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# Islamic Finance

## *A Quarter-Century Assessment*

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### ABSTRACT

The year 2000 marks the end of the first quarter century of modern Islamic finance. This paper analyzes the performance of Islamic financial institutions, revisits successes and disappointments, identifies current challenges, and maps the road ahead. Islamic finance is a success, no longer an uncertain experiment, but a reality, a large and rapidly growing industry. Nonetheless, Islamic finance has its shortcomings: it has not yet fulfilled its original intention of becoming an original and innovative system based on risk sharing and bringing social and economic benefits to the Islamic world. Widely accepted interest-free instruments have yet to be devised. Scandals and other problems have raised serious ethical and religious issues. This paper places these shortcomings in a broader perspective. Most problems of Islamic banks are unavoidable growing pains, and many venerable conventional banking institutions have not proven themselves always to be exemplars either of probity or of strategic acumen. From that standpoint, many of the disappointments of Islamic finance are part of an unavoidable trial-and-error process. Finally, this paper lists the challenges—religious, economic, regulatory, strategic, and political—faced by Islamic institutions and suggests new directions. New directions calling for research encompass areas—the moral economy of Islam, Islamic economic cultures, and the Islamic moral hazard—that many analysts, steeped in literal and legalistic interpretations, tend to shun.

### I. INTRODUCTION

In 1975, the Islamic Development Bank became operational,[i] and the Dubai Islamic Bank, the first modern, non-governmental, Islamic bank, was created. The year 2000 thus marks the first quarter century of modern Islamic finance. This milestone calls for a comprehensive assessment of the experience. This paper will analyze the performance of Islamic financial institutions, revisit successes and disappointments, identify current challenges, and attempt to map the road ahead.

### II. A BALANCE SHEET: SUCCESSES AND FAILURES

The most obvious thing is that Islamic finance has the merit of existing. Islamic finance is thus a success, considering that it is no longer an uncertain experiment, but a reality: it is now a $230 billion-plus industry.[ii] It has grown at rates approaching 20% per annum in recent years and is likely to keep growing at a rapid clip. In many parts of the Islamic world, Islamic banks have been among the most dynamic elements of the banking sector.[iii]

The two important questions however are the following: has the industry met its original objectives? Does it offer features that the conventional banking sector is not likely to provide?

To answer these questions, we need to look at four dimensions of Islamic finance:

1. product innovation;
2. economic benefits;
3. ethics; and
4. the elimination of interest.

#### A. Product Innovation

The rationale behind the creation of modern Islamic finance was to create an original and innovative system, based on risk sharing, that would bring social and economic benefits to the Islamic world.

This principle is at the core of Islamic banking's philosophy. The sharing of profit and loss is at once the most authentic form of Islamic finance, since it replicates the kind of transactions that were common in the early days of Islam.[iv] It is the form most consistent with Islam's value system and moral economy. As it happens, it is

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also the most modern. Indeed, venture capital and merchant banking—both among the fastest growing segments of contemporary finance—would be conventional-banking equivalents of profit-and-loss sharing arrangements.

One of the criticisms of collateral-based lending at a fixed, predetermined rate of interest is that it is inherently conservative. It favors the rich and those who are already in business, and is only indirectly concerned with the success of the ventures it finances. In contrast, under profit-and-loss sharing, Islamic institutions as well as their depositors link their own fate to the success of the projects they finance. The system allows a capital-poor but promising entrepreneur to obtain financing. The bank, being an investor as opposed to a lender, has a stake in the long-term success of the venture. The entrepreneur, rather than being concerned with debt servicing, can concentrate on a long-term endeavor that in turn will provide economic and social benefits to the community.

In the early years of Islamic banking, most institutions plunged with great enthusiasm (and virtually no experience) into partnership finance. The result was, to say the least, disappointing, and rather than learning from experience, most institutions have decided to steer clear from *mu∞āraba* and *mushāraka*.

The vast majority of Islamic operations are in the areas of trade finance, mark-up operations and leasing. Such modes of financing, while accepted by Islamic scholars—sometimes without great enthusiasm, because they do not bring significant social and economic benefits to the community, and tend to mirror conventional finance—were once perceived as stopgap operations allowing banks to generate income while building resources and partnership-finance experience.

