. It is not surprising to hear that many people considered it useless exercise. Based on a few bibliographies prepared on works in Islamic economics, we found that up to 1950 in total 50 works appeared on the subject in three languages – English, Arabic and Urdu – an average of one publication each year. After a quarter century in 1975 number of publications, as reported by Siddiqi in his bibliography, reached to 500. After two years when the author updated it for publication, the number reached to 700 (Siddiqi, 1978). In 1992 Khan presented another bibliography on *Economic System of Islam* who listed more than a thousand publications only in English language up to 1990.(Khan, 1992) In 1994, Ali and Ali in their work *Information Sources on Islamic Banking and Economics From 1980 to 1990* listed 1576 titles from various sources, print and electronic media (Ali & Ali, 1994).

Looking into ever-increasing rate of publications in Islamic economics, and fast development in Islamic banking and finance, both at academic and practical levels, and increasing involvement by the main stream economists, it may safely be estimated that at present hundreds of such publications are coming out annually in various languages of the world.

Role of International Conferences and Seminars

Conferences and seminars have played very significant role in bringing the movement of Islamic finance to mainstream. In the month of February 1976, King Abdulaziz University organized the First International Conference on Islamic Economics in the holy city of Makkah al-Mukarramah. The conference provided a golden opportunity for scholars working scatteredly on Islamic economics to be aware of existing state of affairs in the field of Islamic economics, to exchange ideas with each other, to take stock of the existing literature on the subject and realize the challenges ahead. Islamic economics got a momentum after this conference never seen before. It led to intensive and extensive researches on various aspect of the discipline, development of curricula on Islamic economics, foundation of research centers and study departments, establishment of a chain of Islamic banks and financial institutions which were already founded in few places and issue of specialized journals on Islamic economics.[2]

So far nine international conferences have already been held in this series, and the tenth conference is scheduled to be held during March 23-25, 2015, at Doha, the capital of Qatar, under the theme “Institutional Aspects of Economic, Monetary and Financial Reforms”.[3]

The Fourth International Conference, organized in U.K. was a remarkable event which deserves special mention. Its theme was "Islamic Finance Challenges and Opportunities". It was the first time that an international conference on Islamic economics and banking was organized in a Western country under the auspices of a famous modern academic institution – Loughborough University. The conference was a great success. It was attended by a large number of Western academicians and practitioners.

Harvard Law School regularly organizes **Forum on Islamic Finance and it is playing very important role in introduction of Islamic banking and finance to American audience.** Its events generally have presence of considerable number of Western scholars and participants from mainstream economics departments. The Eleventh Harvard University Forum on Islamic Finance was held at Harvard Law School in Cambridge, Massachusetts, during April 26-27, 2014 under the theme "*Takaful* and Alternative Cooperative Finance: Challenges and Opportunities".[4]

At present hardly a month passes without a seminar or conference on Islamic banking and finance. Just a search on Google will be enough to verify this statement. In view of the expanding practices of Islamic banking and finance, it has become a money-spinning business for some to organize such events in various financial capitals of the world. Looking into the fact that Islamic finance crossed its traditional Arab-Islamic regions to other Asian and Western countries, this is not surprising. As is clear, such events are attended and dominated by mainstream market players with a thin representation of academicians. Of course, not a very healthy phenomenon.

Establishment of Research Centers

Generally, there has been no obstacle in doing research on Islamic economics, banking and finance leading to Ph D. award in modern universities.[5] However, specialized research centers in this area of knowledge could be founded in late seventies of the last century. The year 1977 saw the establishment of International Center for Research in Islamic Economics, (later it was renamed as Islamic Economics Research Center) in King Abdulaziz University, Jeddah, as an implementation of the recommendation of First International Conference on Islamic Economics (Ahmad, 1980). In 2011, it has been upgraded into an institute that interactively combines research, teaching, and training in one location. The number of books, monographs, research papers, articles, etc. published by the Center/Institute reaches to several hundreds. [6]

Another specialized research center called Islamic Research and Training Institute (IRTI) was established again in Jeddah in 1981 to undertake research and provide training and information services in the member countries of the Islamic Development Bank and Muslim communities in non-member countries to help bring their economic, financial and banking activities into conformity with Shari'ah and to further economic development and cooperation amongst them. The main activities undertaken by IRTI are mainly in the areas of research, training and information. [7]

These two research institutes have played important role in bringing Islamic Economics, banking and finance from the niche to the mainstream.

At present we have several research centers on the subject in various countries like Egypt, Jordan, Sudan, Malaysia, etc. Most of the Islamic banks and finance houses have their own research units. Now some of the Western universities have special chairs for teaching and guiding researches on Islamic banking and finance, such as the chair of Islamic finance in Rice University, USA, Sharjah Chair in Islamic Law and Finance, Durham University, UK, and Alshaarani Centre for Islamic Business and Finance, Aston University, Birmingham, UK. In 2011, a joint research chair with King Abdulaziz University has been set up in France called Chair of “Ethics and Norms in Finance”, at University Paris 1 Panthéon – Sorbonne. Seminars have been held every month through videoconferencing between Paris and Jeddah. "[The] international network is expanding with IE Business School in Madrid and INCIEF in Kuala Lumpur joining the monthly video seminar. Partnership is expanding to include Durham and Reading Universities in

UK, Geneva Business School in Switzerland, the Université Libre de Bruxelles and the Law Faculty of the Université de Luxembourg, and partner universities in Tunisia (Sfax, Tunis), all featuring a strong interest in IF" (Merbouh & Pierre-Pradier, 2012).

Earlier in 2008, a center has been established in Spain under the name of *Saudi-Spanish* Center for *Islamic Economics* and Finance at the IE business School, Madrid.

Publication of Specialized Journals

Prior to 1983, there was no specialized journal on the subject of Islamic banking and finance. It was difficult for a writer on Islamic economics and finance to get his research paper published in Western professional journals.[8] However, one exception must be noted and acknowledged. The first article on economic significance of *zakah* was published in the prestigious economic periodical, the *Economic Journal*, London, as early as 1939. At that time its editor was the famous economist J. M. Keynes (Datta, 1939). But the situation in the course of time has changed. Now we frequently see in the world's famous professional journals papers on Islamic economics, banking and finance written by Muslim and non-Muslim scholars.

The first specialized professional journal dedicated to Islamic economics and allied subjects was issued by the International Center for Research in Islamic Economics in 1983. Its title was *Journal of Research in Islamic Economics*, later on it was renamed as the *Journal of King Abdulaziz University – Islamic Economics*. Its contents are listed in JEL and SCOPUS.[9] At present we have more than a dozen of specialized journals in English on Islamic economics and finance.[10] Some of the mainstream professional economic journals have published special issues or special focus on Islamic banking and finance and some others are in the way. In addition, there are a number of virtual journals and bulletins. With all these, one can guess how fast the speed of dissemination of knowledge in Islamic banking and finance is! They are playing important role in bringing the subject of Islamic banking to mainstream economics.

International Prestigious Publishing Houses Enter the Market

There was a time when works on Islamic banking and finance were published by lesser known publishers like Nadwatul-Musannifin, Shaikh Muhammad Ashraf, Islamic Publications, Isha'at-i Islam Trust, Islamic Foundation, International Institute of Islamic Thought (I.I.I.T), etc. Now world's most famous and prestigious publishing houses are competing in bringing out more and more books on Islamic banking and finance. To verify this, one can simply go through the list of publications by Oxford University Press, Macmillan, Longman, Cambridge University Press, Edward Elgar, Mensel, Kegan, John Wiley and Sons, etc., or search books on Islamic finance on Amazon.[11] In fact there is no comparison, in terms of quality, quantity and costs, between the products of these International publishers and the books published by Asian publishers. The books published by Western publishers are according to the standard, taste and style of the mainstream economists. This has also added to the creditability and reliability of the published works.

Teaching and Introduction of Courses

As far teaching is concerned, First time al-Azhar introduced study paper on Islamic economics, of course including Islamic finance, during early nineteen sixties (Namiq, 1981). Next came the King Abdulaziz University which introduced a course on Islamic economics in 1964 (al-Fanjari, p.6), followed by Umm Dorman University, Sudan, which established first Department of Islamic Economics, in 1968 (al-Najjar, 1993, p.105).

The first International conference held at Makkah al-Mukarramah in 1976 recommended development of the curricula of teaching of Islamic economics and introduction of courses on Islamic banking (Ahmad, 1980). Attempts were made by educational institutions of Muslim world to implement conference's recommendations at various levels and introduce courses or establish departments of study. In this connection we mention here three great institutions that took big steps in this respect – Umm al-Qura University, Makkah, established a department of Islamic economics; International Islamic University Islamabad set up International Institute of Islamic Economics, while International Islamic University Malaysia instituted a Faculty of Islamic Economics and Management.

The study courses on Islamic banking and finance are not confined now to Muslim countries. With the commencement of twenty-first century, they have spread all over the world in Asia, Europe, North America, Australia and Africa.[12] In the words of Nienhaus, “Islamic Finance (IF) has caught the attention of students all over the world, especially after the crisis of conventional banking in 2007-8. Muslims and non-Muslims want to learn more about IF and to understand special qualities of what is often seen as the ethical alternative to greedy capitalism"(Nienhaus, 2012).

In 2006, Malaysia took a long leap and established the Global University for Islamic Finance with the support of Malaysia's Central Bank. This University housed the prestigious International Center for Education in Islamic Finance (INCEIF). The INCEIF has collaboration and memorandum of association with a number of international institutions which include two British universities – Reading University and Cardiff University. The teaching and practice of Islamic banking and finance have attracted much attention in the Western countries after the recent financial crises in which the industry has shown high resilience[13] (Belabes & Belouafi, 2011).

However, due to fast growing industry of Islamic banking and finance all over the world, number of the graduates of these institutions remained insufficient as compared to demand for Shariah experts of modern finances, executives and employees. Thus, there is a wide gap between the demand for graduates in Islamic banking and finance and availability of such experts(al-Jarhi, 2008). To meet the growing demand for such expertise, now institutions all over the world are trying to offer courses of Islamic banking and finance.[14] This writer is personally aware that during 2008-09 the Islamic Economics Research Center, King Abdulaziz University, Jeddah, received requests from educational institutions of Spain, Japan, France, Australia, South Africa, and Canada to help them in developing curricula and teaching materials at diploma or degree levels. Some of the Western countries already have started such courses. There has also been a proliferation of courses - some online, some as distance learning and some other as classroom-based - by lesser-known institutions, colleges, community centers and institutes. It will be suffice to give some details of major study centers in U.K. only.

According to Parker: "The global growth of Islamic finance and the UK banks' long involvement in the sector since the early 1980s, has encouraged professional bodies, academic institutions and some private entities to set up Islamic finance courses ranging from certificates, diplomas, undergraduate, masters and post-graduate degrees in Islamic finance and economics. … Professional bodies such as the Securities & Investment Institute (SII) launched its Islamic Finance Qualification (IFQ) a few years ago"(Parker, 2010). Durham University launched undergraduate, master’s and doctorate courses in Islamic finance and economics under the leadership of Professor Rodney Wilson. "Similarly Loughborough University and the School of African & Oriental Studies (SOAS) at London University also offer some courses in Islamic economics and finance, and in

Islamic commercial law. Surrey University has a Ph. D program largely concentrating on accounting and auditing issues in Islamic finance"(Parker, 2010). Markfield Institute of Higher Education, Leicester, UK since more than a decade running a course of MA in Islamic Management, Banking and Finance.

In the opinion of Parker, opening by the Aston Business School, which is part of Aston University in Birmingham, Europe's first dedicated Islamic Finance and business Centre at a mainstream British university in early January 2010, is a clear proof of growing Islamic finance education industry in and out of the UK. "Another important development is the MBA in Islamic finance offered by Cass Business School, part of City University in London." (Parker, 2010). In addition, Bangor University, Newcastle University, and Aberdeen University, Scotland, also offer Master degrees in business and Islamic finance.

On March 15, 2011, two colleague of this author had completed a study on programs and courses on Islamic finance in institutions of higher studies. The paper was presented to the 10th meeting of Chairmen of the Departments of Economics and Islamic Economics, held at the Islamic Economics Institute. With different sources they collected information about 88 programs, 122 courses in 97 institutions of 31 countries. Out of 97 institutions 67 are universities and 3 are institutes and academies. Forty-two percent of these study-programs are found in non-Muslim countries (Belabes & Belouafi, 2011, p.13). They covered only three languages Arabic English and French. Because of language problem or due to non-availability of data, no information could be provided about some very important countries like Turkey, Iran, Sudan, Bangladesh and Indonesia (Belabes & Belouafi, 2011, p.8).

Organizations Setting Standards for Islamic Financial Institutions

At present there are various institutions that try to bring standardization of accounting and auditing of Islamic banks and finance houses to prevent any loophole or deception. For example, the Islamic Financial Services Board (IFSB) in Malaysia and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI in Bahrain are international standard-setting organizations that promote and enhance the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

Islamic Banking and Finance and the Mainstream Economists

Islamic finance is no more a subject of Siddiqi, [15] Ahmad, [16] Chapra, [17] or Kahf [18] only. It has attracted scholars and researchers of mainstream economics, such as Badal Mukharji[19], John Presley[20], Rodney Wilson[21], Vogel,[22] Nienhaus[23], Sundrarajan[24], to name a few. It may be noted that John Presley of Loughborough University has been awarded in 2002 the IDB prize due to his distinguished contribution to Islamic banking and finance. A number of working papers and a few books on Islamic banking and finance have been published by the staff of World Bank groups which is a proof of international significance of the discipline. The risk-sharing feature of Islamic economics has attracted attention of two Nobel Laureates - George Akerlof and Robert C. Merton (Askari et al., 2012).

Concluding Remarks

Out of various branches of Islamic economics, Islamic banking and finance has seen very rapid development both in academic sphere and practical life. Its development in academic field we have discussed above. As for its progress in practice is concerned, it would suffice to say that from one bank in one city in 1975, it increased to more than 300 establishments spread over 75 countries (statistics of 2005) and financial assets crossing 250 billion dollars. It is estimated that they continue their growth at a rate of 15% in the coming years (estimate for FY06 and FY07).[25] Izz al-Din Khoja, General Secretary of CIBAFI (Council of Islamic Banking and Financial Institutions) disclosed in an interview to London based journal *al-Hayah*, that the assets of Islamic banks have reached 700 billion dollars and their number have reached 390 establishment. He estimates that assets of Islamic banks and finance houses would reach 2 Trillion dollars by 2013.[24] A recent study shows that by the end of 2010 the number of Islamic financial institutions has reached 400 and the assets have crossed one trillion dollar (Belabes, 2011).

Islamic finance stands for Justice, equity, cooperation, fellow-feeling and ethics in general along with its profit earning. It prohibits transactions that involve appropriation of others income in wrongful way, such as interest, gambling, and other forms of business leading to exploitation and disputes. Thus, Islamic finance combines welfare as well as finance, 'an approach that eludes the conventional system because the two, welfare and finance, find themselves in opposite camps, sometimes hostile to one another' (Siddiqi, 2004). Islamic finance presents an alternative to conventional finance. It makes finance subservient to exchange of real good and services, rather than the other way round. This position of Islamic finance must be preserved. Its entrance into mainstream raises both hopes and fears. It is an opportunity for practitioners of Islamic banking and finance to prove feasibility, viability and vitality of Islamic finance for the people and the economy. At the same time it also poses a challenge. If the users of Islamic names also adopt the same techniques and approaches that the conventional finance has been doing, time is not far away that , God forbid, it will also meltdown and see the same consequence which its counterpart is facing. A strong and close tie between its theoretical development and practical advancement, between academicians and practitioners, it is hoped, will be a right way to protect and benefit each other and ensure its healthy and sustainable development.[26]
Wa bi'llah al-tawfiq.

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Notes

1. For example: Ibrahim Warde writes: 'Modern Islamic banking would probably not exist were it not for two political-economic developments: pan-Islamism and the increase in oil prices' (Warde, Ibrahim, *Islamic Finance in the Global Economy*, Edinburgh, Edinburgh University Press, 2nd ed. 2010, p.93.). Some others who repeat similar allegations are El-Gamal, Mahmoud A., (2006), *Islamic Finance – Economics, Law and practice*, Cambridge: Cambridge University press, p. 137; Kuran, T. (2004), *Islam and Mammon*, Princeton: Princeton University Press.
2. According to Siddiqi, 'This conference ushered in a new era in Islamic economic thought as it carried the subject to the Muslim academia the world over. Simultaneously, it provided a great impetus to nascent "movement" of establishing Islamic financial institutions'. Siddiqi, M.N. (1992), "Islamic Economic Thought: Foundation, Evolution and Needed Direction", in AbulHasan M. Sadeq and Aidit Ghazali (eds.), *Readings in Islamic Economic Thought*, Kuala Lumpur, Longman Malaysia, p. 26.
3. For details visit: https://conference.qfis.edu.qa , accessed on 20.9.2014.

4. The details of these forums may be found on line at: http://ifp.law.harvard.edu/login/conference.
5. Perhaps the first degree was awarded in early 20th century by an American university to Nicolas P. Aghnides. It was later published in 1916 under the title *Mohammedan Theories of Finance*, New York, AMS. Ali and Ali report that one hundred and five doctoral dissertations on Islamic economics and finance during 1980-1992 were accepted in U.K. and U.S.A. for higher academic degrees, out of which a total of 71 doctoral dissertations came from 48 universities of United States and the rest from other European countries. Ali and Ali, 1994, op. cit., p. 6.
6. The journal of the institute and its publications can be freely downloaded from its websites:
   http://iei.kau.edu.sa/Pages-E-JournalIssues.aspx
   http://iei.kau.edu.sa/Pages-E-EnglishPublications.aspx
7. For the journal and other publications of IRTI click the following link:
   http://www.irti.org/English/Pages/Publications.aspx
8. It is interesting to note that in 1969 Dr. M. N. Siddiqi sent a paper on interest-free banking to the editor of *Quarterly Journal of Economics*, Cambridge, Mass. for publication. The editor Gottfried Haberler returned it with the following note:
   "I am sorry to say that we cannot accept your paper for publication. It poses interesting problems but would be of little interest for a Western country." Siddiqi, M. N. (2002), *Dialogue in Economics*, Leicester, U.K., the Islamic Foundation, p. 90.
9. Its all issues are available at the following site, freely downloadable:
   http://islamiccenter.kau.edu.sa/english/Journal/Issues/List.htm?URL=www.kau.edu.sa
10. Here is an incomplete list of specialized journals on Islamic economics, banking and finance in English:

- *Journal of King Abdulaziz University – Islamic Economics* (Jeddah) (previously it was *Journal of Research in Islamic Economics)*
- *Islamic Economic Studies*, IRTI/IDB (Jeddah, KSA)
- *Review of Islamic Economics* (Leiscester, UK)
- *International Journal of Islamic Financial Services*
- *IIU Journal of Economics and Management* (Kuala Lumpur) (Previously
- *Journal of Islamic Economics* (Selangor)
- *Thoughts in Economics* (Dhaka)
- *Journal of Islamic Banking and Finance* (Karachi)
- *Business Islamica* (Dubai)
- *Islamic Finance Today* (Colombo)
- *The American Journal of Islamic Finance* (Rancho Palos Verdes (U.S.A.)
- *Islamic Business and Finance* (Dubai)
- *ISRA International Journal of Islamic Finance*, (Kuala Lumpur, Malaysia)
- *International Journal of Islamic and Middle Eastern Finance and Management* (UK, Emerald)
- *Journal of Islamic Accounting and Business Research* (UK, Emerald)
- *Global Islamic Finance Magazine* (UK)
- *Journal of Islamic Marketing* (UK, Emerald)
- *Journal of Muamalat and Islamic Finance Research* (JMIFR) (Malaysia)

- Journal of Islamic Business and Management (JIBM) (Islamabad)
- *Islamic Banking and Finance Review*, (Lahore, Pakistan, Latest in the field).

11. It is not possible to give here the list of books published by Western publishers. We mention below a few titles just for examples:

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- Ruimy, Michel (2008), *La finance islamique*, Paris, Arnaud Franel Editions.

12. Countries and number of institutions which offer degree courses or diploma programs on Islamic banking and finance:

Britain 16	USA 4	Canada 2	Morocco 2	Australia 1
France 14	Jordan 3	India 2	Qatar 2	Djibouti 1
Saudi Arabia 8	Malaysia 3	Japan 2	Senegal 2	Germany 1
Egypt 4	Yemen 3	Kuwait 2	Spain 2	Italy 1
Pakistan 4	Algeria 2	Lebanon 2	Switzerland 2	Palestine 1
UAE 4	Bahrain 2	Luxemburg 2	Tunis 2	Russia 1
Source: Belabes and Belouafi, 2011, p. 6.				

13. The authors note that the University Paris 1 Panthéon dropped in April 2009 its master course *marche financier* (financial markets) due to declining interest of students in that paper, while in the same year in October, the University introduced a diploma in principles and practices of Islamic finance. The authors' statement is based on: Haqani, Soraya (2009), *Les formations en finance revoient leurs copies,* AGEFI, 9 juillet.
14. In spite of the fact that Indian scholars have been the pioneers to articulate and Islamic economics, banking and finance, introduction of courses and teaching has been very late and slow. The first time in the session 2009-2010, Aligarh Muslim University has initiated a diploma in Islamic banking and finance. It has its planning to take it to degree levels. There has been some other private and virtual teaching and training institutions in the country.
15. Prof. Muhammad Nejatullah Siddiqi King Faisal laureate, one of the pioneers of modern Islamic economics and banking. Recently he has been appointed to Professor Emeritus in the Department of Business and Management Studies, AMU, Aligarh.
16. Prof. Khurshid Ahmad, winner of King Faisal International award and the prize of Islamic Development Bank for Islamic economics, authored, edited and introduced a number of works on Islamic economics and finance.
17. Dr. M. Umer Chapra, also King Faisal prize winner, is one of the pioneers of modern Islamic economics and banking. Presently he is research adviser of Islamic Research and Training Institute, IDB, Jeddah.
18. Dr. Monzer Kahf, IDB prize winner in Islamic economics and banking, author of several books, currently visiting professor of Qatar University.
19. Dr. Badal Mukharji retired professor of Delhi University, wrote on a micro model of the Islamic tax system, and theory of growth of a firm under zero interest rate.
20. Dr. John Presley retired professor of Loughborough University, U.K., IDB prize winner and author of many works on Islamic banking and finance.
21. Dr. Rodney Wilson professor of Durham University, author of a number of works on Islamic banking and finance.
22. Professor *Frank E***.** *Vogel***,** Director, Islamic Legal Studies Program, *Harvard Law School***,** Cambridge, MA, USA .co-author of *Islamic Law and Finance: Religion, Risk, and Return*, Edinburgh, Edinburgh University Press, 2004.
23. Dr. Volker Nienhaus has been President of the University of Marburg and honorary professor at the University of Bochum since 2004. He has published numerous books and articles on Islamic economics and Islamic banking and finance since the 1980s.
24. Mr. Vasudevan Sundararajan, Deputy Director, IMF Monetary and Exchange Affairs Department, has authored many IMF working papers on Islamic finance.
25. Journal *al-Hayah*, London, dated 10.3.2008.
26. It is to be noted that during the 5th International Conference held during 7th-9th Oct. 2003, in Bahrain, the hub of Islamic finance in the Middle East, it was noticed that the bankers and activists of Islamic finance kept aloof from the conference and avoided interaction with the academicians. Market players took their own course which caused frustrations to Islamic economists.

ISLAMIC BANKING IN PAKISTAN: CHALLENGES AND OPPORTUNITIES A PERFORMANCE BASED ANALYSIS

M. Mahmood Shah Khan
Director
Institute of Islamic Banking
University of Management & Technology (UMT)

and

Farrukh Ijaz
Student - MS Finance
School of Business and Economics
University of Management & Technology (UMT)
farrukh-ijaz@hotmail.com

Abstract

This study is being coxed on performance measurement of Islamic Banking sector of Pakistan. The study has intended to show that Islamic banking sector of Pakistan may work at its optimal level if the altogether separate banking regulatory framework is introduced parallel to the conventional. The secondary data based study has been conducted to measure the performance of the Islamic banks while considering various performance based parameters. The parameters have included productive, operational, allocative, distributive, and stabilization efficiency of Islamic Banks. The study only takes the data of the banks to be analyzed for the performance measurement, which are working as full-fledged Islamic banks in Pakistan. This research may help the State Bank of Pakistan (SBP) and policy makers to redesign their Islamic Banking priorities and take initiative to address those particular areas where its attention is actually needed to attract and sustain the level of Islamic Baking in the country.Most of the operational issues of Islamic banking leading to its sustainability and growth will be brought under discussion. First comprehensive study will be conducted on operational issues of Islamic Banking, uncovering the real exposure of future direction.