Hence the great disappointment of Islamic finance: despite double-digit growth rates, the relative share of profit-and-loss sharing (PLS) operations such as *mu∞āraba* or *mushāraka* has been steadily dwindling. Initially the *raison d'être* of the industry, these forms of partnership finance now account for only about 5% of the operations of Islamic financial institutions.

**B. Economic Benefits**

Islamic finance was supposed to bring a wide range of economic benefits—mobilization of savings, productive investment, and, more generally, economic development.

In the process of transforming savings into investments, Islamic financial institutions are different from conventional lenders in that they must take social and developmental factors into account. In that respect, Islamic banks are expected to play the role once played by state banks and development agencies. These functions, as described by the Handbook of Islamic Banking, can be summarized as follows:[v]

- Broad social-economic benefits: investment policies must reflect the needs and the aspirations of the majority of the population, which must in turn be included in the development process. To help ensure adequate supply and affordability, banks must favor projects in the food, housing, and health services sectors.
- Job creation and focus on promising economic sectors: the emphasis should be on adding value as well as those sectors favored by national plans and objectives. Such sectors include agriculture, industry, and technology-intensive activities because of their potential for job creation, improvement of the balance of payments, and the promotion of technology and education.

There are as yet no comprehensive or comparative surveys of this subject, but anecdotal evidence as well as a number of case studies suggest that such ambitious economic promise does not materialize. Nor is there convincing evidence that Islamic institutions have drawn into the world of productive finance people who had shunned it for religious reasons. Elias Kazarian's study of Egyptian banks suggests that much of the increase in Islamic bank deposits occurred at the expense of conventional banks (and was driven by the increase in the remuneration of accounts), that most of the activities of Islamic banks have been in large cities as opposed to the countryside, where they most needed,[vi] and that the main customers were likely to be the well-to-do, and not the poor or the lower middle class.[vii]

Despite Islamic banks' obtaining support and special privileges (such as guarantees against nationalization, they have behaved like risk-averse agents. Their early goal of concentrating on profit-and-loss sharing was soon abandoned. The objective of penetrating to the hinterland and serving the rural areas was not met.

Most evidence highlights the tendency of Islamic banks to invest in short-term commercial transactions as opposed to industry or agriculture. In the Sudan, an agricultural country, only about 4% of the investments were allocated to agriculture while 90% went to import-export operations.[viii] In Egypt, statistics compiled between 1979 and 1991 compared Islamic banks unfavorably with conventional banks on productive domestic investment. Not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it in foreign currency.[ix]

Judging from the change (or lack thereof) in the level of economic development in those countries that have actively promoted Islamic finance (principally Pakistan, Iran, and the Sudan), it can safely be said that the promised economic benefits have largely failed to materialize.

### C. Ethics

The other major dimension of Islamic finance relates to ethics. While ethics is at the center of Islamic finance, scandals and other problems have plagued a number of institutions, raising serious ethical and religious issues.[x]

Yet, paradoxically, the demand for Islamic products is primarily driven by ethical concerns. Indeed, the main impetus behind the current boom in Islamic finance lies in the very excesses of global finance.[xi] Just as current business excesses have spawned a preoccupation with ethics, the amorality of contemporary finance has generated an interest in imposing morality on finance. And while Western or Judeo-Christian finance has become thoroughly secularized (the religious origin of many financial institutions has long receded from the public consciousness),[xii] the idea of Islamic finance was bound, at a time of rising pietism,[xiii] to strike a chord. Insofar as Islam holds a positive view of economic activities while providing for a strict ethical framework, Islamic finance offers the potential for a fruitful compromise between finance and ethics.

### D. The Elimination of Interest

Islamic financial institutions have not been able to devise a truly interest-free system. Yet paradoxically, it is a much less important issue today than it was 25 years ago. For one thing, the volume of interest-based transactions has lessened considerably. As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income.

In addition, many financial operations, such as the creation and sale of derivatives, do not directly involve interest. Many financial institutions now derive as much as half of their revenues from fees as opposed to interest.[xiv]

In addition, Islam's adaptive mechanisms (discussed in the third part) have been used to tolerate, in many instances, the use of fixed interest. So, although Islamic banks have not innovated much in the area of interest-free finance, they have not been overly stifled within an interest-based financial environment.