Key Words: Islamic Banking, Operational Performance Measurement, Financial Performance Parameters.

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Introduction

Many organizations with in the sphere are re-structuring their business performance and operational methods in an essential and fundamental way. These organizations are exploring to integrate their search for cost-effective development with the promise of environmental protection and social responsibility for present and future generations with the sustainable business development concept. Based on this new phenomenon, many companies and financial institutions are trying to do changes that are significantly important in their policies, business structure, commitments, short and long term strategically framework.

The financial sector in Pakistan is going through a fast-paced, dynamic, vibrant, challenging and competitive environment within the last decade at National and International level. The introduction of Islamic Banking has incredibly changed the view point of both Conventional and Islamic economists and the predictions are there that the products being offered by this new financial system are among the most increasingly used in the upcoming years. In today's era, Islamic Banks are functional in almost all regions of the world. These Islamic Banks considered being the safest, feasible and practical substitute of the so called conventional banking system.

Performance measurement is an important tool to measure the development, growth and long term vision of any organization or sector. The performance measurement methods are used to know about an organization or institution capability, efficiency and effectiveness over the number of years; so that lenders, borrowers, investors and stakeholders have a better picture of that particular institute. Performance measurement of financial institutions provides depositors a bird eye view of its performance in terms of operations, productivity, stable efficiency and profitability. Through which depositors get knowledge in which bank they should deposit their funds and deposits. It also guides bankers that in which sector they should invest the savings and deposits of people and what possible potential sectors are there, generating revenues in the long term. The State Bank of Pakistan (SBP) is also getting guidance for its regulation drives through such performance measurement indicators.

This research is done to measure the Pakistan Islamic banking sector performance by applying banking efficiency model in five different proportions. The five proportions are operational efficiency, productive efficiency, stabilization efficiency, distributive efficiency and allocative efficiency. To measure the productive efficiency dimension, further five more tests are used, namely, project efficiency test, profit maximization test, investment opportunity utilization test, loan recovery test and test of elasticity of loan financing. Sarker (1998) in his study of performance measurement of Islamic banks working in Bangladesh used this banking efficiency model with above mentioned five dimensions and same model and dimensions are replicated in context of Pakistan.

Pakistani Islamic Banking System – Brief History

In the early era, a bank was considered to be an institution which is used to offer deposit and saving services to its clients. Today, these depository institutions are performing numerous roles and functions to provide their customers variety of services, business loans and investment products. In Pakistan, both conventional banks and Islamic banks are assisting and providing their customers with such time saving and investment services. The Islamic banking is a new and one of the evolving fields in global economic market, especially in the Pakistan financial market. The development of banking sector in Pakistan has also been praise worthy during the last ten years. According to one of the published report of State Bank of Pakistan (SBP), the growth rate of Islamic banks in terms of structure and size is of 27% per annum (Islamic Banking Department SBP, 2013)

Table – 1: Islamic Banking Growth and Market Size (2012-13)

	Industry Growth		**Growth %age**		**IB Industry Share**	
	Jun-12	**Jun-13**	**Jun-12**	**Jun-13**	**Jun-12**	**Jun-13**
Total Assets	711	903	26.9%	27.0%	8.2%	9.0%
Deposits	603	771	33.3%	28.0%	8.9%	9.9%
Financing and Investment	543	700	29.2%	28.9%	7.9%	8.8%
Total IB Institutions	17	19	-	-	-	-

Source: Quarterly Unaudited Accounts

The Constitution of the Islamic Republic of Pakistan article 38(f) emphasis that the nation should reduce and eliminate the interest based transactions as soon as possible from the financial system (The Constitution Act, 1973). The Islamic financial system in Pakistan started in the late 1977. At that time three countries were trying to implement Islamic financial system in Pakistan but that was an uphill task to introduce this new financial system, so they start initially in subordinate tasks (Performance of Pakistan Islamic Banking, 2008). In this time period, lots of thing has learnt by personnel who make the policy at that time and reapply their learning from 1977 in 1990s. Also at that time period the aim of SBP was to uphold the Islamic banks analogous to conventional banking system in stable manner under the Islamic banking policy in December 2001. For that purpose, on 15th September, 2003; the SBP established Islamic Banking Department for the promotion & development of Shariah compliant Islamic banking system in the country.

In that era, many licenses issued by the SBP with the very first license issued to Al-Meezan Investment bank parallel to the conventional banking system. This bank was among the first operative Islamic investment bank in Pakistan, and later on SBP issue license to Al-Meezan Investment bank to act as full fledged Islamic bank of the country. Besides that, SBP also allowed conventional banks to open Shariah based banks to offer Islamic banking products. Today after 10 years, there are 13 conventional banks with a network of more than 970 Islamic branches and 5 certified Islamic banks (Meezan Bank Limited, Al-Baraka Bank Limited, Bank Islami Limited, Burj Bank Limited, and Dubai Islamic Bank Limited) are operating in the Pakistan (Islamic Banking Department SBP, 2013). Besides that, the top five major conventional banks are also facilitating their customers with Shariah approved Islamic products and financing activities. The network of branches of both conventional banks Islamic window operations and Islamic banks comprise of more than 1,110 branches in over 52 cities of the Pakistan and AJK (Islamic Banking Department SBP, 2013).

Islamic Banks in Pakistan

Meezan Bank Limited: Meezan Bank Limited is a publicly listed company incorporated on January 27, 1997 and started operations as an investment bank in August, 1997. Meezan bank has the honor of being the country’s first full-fledged Islamic commercial banking license by the SBP.

Bank Islami Pakistan Limited: The SBP issued a No Objection Certificate (NOC) in no time on August 19, 2004 and Bank Islami Pakistan Limited, the second full-fledge Islamic Commercial Bank in Pakistan, was incorporated on October 18, 2004 in Pakistan. The bank is the first to receive the Islamic banking license under the Islamic Banking policy of 2003 on March 31, 2005. The bank envisioned to focus primarily on wealth management as the core area of business in addition to Shariah compliant retail products.

Al Baraka Bank (Pakistan) Limited: Al Baraka Bank (Pakistan) Limited has the honor of being the pioneer of Islamic banking in Pakistan. The bank is merger of Al Baraka Islamic Bank Bahrain and Emirates Global Islamic Bank Pakistan. Over the years, the bank has successfully developed and maintained its identity as one of the leading providers of a host of banking products and services in strict compliance with Shariah principles.

Dubai Islamic Bank Pakistan Limited: Dubai Islamic Bank Pakistan Limited (DIBPL) commenced operations in 2006. Since then, DIBPL has undertaken major initiatives to expand its branch network across the country. Dubai Islamic bank launched Pakistan's first Islamic Visa Debit Card and introduced financial products covering Home Financing, Auto Financing, and Depository products.

Burj Bank Limited: Burj Bank Limited, previously called Dawood Islamic bank Limited, is a unique Islamic bank which offers the service level of an international conventional bank while presenting a diverse portfolio of Islamic products. This bank got license in 2006 and starts its operation in 2007. Burj Bank has a rich Middle Eastern background with the technical support.

Snapshot of Islamic Banking Market Share and Performance

The Islamic banks are offering saving and deposit competitive products targeting to all segments of the society, despite the severe competition from banks and government saving plans. SBP report shows that from the year 2002 to 2010, Islamic banks deposits increased with an annual rate of 59.6%, compared to the sector average of 16.1% during the same period. In the FY'10 Islamic Banking financial system, the number of deposit accounts increased up to Rs. 1,103,437 and amount of deposits increase up to Rs. 314,901.68, which indicates an increase of 6.7% in FY'10 of total amount of deposit in banking sector. Similarly, the number of financing accounts increased to 103,294 from 43,776 in FY'10 and financing amount value increased from 127,969 to 168,073 in FY'10, with an increment of 5% from 4.4% in FY'10. The liabilities to asset ratio increased from 3.7% to 5.2%, deposit to liabilities ratio is from 47.9% to 56.3%, financing to asset ratio to 30%, financing to deposit ratio to 53.4% and investment to deposit ratio to 19.9% in FY'10, reflecting an increase in average returns from 5.03% to 5.20% for the year 2009-10. The Islamic banking market share with respect to overall deposits of banking stands at Rs. 603 billion in FY'12, depicting 1.3% increment from the from the FY'11. Total assets of the Islamic banking sector stands to Rs. 903 billion registering annual growth of 27%, whereas the amount of deposits at 28% by end of FY'13. Investments and financing contributed in an increase amount of assets; although growth in financing (10.4%) was higher to the growth in investments (2.0%). In terms of share, assets of Islamic banks contribute more than 60% in overall Islamic banking sector assets, while the remaining proportion contributed by IBD's operating in the industry. The non-performing financing (NPF) of Islamic banking industry witnessed slight decline and was recorded Rs.19.4 billion compared to Rs 19.5 billion in previous year. Profit of the Islamic banking industry reached above Rs 4.3 billion by end June 2013 from Rs. 2.2 billion by end March 2013, though lower compared to Rs 5.9 billion profits registered during June 2012.

Literature Review

Performance measurement is very important in any sector or industry because the result of performance measurement guide the decision maker for making decisions for future. The performance principally reflects business sector outcomes and results which shows overall financial health of the sector over a specific period of time. It indicates that how well an entity is utilizing its resources to maximize the shareholders wealth and profitability. Although a complete evaluation of a firm's performance take into account many other different kind of measures but most common performance measurement used in the field of finance and statistical inference is financial ratios.

Majority of the people and scholars are of the opinion not a single Hadith or Holy Quran verse provides the idea about the formation or development of the banking system in Islam. This is true, yet these both primary sources of Shariah provide a comprehensive idea about the fundamentals for the formation of Islamic banking (UK Trade and Investment, 2013). The banking sector is essential and vital for all bankers, depositors, investors and borrowers. The Islamic banking system has incredibly changed the perception of the people of Pakistan regarding the banking system. Islamic banking is the "Riba" free financial system, which prohibits the involvement of interest bearing transactions and also works on the mutual risk and profit sharing system. Islamic banking system is not solely a business funding source but also a source of trustee firm for the Muslim community. This is the main reason for the preference to deposit the money by the Muslims with the trust worthy bank which increase the liquidness of the banks.

Islamic Banking growth and development has created significant attention in the economic and financial world in the recent era. The Islamic banking system concept is not just getting acceptance in the Muslim community but it also gets flourished in the non-Muslim western culture nations as well. According to Schmith (2007) comparative to conventional banking, the growth of Islamic financial industry is high within the Muslim world is because they need an alternative to riba based banking. But besides Muslims, this system also attracts many non-Muslims with a growth of 16 percent to 20 percent per annum. In Pakistan, the market share of the Islamic banking industry is nearly 3.2 % with a network of only 170 branches, comparative to 7,700 branches of the conventional banks with five million borrowers. Also the borrowers in conventional system (around 5,000,000) are million times more than the Islamic banking sector, which are just 23,000 in number (Akhtar, 2007). He is of the viewpoint that if Islamic banks want to compete with the conventional banks then they must improve their services and provide quality products to the customers.

In a study, done by Bader et al. (2008), they found that conventional banks are performing well in revenue generating and providing cost effective operations than Islamic banks, which solely working better in profit efficiency. They were of the opinion that there is no such big difference among both types of banking system in the utilization of their factors of production. This study finding is completely parallel to the finding of the research work of Johnes (2008) who using financial ratio analysis of both conventional and Islamic banks in Malaysia found that conventional banking system is cost effective but less profit and revenue effective. They also come to the conclusion that the efficiency in conventional banks is significantly higher comparative to the Islamic banks.

Awan (2009) is of the opinion that in Pakistan the conventional banking system is not performing well when compared to Islamic banks. In his research from 2006 to 2008 on Pakistan Islamic banking sector, he found 100% increment in market share of Islamic banking institutions from 2.5 % to 5 %. He raised the point that in coming years the major challenge for Islamic banks is to compete with conventional banks as SBP has granted permission to them to open Islamic branches and windows in parallel to their interest based banking system.

The customers are more pleased with the performance and efficiency of conventional banks comparatively to Islamic banks (Khattak & Kashif Ur, 2010). The major reason of this could be that the most of the people are not aware about the concept and the products being offered by this Islamic banking system (Imran, Samad, & Masood, 2011). Also, the scope of products being offered by the Islamic banks is limited and not highly efficient as conventional banks do (Iqbal et al., 1999).

In a study done by Jaffar & Manarvi (2011), they found that the performance of Islamic banks is better comparative to conventional banking system. They applied CAMEL methodology to compare the performance of 5 Islamic banks with 5 conventional banks. Their study found that Islamic banks performed better than conventional banks in terms of adequate capital while conventional banks did well in terms of management quality. Moreover, in terms of profitability and liquidity there was no major difference between both banks, which were similar to the findings of Samad (2004).

Most of the researches done on the performance measurement of Islamic and conventional banks disclose that majorities of Islamic banking customers prefer the system largely owing to its perceived compliance with Shariah. El-Hawary, Grais, & Iqbal (2004) in a study found that 67% of Islamic banking customers also use conventional banks parallel to Islamic banking system. Religion is important to the Pakistani banking customer, but they do not seem to be agnostic to service quality either. Islamic banks are insures more stable financial sector than the conventional banks (Khan & Bhatti, 2008). By the other study, in Tunisia it is verified that Islamic banking system showed excellent performing sector by supporting financial sector. In Iran there is another study which shows mixed result both in favor of Islamic bank and in conventional banks that they support and stabilized monitory system (Yousefi et al., 1997).

An earlier study was conducted to evaluate the performance of Islamic banking in Pakistan as it had captured only 2 percent market shares in only three year period. In this study, the performance evaluation has been done in 1999-2006 of Islamic banks. For this purpose, study evaluates the banking sector in four dimensions such as profitability, liquidity, risk and solvency and customer growth. The study used mean, standard deviation, T-test and F-test for the analysis and the data been collected from annual reports of the banks. The study reveals that Islamic bank is less profitable as compared to conventional banking system and Islamic products are also not popular in the system. (Rashid, 2007)

Iqbal & Molyneux (2005) in their book entitled "Thirty years of Islamic banking" explains and elaborate the performance of Islamic banking sector over the last thirty years on the dimensions like theoretical, empirical and legal aspects. The book analyzes the performance of Islamic banks under different dimensions to explain the characteristics of Islamic banking, to elaborate the problems that Islamic banking sector is facing and also to highlight areas where some further research is to be needed such as the ownership arrangements, pellucidity and corporate governance of Islamic banks. Iqbal & Molyneux (2005) was of the view that despite of getting massive success in last thirty years this sector has lots of potential and should have to achieve many more milestones.

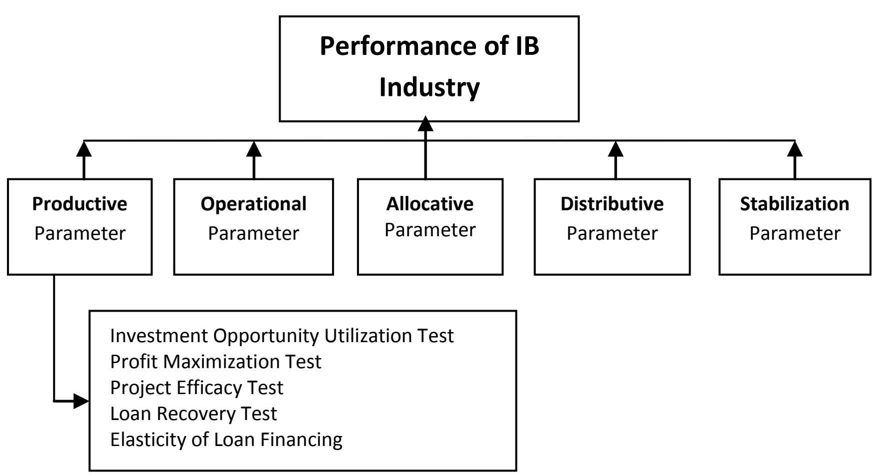
Sarker (1997) measures the Bangladesh Islamic banking efficiency in five different dimensions by using banking efficiency model. The dimensions were productivity, operational, stabilization, distributive and allocative. The study also measures the productive efficiency in further five tests and then elaborates some problems and recommends the future policy for Islamic banking sector of Bangladesh.

Research Methodology

In this study secondary data is used. The qualitative data is in the form of research journals, articles and literature on the Islamic Banking sector is collected from the electronic database, while quantitative data in the shape of financial figures were taken from the annual reports of Islamic Banks, credit and accounts department of these banks as well as from the reports "SBP Banking Surveillance Department Quarterly Performance Review of the banking System 2012" and "SBP Banking Surveillance Department Financial Soundness Indicators (FSIs) 2012" published on the website of SBP. Apart from this, where ever required, Karachi Stock Exchange (KSE) published information is also used.

The financial data duration is expanded over the 5 years period from 2006 to 2010 and the sample consists of 5 Islamic Banks from the Pakistan financial system, namely Meezan Bank Limited, Emirates Global Islamic Bank, Dubai Islamic Bank, Al-Baraka Islamic Bank, Bank Islami and Burj Islamic Bank Limited from the population size of 18 banks of Pakistan banking sector. The reason for selecting the sample size is that these banks are operating as full fledged banks; irrespective of banks that are providing just stand alone window operations of Islamic Banking. In order to analyze performance of Islamic Banking sector various performance based parameters has been used. The parameters will include productive, operational, allocative, distributive, and stabilization efficiency of Islamic Banks. These five efficiency test criteria are called Banking Efficiency Model. We applied five more test to measure the Productive Efficiency which is Investment Opportunity Utilization Test, Profit Maximization Test, Project Efficacy Test, Loan Recovery Test and Test of Elasticity of Loan Financing. This Banking Efficiency Model has been used by (Abdul Sarker, 1998) for performance evaluation of Islamic banks operating in Bangladesh in 1998. We apply these five efficiency test criteria of Banking Efficiency Model and conclude with a best bank rating. Descriptive statistics and Ratio analysis are carried out with the use of MS Excel and SPSS.

Research Model



Performance Analysis of Islamic Banks

Analysis of the performance is very important for every sector or industry because it guide the policy maker about their decision making and guide to take corrective measure if any lapses are there in the policy and work accordingly. In order to measure the financial performance of the Islamic banking sector of Pakistan for the time duration of FY 2007-2012 of the 5 full fledged Islamic banks, first it is important to study the descriptive statistics of the financial ratios which are used as an explanatory variables to measure the major impact on the return on investment (Exploratory variable) taken in the study. The performance of Islamic banking is measured in five areas by using **Banking Efficiency Model.**

1. Productive Efficiency of the Islamic Banks

Investment Opportunity Utilization Test

Investment opportunity utilization of the banking system is determined by fund utilization ratio, per employees deposit mobilization and per employee fund utilization. The ratio of fund utilization explains the organization's fund advances to the loanable funds available. The fund utilization ratio of Bank Islami is higher comparative to other Islamic banks in 2006, whereas in financial year 2007 Burj Bank utilization ratio doubled the industry average. Similarly, in 2008 and 2009, Burj bank of Pakistan contributes more in employee's advances with respect to the other banks. From the FY'10 to FY'12 almost all banks are near to the industry averaged benchmark fund utilization ratio of 103.24% as shown in the below table.

Fund Utilization Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Al-Baraka Islamic Bank	97.54	98.94	101.49	100.20	99.80	99.39	98.08
Bank Islami	145.29	110.41	109.55	83.72	99.48	98.73	99.80
Meezan Bank	98.00	102.00	101.00	99.00	98.00	98.00	99.00
Dubai Islamic Bank	-	98.00	102.00	102.00	104.00	102.87	103.00
Burj Bank	-	205.74	160.47	143.12	111.04	118.48	106.22

Per employee deposit mobilization ratio is calculated by dividing the total deposits by the total number of employees in a calendar year. The Al-Baraka Islamic bank Pakistan enjoys the highest mobilization of employee deposits ratio from FY'06 to FY'11, accounting from amount Rs 45,168 to Rs. 37,536 respectively. Meezan bank limited contributing stable amount of mobilization for the last 7 years. The per employee deposit mobilization for Dubai Islamic bank limited has gone double in number in 2010 from the financial results of the year 2007. The deposit mobilization ratio per employee for all banks except Burj Islamic bank is above Rs. 30,000, managing to stable with the industry average amount.

Per Employee Deposit Mobilization (in Rs. '000')							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Al-Baraka Islamic Bank	45,168	46,606	40,299	42,872	37,310	37,536	31,991
Bank Islami	7,534	17,645	10,503	19,026	28,358	30,353	38,966
Meezan Bank	24,802	24,754	22,155	26,791	29,447	34,700	38,708
Dubai Islamic Bank	-	16,244	30,821	28,435	31,732	27,494	30,540
Burj Bank	-	32,458	23,01	15,110	26,714	24,806	23,494

The ratio of per employee fund utilization explains the organization's fund advances that are being employed by their employees over a specific period of time. Per employee fund utilization rate of Al-Baraka Islamic bank is highest in Islamic banking sector of Pakistan for the financial years 2008-11. Dubai Islamic bank is second highest among Islamic banking sector of Pakistan, but in 2012 it has the highest fund utilization amount allocation to employees. This ratio is equally shared at the below level between the Burj bank limited and Dubai Islamic bank limited, whereas the Meezan bank of Pakistan enjoys the highest rank in comparative to other Islamic banks in the FY'12.

Per Employee Fund Utilization							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Al-Baraka Islamic Bank	50,095	49,673	45,295	47,252	39,316	38,361	32,364
Bank Islami	11,254	19,620	11,733	16,017	28,472	30,443	39,872
Meezan Bank	27,369	26,495	23,770	28,718	30,003	35,771	41,238
Dubai Islamic Bank	-	15,946	31,400	29,275	34,081	29,835	32,500
Burj Bank	-	66,779	37,303	25,115	30,338	30,036	27,099

Profit Maximization Test

Profit maximization is the ultimate goal of all stakeholders and organizations. To measure the profit maximization of the Islamic banking sector, following five indicators are used; Cost - Income ratio, Income - Expenditure ratio, Profit - Expenditure ratio, Profit - Loanable Fund ratio and Profit - Employed Fund ratio. Cost – Income ratio tells us about the firm's fraction of total costs to total income. This means that how much an organization generating with respect to its costs of doing business. The overall cost-income ratio of Meezan bank limited, Dubai Islamic bank limited and Bank Islami limited is well managed. The ratio is dramatically increased for Burj bank of Pakistan from 23% in 2007 to 72.00%% in 2012. Al-Baraka bank maintained an average cost income level of 73.45% over the under studied years.

Cost-Income Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	54.14	53.61	45.40	49.20	53.75	48.06	52.13
Al-Baraka Islamic Bank	74.13	73.00	75.57	79.86	75.43	74.65	75.35
Bank Islami	18.66	50.47	49.67	56.14	54.06	52.40	58.69
Dubai Islamic Bank	-	41.91	50.57	49.52	52.30	51.72	49.41
Burj Bank	-	23.18	47.17	57.49	57.49	59.91	72.00

Income - Expenditure ratio of Meezan bank limited in 2003 and 2004 stands out 147% and 130%, but it continually increase from the year 2004 to 2012 to almost 305% respectively. This ratio is excellent for Meezan bank limited. The trend of income-expenditure ratio for Al-Baraka Islamic bank is totally opposite to the Meezan bank limited, where this ratio shown a decline over the years from 424% to 137% from the year 2006 to 2010. Dubai Islamic bank and Bank Islami show the similar pattern with an averaging 194.34% of income-expenditure ratio in 2010. Overall the ratio is well maintained to industry benchmarked average in the year 2012.