### E. Conclusion

By not embarking on a path of true financial innovation and by not fulfilling their original promise from the standpoint of economics as well as ethics, Islamic institutions raise the inevitable question: Is Islamic finance necessary? Arguably it is, since it can still fulfill its original objectives. And at a time when Islamic countries are overhauling their regulatory systems and entering the global economy, it can provide a much-needed ethical framework as well as useful correctives to the excesses of contemporary financial practices.

The shortcomings of Islamic finance should also be placed in a broader perspective. For one thing, most of the problems encountered by Islamic banks can be looked upon as unavoidable growing pains. The gap between promise and performance can be attributed to the youth of the industry. It would thus be unfair to judge Islamic institutions too harshly, especially since many venerable conventional institutions have not proven, in recent years, to be exemplars either of probity or of strategic acumen. From that standpoint, many of the disappointments of Islamic finance are part of an unavoidable trial-and-error process.

The following pages single out some of the issues and challenges that Islamic financial institutions should address.

## III. Issues and Challenges

The main issues still to be addressed and the challenges to be met can be grouped into five categories: religion, strategy, economics, regulation, and politics.

### A. Religion

Two contradictory sets of issues must be addressed. First is the issue of diversity. Any religion that has survived for 14 centuries and has some 1.2 billion followers throughout the world must have some measure of flexibility and diversity. Common perceptions to the contrary, Islam is anything but monolithic. Muslims constitute the majority in some 50 countries in Africa, the Middle East, and Central, South, and Southeast Asia. They are a minority, often a fast-growing one, in most parts of the world, including Western and Eastern Europe, Russia, the Americas and Australia. Their diversity is religious, racial, ethnic, political, social, economic, and cultural. Despite the unifying language of the *umma*, Islam is fragmented and decentralized, with no standard, official clergy and no

Vatican. Only a few countries—most notably Iran—have a tradition of an autonomous hierarchically structured clergy. Most people are familiar with the Sunni-Shīʿa divide. But there is a far greater diversity of religious groups, beliefs, and practices than that. These differences can be attributed to religious schisms, but more commonly they are due to differences in historical paths as well as exposure to outside influences.

Islamic finance reflects that diversity. Financial experiments have taken place wherever Islamic communities exist. They are usually driven not, as often thought, by political Islam, but rather by the rise in pietism that has been occurring throughout the Islamic world.[xv]

Diversity is a double-edged sword. While it leads to varied experimentation, it tends to foster mutual recrimination, if not accusations of heresy. Indeed, doctrinal consensus has proven elusive. Coordination and homogenization are complicated by disagreements among *sharīʿa* boards as to what activities are permissible, as well as rivalries between countries and financial institutions. Yet there is a need for coherence, if not uniformity, and to avoid an anything-goes attitude. There is also a need to create a secondary Islamic market.

**B. Strategic and Competitive Issues**

The Islamic financial market is increasingly competitive, and growing pains have accompanied rapid growth. There are indeed considerable strategic, managerial and cultural challenges facing Islamic banks.

<u>1. Competition from Conventional Institutions</u>

Where once Islamic institutions had the Islamic market to themselves, they now face, on their own turf, competition from conventional institutions. Today there is hardly a major international financial institution that does not have, if not an Islamic subsidiary, at least Islamic "windows" or a range of Islamic products. Since such institutions usually enjoy superior expertise and technology, they have distinct competitive advantages over Islamic institutions.

<u>2. Fragmentation</u>

In addition, the Islamic financial community is highly fragmented; it lacks industry-wide norms and a true secondary market. The managerial task is not eased by the imposition of complex secular and religious norms of national and transnational scope.

<u>3. Liquidity</u>

At the time of the 1991 Gulf War, Islamic banks in the Gulf lost 40% of their deposits. This highlights one of the weaknesses of Islamic finance. Lacking a deposit insurance program that can reassure depositors and prevent massive withdrawals, Islamic institutions cannot depend on the flexibility afforded either by a secondary market, or by a ready discount window. Opportunities for securitization are limited, and there is no true Islamic interbank market to help fund daily liquidity. In contrast, conventional banks can reassure their depositors by providing deposit insurance, and they have the flexibility to manage assets and liabilities by reselling loans to other financial institutions, by transforming such loans into tradable securities using the discount facilities of their central bank, or by borrowing at interest.