Income-Expenditure Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	263.12	259.20	250.75	292.10	270.98	294.36	304.58
Al-Baraka Islamic Bank	424.04	445.08	308.12	360.53	137.84	347.74	298.26
Bank Islami	62.78	117.91	142.05	123.27	198.38	248.35	262.10
Dubai Islamic Bank	-	77.01	151.53	209.68	193.02	195.66	197.58
Burj Bank	-	149.94	197.02	165.00	123.91	192.16	224.39

The profit to expenditure ratio of the whole Islamic banking industry seems to be not favorable in the year 2009 and 2010, while it grows and show some profitability in the last two years. As the industry going through the initial phase of emergence its performance with respect to profit to expenditure is declined over the years. This doesn't mean the industry is in poor condition to challenge the conventional system of banking. The decline was seen due to massive increase in expenditures local transportation and car running and service charges but profit does not increase with the same ratio therefore increase is lesser as compared to previous year's. As we can see from the latest FY 2012-13 facts and figures of SBP that the Islamic financial industry is growing in size and deposits, comparative to the previous year findings.

Profit-Expenditure Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	58.79	54.60	22.90	29.65	36.37	55.36	48.93
Al-Baraka Islamic Bank	54.90	73.19	-12.77	-39.72	-65.17	21.30	-30.57
Bank Islami	-5.24	-7.25	-5.12	-27.73	2.43	18.50	18.02
Dubai Islamic Bank	-	-25.39	-10.12	13.04	0.38	8.05	12.02
Burj Bank	-	30.63	7.54	-42.66	-52.52	77.04	62.84

Profit – Loanable Fund ratio shows some what a similar pattern like of Profit – Expenditure ratio. The ratio decrease in 2008 from the early years due to lesser increase in profit during the year but loanable fund is increase massively during the year. However, the banks are now getting profits more from the past, and the ratio is showing improvement in the coming years.

Profit-Loanable Fund Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	1.56	1.69	0.84	0.94	1.20	1.89	1.41
Al-Baraka Islamic Bank	0.92	1.34	-0.36	-1.13	-2.00	0.65	0.98
Bank Islami	-0.46	-0.37	-0.42	-1.74	0.12	0.80	0.62
Dubai Islamic Bank		-2.29	-0.71	0.81	0.02	0.47	0.63
Burj Bank		1.77	0.64	3.71	4.14	4.58	2.59

Profit – Employed Fund ratio of the Islamic banks has been improved over the years except Al-Baraka Islamic bank. Al-Baraka bank shows negative trend due to the more advances employed to their employees in the years 2008-12, comparative to the industry ongoing positive average.

Profit- Employed Fund Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	1.59	1.65	0.82	0.95	1.24	1.93	1.43
Al-Baraka Islamic Bank	0.94	1.36	-0.35	-1.13	-2.00	0.65	-1.00
Bank Islamic	-0.31	-0.34	-0.38	-2.08	0.12	0.81	0.63
Dubai Islamic Bank	-	-2.33	-0.70	0.79	0.02	0.46	0.61
Burj Bank	-	0.86	0.40	2.59	3.73	3.87	2.44

Project Efficacy Test

Meezan bank is on top in this test, Al-Baraka Islamic bank secure second number in this test, Dubai Islamic bank secure third number in this test, Burj Bank secure fourth place in this test and Bank Islami Secure fifth number in this test in Islamic banking sector of Pakistan, as shown in the below table performance measurements.

Loan Recovery Test

Loan recovery test, also called bad debt ratio, is used to calculate the percentage of bad debts to the accounts receivable. It is depicted from the analysis for Meezan Bank Ltd, that its bad debt ratio has been increased from the year 2006 to 2010, and reached at its peak in the FY'10. This is similar to the ratios of Burj bank limited, Dubai Islamic bank and Al-Baraka Islamic bank. Bad Debts ratio for Bank Islami Pakistan is 0.04%, 0.27%, 1.16%, 1.04%, 0.99% in 2006,2007,2008,2009 and 2010 respectively. From the year 2010, the ratio of loan recovery keep on declining for all the banks which means banks have regulated more strict policies to recover the bad debts.

Loan Recovery Test (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	0.65	1.18	1.89	2.73	3.38	2.99	2.38
Al-Baraka Islamic Bank	1.24	1.47	1.70	3.30	3.95	-0.36	1.25
Bank Islami Pakistan	0.04	0.27	1.16	1.04	0.99	0.50	0.26
Dubai Islamic Bank Pakistan	-	0.64	1.00	1.31	1.67	1.36	1.53
Burj Bank Pakistan	-	0.03	0.07	2.38	4.87	1.02	0.42

Test of Elasticity in Loan Financing

Discussion and panel interviews with the executives and head of departments of the Islamic banking sector of Pakistan reveal this fact that mechanism is still less elastic. Not any single bank but the whole Islamic banking sector in the Pakistan is facing these problems e.g. lack of suitable modes in meeting call loan demands as well as working capital needs of the entrepreneurs. This is still less elastic because most of the customer of conventional banking to whom we approach they just ask us can you give us running finance and call loan? There is no answer to this question. Only 5 % of conventional banking customer is satisfied with us whom we are offering our products, rests are not fully satisfied with our products. So there should be any product like running finance and call loan so Islamic banking can grow massively.

Operational Efficiency of the Islamic Banks

Investment to Administrative Cost Ratio

The investment to administrative cost ratio is decreased over the years for the Islamic banks except Bank Islamic Pakistan. This ratio is showing declining trend due to bad economic condition of the country and the global financial economy crisis in the 2008-09. Overall, the ratio of Al-Baraka bank and Bank Islami is better than the competitive Islamic banks in the region.

Investment to Administrative Cost Ratio (in Rs '000')

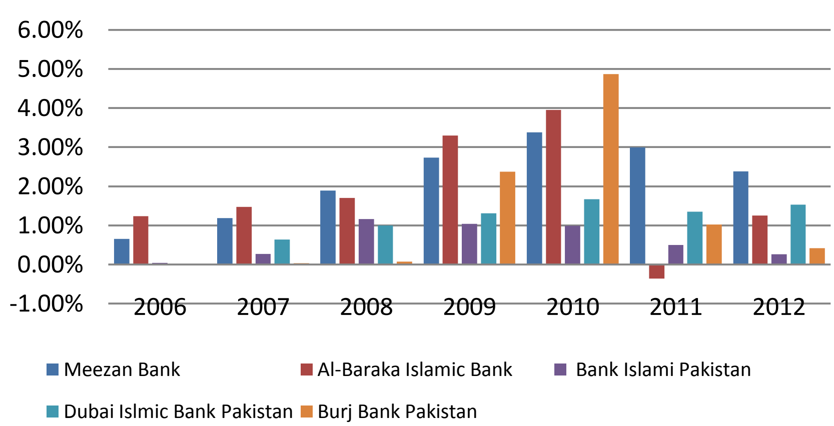
Banks/Years	2006	2007	2008	2009	2010	2011	2012
Meezan Bank	37.16	33.27	28.69	30.47	29.94	29.42	34.13
Al-Baraka Islamic Bank	58.72	53.97	35.99	35.42	34.45	32.93	32.15
Bank Islamic Pakistan	18.25	22.49	13.56	13.42	20.23	35.96	38.32
Dubai Islamic Bank Pakistan	-	8.83	17.84	16.70	16.10	16.73	19.86
Burj Bank Pakistan	-	35.80	18.91	16.45	14.54	20.03	25.68

Per Employee Administrative Cost

The administrative cost per employee is well managed and maintain by Meezan bank and Al-Baraka bank, averaging Rs. 1070.17; whereas Burj bank and Dubai Islamic bank employees administration cost almost doubled to the former banks. All these banks have maintained a balanced per employee administrative cost over the financial years.

Per Employee Administrative Cost (in Rs.)

Banks/Years	2006	2007	2008	2009	2010	2011	2012
Meezan Bank	736.49	796.26	828.58	942.63	1002.20	1216.04	1208.22
Al-Baraka Islamic Bank	853.16	920.36	1258.65	1333.96	1141.14	1165.08	1006.64
Bank Islami	616.64	872.42	865.52	1193.41	1407.18	846.68	1040.39
Dubai Islamic Bank		1805.73	1759.97	1752.51	2116.73	1783.33	1636.68
Burj Bank		1865.16	1972.71	1527.12	2085.82	1499.20	1055.07



In operational efficiency test, Meezan bank is on top in whole Islamic banking sector of Pakistan. Al-Baraka Islamic Bank is on second number, Bank Islami is on third, Dubai Islamic Bank is on fourth number, and Burj Bank is on number fifth number in the whole Islamic.

Allocative Efficiency of the Islamic Banks

Meezan Bank Limited short term financing remains 4.54%, 3.01%, 0.99%, 1.97% and 3.20% of total allocation of resources in 2006, 2007, 2008, 2009 and 2010. Term financing remains 18.10%, 12.28%, 13.19%, 9.57% and 11.52% of total allocation of resources in 2006, 2007, 2008, 2009 and 2010. Trade Financing accounts 20.31%, 20.34%, 19.03%, 19.64% and 10.91% of total allocation of resources in 2003, 2004, 20005, 2006, 2007, 2008, 2009 and 2010. Investment in government securities is 1.26%, 1.85%, 3.34%, 5.11%, and 11.08% of total allocation of resources in 2006, 2007, 2008, 2009, 2010. Investment in other institutions is 55.78%, 62.52%, 63.44%, 63.70% and 63.29% of allocation of resources in 2006, 2007, 2008, 2009 and 2010. Al-Baraka Islamic Bank Pakistan short term financing is 14.20%, 11.87%, 9.59%, 13.67%, and 6.21% in 2006, 2007, 2008, 2009 and 2010. Term financing is 8.76%, 10.32%, 9.99%, 8.31%, and 18.38% in 2006, 2007, 2008, 2009 and 2010. Trade Financing is 21.82%, 21.55%, 22.62%, 22.22%, and 14.82% in the respective years. Investment in government securities is nil during the years, while investment in other account 55.22%, 56.27%, 57.80%, 55.81% and 60.59% in 2006, 2007, 2008, 2009 and 2010. Bank Islami financing and investment activities are somehow same as that of the Al-Baraka Islamic bank, as shown in the table. Burj Bank is new in the Islamic banking system and has gain much share in term and trade financing activities. Short term financing is 3.16%, 3.12%, 5.12% and 4.94% in 2007, 2008, 2009 and 2010 respectively. The term financing stands 48.03%, 59.30%, 52.43% and 57.08% in 2007, 2008, 2009 and 2010. Trade Financing is 44.04%, 32.53%, 38.81% and 33.03% in 2007, 2008, 2009 and 2010 respectively. Investment in government securities is nil during the years. Dubai Islamic Bank Short Term Financing 8.86%, 12.52%, 8.44% and 10.24% in 2007, 2008, 2009 and 2010 respectively. Term Financing is 73.60%, 69.82%, 66.61 and 59.23% in 2007, 2008, 2009 and 2010 respectively. Trade Financing is 16.56%, 16.77%, 22.12% and 19.29% in 2007, 2008, 2009 and 2010 respectively. Investment in others is 0.99% and 0.89% in 2007 and 2008 respectively and nil in 2009 and 2010.

In Allocative efficiency test Dubai Islamic Bank is on top, Burj Bank is second highest in allocative efficiency test, Bank Islami is third in allocative efficiency, Al-Baraka Islamic Bank fourth highest bank in allocative efficiency test and Meezan Bank is fifth highest in allocative efficiency test in Islamic banking sector of Pakistan.

Distributive Efficiency of the Islamic Banks

Gross Profit-Income Ratio

The gross profit-income ratio is used as one indicator of a business's financial health. The higher the ratio, the more efficiently the organization is operating. The ratio of Meezan bank gradually increases from 2006-2008, but from onwards it shows downward behavior. Al-Baraka bank gross margin remains below the industry average for all the years. Bank Islami enjoys higher profit income ratio in 2006, but in the later years the ratio is equals the Islamic banking sector average profit-income ratio.

Gross Profit-Income Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	45.86	46.39	54.60	50.80	46.25	44.53	43.74
Al-Baraka Islamic Bank	25.87	27.00	24.43	20.14	24.57	19.87	22.97
Bank Islami Pakistan	81.34	49.53	50.33	43.86	45.94	39.96	38.92
Dubai Islamic Bank Pakistan	-	58.09	49.43	50.48	47.70	50.54	51.80
Burj Bank Pakistan	-	76.82	52.83	42.51	42.51	40.09	32.01

Growth in Deposit

The deposits of Al-Baraka bank had increased 4 times more comparative to the industry average of 28% in the year 2010. This was the case for Bank Islami in the year 2009. The deposit growth rate of all the banks, remain near to the industry ongoing average rate.

Growth in Deposit (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	51.30	58.44	28.67	42.86	30.64	29.72	35.52
Al-Baraka Islamic Bank	0.00	22.74	8.09	23.45	17.90	24.80	21.79
Bank Islami Pakistan	0.00	458.73	25.61	124.29	36.48	32.38	26.99
Dubai Islamic Bank Pakistan	-	0.00	57.99	9.91	12.27	22.53	37.98
Burj Bank Pakistan	-	0.00	38.08	37.41	27.25	60.97	76.60

Growth in Advances

The growth in advance, like deposit growth rate, also increases for Al-Baraka Islamic bank at its highest level. Meezan bank advances growth shows up and down trend over the under study years. It remains almost stable for the year 2006 and 2007, in the year 2008 it decreased up to 29% and again in 2009 it raised up to 43%. Bank Islami, Dubai Islamic and Burj bank advances ratio decreased tremendously over the years.

Growth in Advances (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	56.99	53.67	28.98	42.73	24.17	31.25	40.06
Al-Baraka Islamic Bank	0.00	17.95	13.98	21.06	108.33	21.04	19.76
Bank Islami Pakistan	0.00	315.89	26.19	69.04	51.88	32.24	29.56
Dubai Islamic Bank Pakistan	-	0.00	63.96	11.07	17.13	23.80	35.31
Burj Bank Pakistan	-	0.00	38.08	37.41	27.25	51.64	58.23

Financing to Deposit Ratio

Financing to deposit ratio is used to assess a bank's liquidity by dividing the banks total loans by its total deposits. The higher the ratio means the bank might not have enough liquidity to cover any unforeseen fund requirements. This ratio is higher for Dubai Islamic bank in the year 2010 and for the Burj bank limited for the years 2007-08 respectively. Bank Islami ratio in 2009 is around 38.26% indicating that the bank may not be earning as much as they could.

Financing to Deposit Ratio (in %age)							
Banks/Years	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Meezan Bank	79.16	64.58	58.19	44.09	44.29	41.39	38.48
Al-Baraka Islamic Bank	71.45	75.35	80.26	68.55	58.43	47.36	45.49
Bank Islami Pakistan	54.00	40.19	53.59	38.26	44.50	48.78	42.72
Dubai Islamic Bank Pakistan	-	71.05	72.00	74.91	74.23	180.84	166.98
Burj Bank Pakistan	-	128.97	111.50	73.72	49.36	61.11	65.06

Stabilization Efficiency of the Islamic Banks

Bank Islami is on number 1st in stability according to this test one of the reason is they are very rigid in financing. Emirates Global Islamic bank is on number 2nd in stability according to this test. Dubai Islamic Bank is on number 3rd in stability according to this test. Meezan Bank is on number 4th in stability according to this test. Burj Bank is on number 5th in stability according to this test. Al-Baraka Islamic Bank is on number 6th in stability according to this test.

Bank Islami is highest in stabilization efficiency test, Emirates Global Islamic Bank is second highest in stabilization efficiency test, Dubai Islamic Bank is third highest in stabilization efficiency test, Meezan Bank is fourth highest in stabilization efficiency test, Burj Bank is fifth highest in stabilization efficiency test, Al-Baraka Islamic Bank is sixth highest in stabilization efficiency test in whole Islamic banking sector of Pakistan.

Stabilization Efficiently of the Islamic Banks (in %age)

Banks/Years	2006	2007	2008	2009	2010	2011	2012
Meezan Bank	0.65	1.18	1.89	2.73	3.38	2.99	2.38
Al-Baraka Islamic Bank	1.24	1.47	1.70	3.30	3.95	-0.36	1.25
Bank Islami Pakistan	0.04	0.27	1.16	1.04	0.99	0.99	0.50
Dubai Islamic Bank	-	-	0.64	1.00	1.31	1.67	1.35
Burj Bank	-	-	0.03	0.07	2.38	4.87	1.02

Problems of Islamic Banking Industry of Pakistan

Islamic Banking is facing hard challenges in the world as well as Islamic Banking sector of Pakistan is also facing different problem at micro and macro level of operations. First of all they face lack of short term market where they place their surplus funds. There is no such interest free mechanism for employment of fund in Islamic Banking sector. These banks also face the problem in consumer financing and as well as financing government budgets.

Secondly, risk is so high which is faced by Islamic banking sector in profit-sharing nearly altogether of the Islamic banks in Pakistan invest into a sector which gave them stable return. By way of outcome, People criticize that Islamic banking is only the change of name of conventional banking.

Thirdly, SBP does not gave them Islamic banks any kind of lawful support the Islamic banks do not have the lawful support ,the essential know-how and proficient human resources to measure, display, for the finance project audit these essentials know how and proficient human resources are required. By way of outcome, they cannot inflate despite having gigantic excess financial liquidity.

Following are the list of the issues which Islamic Banking Sector of Pakistan is facing includes:

1. Macro Operational Difficulties of the Pakistan Islamic Banking Industry

- Liquidness and Capital: There is a problem of liquidity in Islamic banking sector of Pakistan due to lack of short term money market specifically for Islamic banking sector.
- Valuation of bank Assets: The assets of the banks mentioned on financial statements usually highly risky due to chances of risk because the asset which is

mentioned on the statement can be default so the valuation of asset is another problem.

- Financial Stability: Financial Stability is another problem for Pakistan due to bad government policies and load shedding due to this financial stability is hurt badly in last few years. For example due to load shedding our industry will have to bear extra cost for arranging alternative source of electricity that increase the per unit cost of the industry that hurt while competing in international market so that will decrease our export so our balance of payment will be negative. On the contrary government revenue will also decrease so budget deficit will also decrease.
- Lack of human resources for Islamic Shariah banking: Islamic banking sector does not have qualified Islamic banking professionals. The State Bank of Pakistan do not have the essential know-how and proficient manpower to evaluate, display, value an audit the projects that are required to finance. As a result, they cannot inflate despite having gigantic excess financial liquidity.
- Global Awareness Campaign: There is need a of awareness campaign in international financial and non-financial sector.
- Severe Competition in the Financial Sector: There is a severe competition in financial sector there is more than 30 conventional banks are operating in Pakistan.
- Economic go-slow and Political Situation of the Country: Another big problem in Pakistan is economic slowdown and political instability in the country which hurt the banking sector very badly.
- Defaulting Culture of the Borrowers: Another defaulting culture of the borrowers in Pakistan is another macro problem. In current days borrowers invest their money in those sectors which ultimately end up with bad debts lack of entrepreneurs in the country is also lead to bad debts.
- Absence of Uniformity in Operation's Processes: Due to absence of uniform operational procedure customer are facing difficulties to understand the procedures and policies of Islamic banking sector and lack of awareness is of Islamic banking system is a big hurdle.

2. Micro Operational Difficulties of the Pakistan Islamic Banking Industry

- Higher Cost related to Information: This Cost increase in current era bank face difficulties while collecting the information about the financed projects.
- Control over Cost of Funds: Due to bad economic condition as well as severe competition bank has to pay more profit to the depositor to attract the depositor. So the cost of fund would increase.
- Usage of Interest Rate for the Profit Margin: Islamic banks used conventional bank interest rate for determine profit margin on Bai modes which is contradictory up to some extent and criticize by some Islamic bankers.
- Absence financing of Islamic bank to Government: Government does not want to take financing from Islamic banking sector based on Shariah if government support Islamic banking sector then that would be helpful for Islamic bank.
- Islamic Banks failed to Finance Higher Profitable Projects: Islamic banks fail to finance high returns projects because Islamic banks share profit therefore large organization prefer conventional banking sector rather than borrowing from Islamic banking sector. Conventional banking sector charge fixed mark up.

- Sacrifice of Allocative Efficiency: Islamic banking sector sometime allocate their resources in less productive sector which sacrifice the allocative efficiency.
- Loss of Distributive Efficiency: Distribution of resources is compromise by the Islamic banking sector which ultimately affects the distributive efficiency of the Islamic bank.
- Lack of Full-fledged Shariah Audit: Islamic banking sector does not have full-fledged Shariah audit which is hurdle in rapid growth of Islamic banking sector.
- Minimum Budget for Research and Development: Islamic banking sector of Pakistan is not allocating handsome amount of money in research and development therefore product development is very slow in Islamic banking sector.
- Absence of Linkage between Training Institutes and Shariah Bodies: In Pakistan there is a lack of linkage between training institutes and Shariah supervisory bodies in the country. If linkage is established then it would be beneficial for whole Islamic banking sector of Pakistan.

Recommendations and Suggestions

- **Re-structure the financial System:** There is need to re-organize the whole capitalistic financial system of the world and launch Islamic reforms which based on Islamic shariah. Need of the time is follow Islamic finance as globally a movement has been started namely "Banked like a Islamic way" Islamic banking is showing excellent performance despite of working beneath the traditional banking structure.
- **Future Policy and Strategy:** Islamic banks should launch awareness campaign about the actual concept of Islamic banking and develop Islamic banking in the mind of public as a PLS mode banking because public perceive Islamic banking as same as conventional banking system.
- **Stepping for Distributional Efficiency:** Distribution of resources is compromise by the Islamic banking sector which ultimately affects the distributive efficiency of the Islamic bank. Islamic banks develop such distributional policy for their resources which able Islamic banks to become profit and loss sharing banks and convert banking into PLS mode banking. Bank should be selective in deciding about the borrowers.
- **Promotion of Allocative Efficiency:** Islamic banking sector sometime allocate their resources in less productive sector which sacrifice the allocative efficiency. Islamic banks can mend allcative efficiency by investing their fund in priority sectors i.e. agriculture, Garments, Small and cottage industry and in those avenues where efficiency can't be compromise and keep in mind the profitability when devising the policy about the priority sector for investable funds.
- **Modern banking Policies and Practices:** Islamic banking sector has to develop such a policies which are aligning to modern banking practices because survival under the conventional banking framework would not be possible without the modern banking policies.
- **Development of New Products:** Islamic banks must develop a product like running finance and call loan because almost all the banks facing difficulty while targeting conventional banking customers. If any product same like running finance is develop then it would change the pace of growth of Islamic banks.

Conclusion

Overall, Meezan Bank is on highest position in these banking efficiency models test, Dubai Islamic Bank is on 2nd highest in these tests, Al-Baraka Islamic Bank is on 3rd number, Burj Bank is on 4th number in this test and Bank Islami is on 5th number in this test.

In Operational Efficiency test Meezan Bank is on top in whole Islamic banking sector of Pakistan. Al-Baraka Islamic Bank is on second number, Bank Islami is on third, Dubai Islamic Bank is on fourth number, and Burj Bank is on number fifth in the whole Islamic banking sector of Pakistan.

In Allocative efficiency test Dubai Islamic Bank is on top, Burj Bank is second highest in allocative efficiency test, Bank Islami is third highest in allocative efficiency, Al-Baraka Islamic Bank fourth highest bank in allocative efficiency test and Meezan Bank is fifth highest in allocative efficiency test in Islamic banking sector of Pakistan.

Bank Islami Pakistan is secure 1st highest position in Distributive Efficiency test, Meezan Bank is secure 2nd highest position in Distributive Efficiency test, Burj Bank Pakistan is secure 3rd highest position in Distributive Efficiency test, Dubai Islamic Bank Pakistan is secure 4th highest position in Distributive Efficiency test, and Al-Baraka Islamic Bank is secure 5th highest position in Distributive Efficiency test in Islamic banking sector of Pakistan.

Bank Islami is highest in stabilization efficiency test, Dubai Islamic Bank is second highest in stabilization efficiency test, Meezan Bank is third highest in stabilization efficiency test, Burj Bank is fourth highest in stabilization efficiency test and Al-Baraka Islamic Bank is fifth place in stabilization efficiency test in whole Islamic banking sector of Pakistan.