<u>4. Staffing</u>

One of the most vexing managerial issues is the lack of qualified personnel. Bank officers must possess not only the management skills appropriate to a conventional institution but also considerable religious training. The need (admittedly mostly theoretical) for expertise in profit-and-loss sharing also requires that the Islamic banker combine the skills of the commercial banker with those of the venture capitalist—which further reduces the pool of available talent.[xvi]

<u>5. Marketing</u>

To attract and retain customers, Islamic institutions need to sharpen their marketing skills.[xvii] At the heart of the marketing effort lie a few basic questions: Who are the actual and potential customers of Islamic financial institutions? What are their motivations and behavioral characteristics? What should banks do to reach them? Should the institution compete primarily on the basis of religious credentials or products and service?

**C. Economics**

Promoters of Islamic finance have argued that Islamic finance is not only consistent with capitalism (i.e., with a market-driven allocation of resources), but that it is in many ways better suited to a dynamic economy. More specifically, Islamic finance could bring about more efficient mobilization of savings, a more equitable and just distribution of resources, more responsible and profitable lending, as well as less volatile business cycles and more stable banking systems.

This of course is the theory. The difficult part has been to translate the broad principles of Islamic finance into concrete reality. More specifically, in order to contribute to the process of economic growth and development, banks must learn how to transform savings into real investments, and how to do it efficiently—transforming small deposits into larger loans, acting as risk arbitrageurs among investments with different rates of return and risk levels, devising an attractive mix of financial instruments, etc. Overall, there are four sets of economic issues and challenges they must meet: the mobilization of savings, economic development and fund allocation, Islamic capital markets, and using Islamic tools to shape macroeconomic policies.

As far as the first two are concerned, as we saw earlier, the available evidence, though scant, suggests that Islamic institutions still have a long way to go. As for creating and nurturing Islamic capital markets, countries such as Malaysia and Bahrain have made significant strides. The use of Islamic tools to shape macroeconomic policies has barely started, as Islamic institutions and governments are hampered by their misgivings about fixed interest rates.

Advocates of Islamic banking argue that tools that do not rely on interest rates can be just as effective as those that do. Among such tools are the modification of reserve requirements for banks, the manipulating of budget surpluses or deficits, the imposition of new lending ratios (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or refinance ratios (which refer to the central bank's refinancing of a portion of the interest-free loans made by commercial banks).[xviii]

Similarly, in connection with public borrowing, a number of concepts have been devised, among them issuing bonds based on the *mu∞āraba* principle: fixed interest would be replaced by a rate that would vary according to the economy's growth and inflation rate. One complication is that governments do not have the same criteria of profitability as the private sector, and social rates of return have yet to be made operational in a way that can satisfy investors.

**D. Regulation**

Of special importance are the regulatory regime to which Islamic institutions are to be subjected—how they are to be regulated and whether they are to be given special status—and the compatibility of Islamic norms with emerging global norms.

As for the first issue, the question is whether Islamic institutions should be regulated in the same way as conventional institutions. On the one hand, the one-size-fits-all approach helps achieve macroeconomic and regulatory coherence, but it does not recognize the specific features of Islamic finance. On the other hand, the special treatment given to Islamic institutions raises the issue of fairness and equity, since it can amount to special privilege or, conversely, discrimination.

Another complication arose well after the creation of the first modern Islamic institutions. In the 1970s, regulators, outside of the political limelight, still performed tasks mostly of a technical nature. National regulators also enjoyed wide autonomy. This is why, in the early years of modern Islamic banking, ambitious Islamic regulatory schemes were devised. There was talk of an Islamic Central Bank, of a global *zakāt* fund, and of other collaborative schemes.[xix] Scholars then believed in the possibility of achieving a unique Islamic approach to bank regulation.[xx] Most of these ideas were never put into practice: they were simply overtaken by events. Today, regulators have lost the margin they once enjoyed for maneuvering. Most of the norms and practices of financial regulation have been established internationally, with little input from regulators outside the industrial world.