According to the banking efficiency model five test criteria rating for the Islamic banking sector would be Meezan Bank will be on top followed by Bank Islami, Dubai Islamic Bank, Burj Bank and Al-Baraka Islamic Bank respectively.

Current performance Islamic banking sector of Pakistan is satisfactory under this condition of the financial system but Islamic banks can serve more proficient then currently they are serving if they are buoyed with apt banking laws and regulations. If this would happened As a result very soon they will launch PLS modes of processes, which are very much encouraging to economic growth. Islamic banking sector is working efficiently under conventional banking system and applying PLS mode. There is no need to restructure the whole wheel. All the effort should be made to transform conventional accounting theory to make it attuned with Islamic Shariah. This will save vitality and phase which should be expended over the progress of new Islamic modes of financing and improving the overall operations of Islamic economic and banking system.

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Appendix

Project Efficacy Ratio Test

Indicators / Bank	Burj Bank Limited	Bank Islami Limited	Al-Baraka Islamic	Meezan Bank Limited	Dubai Islamic Bank
Project Selection Preferences	Textile Sector affected; Commodity market which include Sugar, rice and wheat; Prefer to lend Government based entities.	Finance all the businesses which are according to Shariah.		No preference policy in specific sector exposure but lend every sector which are doing business	Make the policy year wise which sector have to finance; Define the exposure of the financing accordingly particular sector expected growth
Policy	Follow push policy they lend those borrowers whose Bargaining power is high. So the recovery of loan to that customer is very easy.	Prefer push policy because recovery of loan is very easy but also go for pull policy after securing the investment.			Have no defined policy which customer they have to target either Push or Pull.
Lending limit	Lend 25 % of equity	Lend 30 % of equity	Lend 25 % of equity		Lend 25 % of equity
Pre Financing Appraisal of Projects	Financial Analysis (Net Worth, Current Ratio, Profit Margin, Adjusted Leverage, ROCE) Business Analysis (Industry Potential, Ownership, Years in Business, Strength of Sponsor's, External Rating, Internal Control) Other Factors (Quality of Financial Reporting, CIB Report, Credit Relationship with Bank)	Use the data of cash flow statement, Balance Sheet and profit and loss account. Other pre financing appraisal method are same as other banks	Risk Appraisal; Financial Spreadsheet; Ratio Analysis; PR Compliance Sheet; Visit Report	Development impact and focus on the majority Innovation; Responsiveness to need; Sustainability; Organizational capacity; Quality and feasibility of the proposal; Financial Spreadsheet; Risk Appraisal; Ratio Analysis; Market Report; CIB Reports; Physical Information	Cash flow Statement; Balance Sheet; Profit and Loss Account; Credit rating Score Card; Business Analysis; Financial Analysis
Post Financing Supervision	Stock Movement Report; Market Share; Word of Mouth; Physical Visits of Site;	For supervision bank nominate independent agent. Bank personnel also physically visit and inspect the project.	Stock Movement Report; Market Share; Physical Visits of Site; Other bank reports about our client	Stock Movement Report; Market Share; Word of mouth Physical Visits of Site; Other bank reports about our client	Word of Mouth; Stock Movement Report; Market Share; Other bank reports about our client; Physical Visits of site
Builtin Mechanical Linkage to the Financed Projects	*Built* into a process from the very start with its financed projects & implementing different methods to check *their linkages* with projects.	Don't have any sector preferences in lending.	Have no built-in mechanical linkage of the bank with its finances projects.	Built-in mechanical linkage of the bank with its finances projects.	

Allocative Efficiency of the Islamic Banks

Meezan Bank Limited					
	2006	2007	2008	2009	2010
Short term financing (TDR)(MC)	4.52%	2.99%	0.99%	1.96%	3.18%
Term financing (Musharaka, Hire Purchase) (M)	18.42%	12.50%	13.36%	9.86%	11.85%
Trade financing (Murabaha, Bai-muajjal) (MA)	20.19%	20.22%	18.94%	19.51%	10.81%
Investment in Govt. Securities Term Bills other approved securities (C)	1.25%	1.84%	3.33%	5.07%	10.98%
Others (A)	55.62%	62.45%	63.38%	63.60%	63.18%

Al-Baraka Islamic Bank Pakistan					
	2006	2007	2008	2009	2010
Short term financing (TDR)(MC)	14.20%	11.87%	9.59%	13.67%	6.21%
Term financing (Musharaka, Hire Purchase) (M)	8.76%	10.32%	9.99%	8.31%	18.38%
Trade financing (Murabaha, Bai-muajjal) (MA)	21.82%	21.55%	22.62%	22.22%	14.82%
Investment in Govt. Securities Term Bills other approved securities (C)	0.00%	0.00%	0.00%	0.00%	0.00%
Others (A)	55.22%	56.27%	57.80%	55.81%	60.59%

Bank Islami Limited					
	2006	2007	2008	2009	2010
Short term financing (TDR)(MC)	14.74%	13.14%	7.68%	3.41%	0.61%
Term financing (Musharaka, Hire Purchase) (M)	11.66%	32.84%	31.91%	29.11%	14.87%
Trade financing (Murabaha, Bai-muajjal) (MA)	14.38%	6.26%	8.25%	10.86%	12.21%
Investment in Govt. Securities Term Bills other approved securities (C)	4.66%	0.00%	0.00%	0.00%	10.45%
Others (A)	54.56%	47.76%	52.16%	56.63%	61.85%

Burj Bank Limited					
	2006	2007	2008	2009	2010
Short term financing (TDR)(MC)	-	3.16%	3.12%	5.12%	4.94%
Term financing (Musharaka, Hire Purchase) (M)	-	48.60%	60.09%	52.97%	57.08%
Trade financing (Murabaha, Bai-muajjal) (MA)	-	44.04%	32.53%	38.81%	33.03%
Investment in Govt. Securities Term Bills other approved securities (C)	-	0.00%	0.00%	0.00%	0.00%
Others (A)	-	4.21%	4.26%	3.10%	4.95%

Dubai Islamic Bank					
	2006	**2007**	**2008**	**2009**	**2010**
Short term financing (TDR)(MC)	-	8.86%	12.52%	8.44%	10.24%
Term financing (Musharaka, Hire Purchase) (M)	-	73.60%	69.82%	66.61%	59.23%
Trade financing (Murabaha, Bai-muajjal) (MA)	-	16.56%	16.77%	22.12%	19.29%
Investment in Govt. Securities Term Bills other approved securities (C)	-	0.00%	0.00%	2.83%	11.24%
Others (A)	-	0.99%	0.89%	0.00%	0.00%

BOOK REVIEW

Contemporary Literature on Islamic Economics: A Select Classified Bibliography of Works in English, Arabic and Urdu up to 1975

By Muhammad Nejatullah Siddiqi,
Jeddah: International Center for Research on Islamic Economics, King Abdulaziz University, and Leicester: The Islamic Foundation, 1978, 69pp.

The author's main purpose is to compile a bibliography of Islamic Economics literature, both books and articles, published up to 1975 in three languages: English, Arabic and Urdu. The book contains references to 700 works of over 400 authors on the subject. It is a prudent resource book for Islamic and Economics scholars and students who are engaged in active research in the field. The author has accomplished this enormous task because his own work experience of being a Professor of Islamic Studies and Reader in Economics at Aligarh Muslim University, India makes a perfect fit between the subject and his area of expertise.

The bibliography covers five main areas of Islamic Economics literature. The first chapter provides references on the philosophy of Islamic Economics. The section on Economic System of Islam provides literature references on the foundational principles of Islamic Economics whereas the third section covers critique on the contemporary economic theories of capitalism and Marxian-based Socialism. The main works on the instruments of Islamic economics and history of economic thought development are compiled in the next two chapters.

This work has five outstanding features. First of all it is one of a kind. Its enormity and importance increases manifolds when the context in which it was compiled is considered. One can well imagine how precious, useful and handy the collection would have been for researchers in those times without computer search engines and e-libraries. Secondly, the referencing scheme of the author is amazingly consistent and accurate. All entries are arranged alphabetically according to authors' surname. All book references mention the total number of pages and give an instant idea to the reader about how voluminous the work is. Thirdly, the bibliographic entries cover English (37%), Arabic (41%) and Urdu (22%) works. The tri-lingual resources of the book on this specific subject enhance its effectiveness for the range of scholars using it. Fourthly, the book is high on clarity and user-friendliness not only because of the consistency of referencing methodology but also because of the Transliteration Scheme which greatly facilitates the recognition of English, Arabic and Urdu alphabets. Last but not the least, both topics and authors are easily locatable because the book presents them separately in the opening list of contents and the closing index, respectively. The system of interlocking the page numbers with entry numbers increases the ease with which topics and authors can be tracked and accessed.

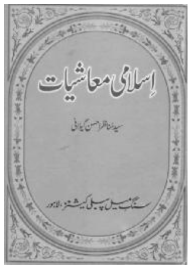
Yazdani, Naveed (2014) Rev. of Contemporary Literature on Islamic Economics: A Select Classified Bibliography of Works in English, Arabic and Urdu up to 1975 by Siddiqi, Muhammad Nejatullah *Islamic Banking and Finance Review*. 1(1): 71-72 ISSN 2221-5239. © 2014

Certain earliest known Islamic economic writers such as al-Shaybani (d. 804) and Abu'l Fadl Ja'far's Kitab al-Ishara ila mahasin al-tijara (Indications of the merits of commerce) written in the 11th or the 12th century are, however, missing from the list. Western writers consider Abu'l Fadl Ja'far's work a far more practical discussion on economics as compared to Plato's *Politics* or Aristotle's doctrine of the golden mean. Another area which might have been included as a separate section is the specific Quranic verses and Hadith the Prophet (Peace Be Upon Him) on the desired economic behavior of individuals and society. No doubt that Divine and Prophetic ordinations and injunctions are covered indirectly through various works of the bibliography. One still feels the need that these basic injunctions would have been compiled under a separate heading or chapter for the benefit of those who want to formulate their original and direct analysis based on the first-hand sources. It is probably because of this omission that Quranic Ordinations regarding debt and mortgage, state expenditures, food and drinks, begging and spending, bribery and deceit, breach of trust, using orphan's property, weights and measures and, prostitution do not come up directly for a researcher to access.

The book is however a unique and condensed source of knowledge and is highly recommended for all those working in the field of Islamic Economics. The volume of work in the field has swelled to a great extent as compared to its emergent status in the 1970s. A bibliographic compilation of works in the field from 1975 onwards seems a real need of contemporary times.

Dr. Naveed Yazdani
Director, School of Professional Advancement and Organization Theory Center,
School of Business and Economics, University of Management and Technology,
Lahore, Pakistan

BOOK REVIEW



Islami Muaashiyaat

By Sayyid Munazar Ahsan Gilani,
Lahore: Sang-e-Meel Publications,
2007, 478pp.

This valuable and absorbing book brings out facts not generally discussed in the field of economics. It presents complex ideas of Islamic Economics from the Quranic and *Hadith* perspective in a literary and lucid style. Sometimes novice Urdu reader is digressed, but the author's artistic style keeps the reader engaged to the end. Gilani begins with factors of production, capital and Quran, labor and Quran, and world as a system of earning bread and butter, equal rights of men and women in the field of economics and then logically links these with prerequisites by mentioning just two words "guardian scholar" (*Hafeez o Aleem*). In fact, Prophet Hadhrat Yousaf introduced himself to the Egyptian King saying "I am *Hafeez o Aleem*, so appoint me as a custodian of your lands." These two words are hardly found in the vocabulary of economic scholars.

Gilani categorically refutes the western *monks* and eastern *Jogis*. Notably Gilani said that one can simultaneously reach the height of spirituality and economic progress. He highlights the importance of economic issues by quoting prayer of our beloved Prophet (peace be upon him) for economic prosperity of the *Ummah*. For instance, the Prophet's (peace be upon him) face glowed with pleasure upon receiving the news of economic prosperity of his companions. Gilani is of the view that *Salat-e Tahajjud* was suspended to facilitate economic activity. Again, he quotes Hadhrat Aisha (may Allah be pleased with her) that even at the Day of Judgment if someone had a plant in his possession and if he could plant it, then he should do so, said the beloved Prophet (peace be upon him).

Gilani explains the concept of cosmic beauty with examples of earth, horses, shroud of the dead, graves and properly trimmed beard and even the beauty of Allah. Allah is beautiful and likes beauty (*Sahih Muslim*). Gillani also gives definition of *Ihsan* – to create beauty, and *al-Mohsinin* are those people who create beauty in every aspect of their *Iman* (Faith) and good deeds. There is no concept of laziness and idleness as Hadhrat Abdullah ibn Masud (may Allah be pleased with him) said: "I hate a person who is totally useless: neither doing anything for worldly good nor for the Hereafter" (*Musnad Ahmad*). Gilani explains the prophetic station with examples: Prophet Hadhrat Nuh was the inventor of a large size boat and Prophet Hadhrat Daud made shields from iron. Arabs made Iranian bows. Our beloved Prophet (may Allah be pleased with him) himself made *Rumi Dabdaba*, and Companions of the Prophet (may Allah be pleased with them) learned foreign languages and industrial knowhow. Wind mills were used in Madinah Munawwarah during the period of Hadhrat Othman (may Allah be pleased with him). The idea of digging the ditch (*Khandaq*) was given by Hadhrat Salman Farsi (may Allah be pleased with him).

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Gilani provide examples from the life of our beloved Prophet (peace be upon him) and his Companions such as the history of pulpit in mosque, use of chair in the Prophet's Mosque and use of Iranian *Shalwar* and Hindi wood as medicine. Gilani describes the concept of virtuous life (*Hayat-e Tayyabah*) and gives ample examples form Quran in warding off troubles through piety (*Taqwah*). Gilani describes Quranic method of earning livelihood by a blend of two perfect strategies: praying to Allah (*Tadbir-e Duaiyyah*) and the use of wisdom (*Tadbir-e Aqliyyah*). He mentions the Prophetic passion and deep absorption in praying to Allah at the battle of Badr, yet he left no stone unturned in his strategic moves. Gilani is of the view that *Tadbir-e Aqliyyah* is incomplete without *Tadbir-e Duaiyyah*. Quran demands us to adopt both. In *Surah Quraish* Quran exhorts us to accept Allah as the ultimate sustainer (*Ilah al-Ma'ash*) through extensively praying to Him. Gilani explains the causes of economic difficulties and salient characteristics of human nature from Quranic verses:

1. Man is born meek.
2. Man is greedy and impatient
3. Man is highly ambitious. He always wants more and more. (if you give him two valleys of money he will desire the third one.
4. Economic productions are always limited.
5. Men are at different levels due to their different born characteristics.

Gilani explains two scales of economic distribution from the Quran. He also explores philosophy of capitalism, socialism, Buddhism and scholasticism. According to him, all these ideologies are fighting against laws of Nature through, what he calls, *Izala* or a strategy of elimination. Only Islam advocates the *Amala* approach that is aimed at reorientation. Unlimited desires can never be fulfilled from limited resources. Only unlimited power of Allah can fulfill the unlimited desires of human beings. Only through *Amala* can one fulfill unlimited desires. By the use of *Amala* one can rectify one's morality and ethics and start fighting against the Satan. Herein lies the evolution of humanity. In describing two scales of *ma'ashiyaat* (poor and rich), Gilani explicates some of the responsibilities of the rich such as thankfulness, paying *Zakat*, feeding hungry, poor and orphans while those of the poor include patience and fixing their gaze upon Allah. He also enumerates consequences of violations of these obligations.

Gilani argues that our beloved Prophet Muhammad (peace be upon him) did not scorn wealth and power, but taught how to make proper use of both. There is no dichotomy of human affairs into spiritual and temporal in Islam. Islam teaches exertion and struggle, not merely in the recesses of one's heart, but also in the field of action. The Quran portrays the life of the Companions of our beloved Prophet (may Allah be pleased with them) in these words "Men whom neither merchandise nor sale beguileth from remembrance of Allah." They carry on their trades and professions as well as seek the pleasure of Allah. They do not give up one for the other, but apply themselves to both in the same breath.

Gilani's book reveals a man of unusual mind as Syed Salman Nadvi had rightly called him the King of the Pen (*Sultan al-Qalam*). Manazir Ahsan Gilani's book is a living proof of Syed Nadvi's attribution.

Rana Zamin Abbas
Assistant Professor and Editor, *Organization Theory Review*, Organization Theory Center, University of Management and Technology, Lahore

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National Conference on Islamic Banking

Perspectives in Islamic Banking, Finance and Investments

Zul-Qaadh 29, 1435/September 24, 2014

Institute of Islamic Banking will hold a National Conference on Perspectives in Islamic Banking, Finance and Investments at University of Management and Technology, Lahore, Pakistan. The Conference is slated to be a major forum for discussion on both contemporary and future dimensions of Islamic Banking, Finance and Investments. Papers are invited form scholars, practitioners, and students of Islamic Banking, Finance and Investments covering both theoretical and empirical work under the following themes:

Themes of the Conference

1. **Islamic Banking, Finance and Investment**
   - Islamic Banking
   - Islamic Money and Capital Market
   - Islamic Investment
   - Islamic Wealth Management
   - Islamic Microfinance
   - Risk Management, *Takaful* and Re-*Takaful*
2. **Islamic Accounting and Shariah Auditing**
   - Reporting Issues in Islamic Organizations
   - Ethical issues in Islamic Financial Institutions and financial markets
   - Corporate and *Shariah* Governance in Islamic-based Organizations
   - Accounting for *Takaful*
   - Taxation and *Zakat* Accounting
   - Corporate Social Responsibility from the Islamic Perspective
3. **Islamic Social Security**
   - *Zakat* – *Faraid*
   - *Sadaqah* – Poverty Alleviation
   - *Hibah* – Social Capital
4. **Islamic Economics System**
   - Islamic Economic Theories, Practices and Developments
   - Islamic Economy in the Post-Crisis Period
   - Case Study in Islamic Economy
   - Comparative Economics System
   - Islamic Economic Thought
   - *Muamalat* Principles and Practices
5. **Issues in Waqaf**
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   - Corporate *Waqaf*
   - *Waqaf* Management
   - *Shariah* Issues related to *Waqaf*
   - Issues on the investment of *Waqaf* assets
   - Emerging issues in *Waqaf*
6. **Any other relevant areas of interest**

Important Dates

Action	Deadline
Abstract Submission	July 25, 2014
Acceptance of Abstract Announcement	August 10, 2014
Submission of First Draft	August 25, 2014
Submission of Final Draft	September 10, 2014

All submissions must be in MS-Word format, after APA style guide. A good quality scanned image (jpg) and a biographical note on author(s) must accompany all submissions. Abstracts may not exceed 250 words, including five Keywords. All submitted papers must carry author's institutional affiliation, complete address, and a valid contact email.

All submissions to be addressed to the following Conference Managers:

Ms. Syeda Hameeda Batool <hameeda.gillani@umt.edu.pk> and Ms. Rozeen Shaukat <rozeen.shaukat@umt.edu.pk>

Muhammad Mahmood Shah Khan, Director, Institute of Islamic Banking
University of Management and Technology, CII, Johar Town, Lahore-54770, Pakistan
Tel: +92-42 3596-8901-10 * Ext: 3361 Web: http://www.umt.edu.pk

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Islamic Banking and Finance Review

University of Management and Technology

ISSN: 2221-5239

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Deadline for Paper Submission: October 1, 2014

Islamic Banking and Finance Review is a peer review international journal, published annually. The journal aims to be a major forum to produce publications on both contemporary and future dimensions of Islamic Banking and Finance globally. The journal welcomes strong evidence-based theoretical and empirical work to clarify best practices. Journal is edited under the auspices of Institute of Islamic Banking and published by UMT Press, University of Management and Technology, Lahore, Pakistan.

Journal coverage includes the following but is not limited to:

- Epistemological Foundations of Islamic Banking
- Banks: Islamic vs Conventional
- Perceptions of Islamic Banking: Public vs Practitioners
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- Product Development and Innovations in Islamic Banking
- Information Resource Development in Islamic Banking
- Pedagogical Challenges of Islamic Banking
- Islamic Banking in Non-Islamic Countries
- Financial Crisis and the Performance of Islamic Banks
- Impediments to Islamic Banking and Finance
- Sukuk, Takaful and Islamic Banking
- Future of Islamic Banking and Finance
- Fundamentals, Trends and Opportunities in Islamic Finance
- Islamic Investment Strategies
- Islamic Wealth Management
- Financial Legal and Regulatory Issues

Submission Guidelines:

- All submissions must be in MS-Word format, after **APA style guide.**
- All submitted papers must carry author's institutional affiliation, complete address, and a valid contact email and biographical note of each author.
- Article title should not exceed more than 10 words, having structured abstract along with up to five keywords.
- Headings must have a clear distinction among the hierarchy of headings.
- Paper length should not exceed up to 8000 words in length (including references and appendices).
- All figure and tables should be of high quality, legible and numbered adequately.
- Check all in-text citations and references carefully.

For further details, please visit:
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Acceptance Notification: Within 15 days from the date of manuscript submission

Note: Each paper is reviewed by the editor and, if it is judged suitable for this publication, it is then sent to two independent referees for peer review. Based on their recommendations, the editor then decides whether the paper should be accepted as is, revised or rejected.

Date of Publishing: IBFR is inviting papers for Volume 1, Number 1 which is scheduled to be published on December, 2014.

Submit your Queries to: Ms. Syeda Hameeda Batool <hameeda.gillani@umt.edu.pk> and Ms. Rozeen Shaukat <rozeen.shaukat@umt.edu.pk> Muhammad Mahmood Shah Khan, Editor-in-Chief, IBFR
A Product of Institute of Islamic Banking
University of Management and Technology, CII, Johar Town, Lahore-54770, Pakistan
Tel: +92-42 3596-8901-10 * Ext: 3361 **Web: http://www.umt.edu.pk**

Style Guide

Format	All files should be submitted as a Word document. **Font : "**Times New Roman" **Size:** "12" **Page Margins:** "1"
Article Length	Articles should be between 3000 and 9000 words in length. This includes all text including references and appendices.
Article Title Page	**Article Title**: Words should not exceed more than 10 words. **Author's Details**: Full name of each author, Department, University/Institution, City and Country. Please mention corresponding author Name and Email. **Structured Abstract:** Abstract may not exceed from 250 words and must consist of Purpose, Design/methodology/approach, Findings, Research limitations/implications and Originality/value **Keywords**: Please provide up to five keywords
Running Text	**Headings:** Headings must be concise, with a clear indication of the distinction between the hierarchy of headings. **Figures:** All (charts, diagrams, line drawings, web pages/screenshots, and photographic images) should be of high quality, legible and numbered adequately. **Tables:** Each table position should be labeled clearly
Citations and References	It must be in **APA** style and carefully checked for completeness, accuracy and consistency. **For Books:** Author's Last Name, First Initial. Middle Initial. (Year of publication). *Title of work: Capital letter also for subtitle*. Location: Publisher. **For Book Chapters:** Author's Last, F. M. (Year Published). Title of chapter In F. M. Last Editor (Ed.), *Title of book/anthology* (pp. Pages). Publisher City, State: Publisher. **For Journals:** Last, F. M., & Last, F. M. (Year Published). Article title. *Journal Name, Volume* (Issue), pp. Pages. **For Conference Proceeding:** Last, F. M., & Last, F. M. (Year, Month date). Title of paper. In A. Editor, B. Editor, & C. Editor. *Title of Published Proceedings*. Paper presented at Title of Conference: Subtitle of Conference, Location (inclusive page numbers). Place of publication: Publisher. **For Working Papers:** Last, F. M. (year). *Title of work* (Report No. xxxx). Location: Publisher. **For Encyclopedia:** Author's Last, F. M. (Year of Publication). Title of entry or article. *Name of reference source* (Vol. number, pp. pages). Place of Publication: Publisher. **For Newspaper Articles:** Author's Last, F. M. (Year, Month Date). Title of article. *Title of Newspaper*. pp. Page(s). Retrieved from URL.

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M.A. Jinnah

(Quaid-e-Azam Muhammad Ali Jinnah)

On the occasion of the Opening Ceremony of The State Bank of Pakistan, 1st July, 1948

معهد المصارف الاسلامية

Institute of Islamic Banking