Once confined to developed countries, the new rules of global finance are now extending to the rest of the world. By October 1998, regulators worldwide were committed to implementing the "Core Principles of Banking Supervision" issued in 1997 by the Basle Committee on Banking Supervision. Similarly, since March 1999, the 102 signatories of the December 1997 Free Trade in Financial Services Agreement (under the aegis of the World Trade Organization) have been expected to liberalize their financial markets.

Today, all countries are urged to comply with new international rules, as well as liberalize their markets and open their financial sector to foreign competition. Islamic regulators thus face a daunting task for which they are singularly ill prepared: they must engage in consolidation and reform in the face of considerable obstacles before domestic banks confront the onslaught of foreign competition.

**E. Politics**

Both at the national and at the international level, Islamic institutions have been caught in a political crossfire. In recent years, Islamic financial institutions have on occasion been suspected of having a political agenda, domestically working to establish a fundamentalist Islamic regime, or internationally financing or serving as a conduit for international Islamic terrorism, or even for the development of an "Islamic bomb." Indeed, and against much of the available evidence, Islamic finance is usually associated with the radical brand of political Islam.[xxi] Every book on Islam has a page or paragraph or two devoted to Islamic finance, often with no distinction made between Islamic politics and finance. A recent French book entitled *The* Fatwā *against the West* implies, for example, that the main, if not the sole, purpose of Islamic financial institutions is to finance terrorism.[xxii]

Do Islamic banks really have a domestic or international political agenda? Do they play a role in promoting radical Islam and international terrorism? The short answer is that they usually do not, but their opponents point to their resources to show that they have the potential to create mischief. The suspicions surrounding Islamic banks are implicitly justified by a flawed syllogism: political Islam at the domestic and international level requires financial resources, Islamic banks are committed to Islam and have vast financial resources; therefore Islamic banks are likely to advance the political goals of potentially subversive Islamic groups.

At the international level, Islamic financial institutions are all the more likely to be scrutinized, since the "war on terrorism," just like the "war on drugs," is now being fought in large part on the financial terrain-figuring out the financial flows involved and tracking them nationally and internationally.[xxiii]

The rationale for the financial focus of most recent anti-terrorist legislation is twofold. First, tracing financial flows can untangle money puzzles and yield a great deal of information about subversive and otherwise shadowy groups. Second, the use of economic and financial tools—embargoes, asset seizure, and the like—can starve terrorism. Although there is not much evidence that Islamic banks harbor more terrorism-related funds than conventional ones, suspicions can hamper their operations and growth.

## IV. The Road Ahead

In Islamic finance there is a vast gap between theory and practice, while research still offers Islamic bankers relatively little guidance. This section offers tools to help narrow the gap. It places Islamic finance in its real-world context, focusing on Islam's adaptive mechanisms and suggesting areas for future research and inquiry.

### A. Contextualizing Islamic Finance

The majority of the writings on Islamic finance fall in one of two categories: they are ahistorical, discussing Islamic finance as if there were no outside constraints; or they are somewhat frozen in time, looking at the world as it was in the early years of modern Islamic finance, that of the 1970s, when Islamic finance was first updated. In order to understand why Islamic finance came into being and how it has evolved, we need to focus on political, economic, and ideological context.

A fruitful approach would consider modern Islamic finance from the standpoint of two movements toward aggiornamento.[xxiv] The first occurred in the early 1970s, at the intersection of two important developments in the Islamic world: the rise of pan-Islamism and the oil boom. The 1967 Six-Day War marked the end of the secular, pan-Arab Nasserite movement and the start of the regional dominance of Saudi Arabia, under the banner of pan-Islamism.[xxv] With the creation in 1970 of the Organization of the Islamic Conference (OIC), the idea of updating traditional Islamic banking principles—an endeavor that had preoccupied a few Islamic scholars, particularly in Pakistan, for a number of years—was soon on the agenda. And in the wake of the quadrupling of the oil price, the 1974 OIC summit in Lahore voted to create the inter-governmental Islamic Development Bank (IDB), which was to become the cornerstone of a new banking system inspired by religious principles. In 1975, the Dubai Islamic Bank, the first modern, non-governmental Islamic bank, came into existence. Soon afterwards, similar institutions started proliferating, as did research institutes focusing on Islamic economics and finance.[xxvi] The International Association of Islamic Banks (IAIB) was created to establish common norms and standards. In 1979, Pakistan became the first country to embark on a full Islamization of its banking sector, followed by in 1982 Sudan and in 1983 by Iran.

The first paradigm of modern Islamic banking was established in those years. Islamic jurists reinterpreted a rich pre-capitalist legal tradition to suit the requirements of the modern era. The main difficulty was that, though commerce had always been central to the Islamic tradition (the Prophet Muhammad was himself a merchant), profits from purely financial transactions were viewed with suspicion. The Qur'an states, for example, that despite their superficial resemblance, profits from commerce are fundamentally different from those generated by money lending (2:275). More specifically, Islam prohibits *ribā*. Literally meaning "increase," the term has been variously interpreted—sometimes as usury (or excessive interest), more often as any kind of interest. Though major scholars—including the current head of Egypt's Al-Azhar, one of Islam's oldest and most prestigious centers of learning—have condoned the use of certain forms of interest, the majority of Islamic scholars still equate *ribā* with interest of any kind.[xxvii]

While accepting the notion that time has to be calculated into prices, Islamic scholars objected to any risk of the lender's exploiting the borrower by exacting a fixed, pre-determined rate of interest-based, a prohibition, incidentally, which Islam shares with other religious traditions.[xxviii] In the early days of Islam, the dominant form of finance consisted in a partnership between lender and borrower, based on the fair sharing of both profits and losses—a logic similar to today's venture capital, where financiers link their fate to that of firms in which they invest. For instance, in medieval Arabia, wealthy merchants financing the caravan trade would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was stolen, lost, or sold for less than cost.[xxix]

But just as new standard practices were finally established, the first movement toward aggiornamento in Islamic finance was becoming obsolete. Forays into profit-and-loss sharing were disappointing, and Islamic finance began to be seen as an exercise in semantics: Islamic banks were no different from conventional banks, except in their use of euphemisms to disguise interest.[xxx] The image of Islamic banks was also tainted by the failure of Islamic money management companies (IMMCs) in Egypt in 1988 and by the collapse of the Bank of Credit and Commerce International (BCCI) in 1991.[xxxi] It became the fashion to dismiss Islamic banking as a passing fad, one associated with the oil boom and the fleeting belief in a New International Economic Order (NIEO).

In reality, Islamic finance was on the verge of a major boom, albeit after major changes. Indeed, the world of international finance was being turned on its head as a result of deregulation and technological change. At the same time, political, economic, and demographic forces were transforming the Islamic world.

Whereas the traditional world of finance, dominated by commercial, interest-based banking could raise potentially troublesome theological issues, the new world of finance, characterized by the blurring of distinctions between commercial banking and other areas of finance, the diminishing importance of interest income, and financial innovation, formed the basis of a new aggiornamento that was barely noticed in the literature.

Neo-liberalism and an emerging Islamic ideology were converging. Two areas where the Islamist critique of statism and the "Washington consensus"[xxxii] converged are most significant. First is the Islamic commitment to private property, free enterprise, and the sanctity of contracts. In many countries, Islam became the tool of entrepreneurs seeking to get around restrictive regulation and an instrumental factor in privatization and deregulation—and the best excuse for disengaging the state from the economy. In their efforts to downsize in line with the dictates of neo-liberalism, governments also relied on the "privatization of welfare" (through reliance on *zakāt* and other religiously-based redistribution schemes) advocated by Islamists.

There was a similar convergence in the area of finance. Indeed, among the characteristics of the global financial system that has emerged since the 1980s are the downgrading of interest (and the concomitant rise of fees as a major source of revenue for financial institutions), the creation of new financial products, and the blurring of the lines between finance and other business endeavors.[xxxiii] The lesser importance of interest, once the cornerstone of financial revenues, allowed Islamic bankers to sidestep the controversial *ribā* issue. As for the financial innovation made possible by deregulation, it fostered the creation of tailor-made Islamic products. Until the 1970s, financial institutions could sell only a narrow range of financial products. With the lifting of constraints on the products that financial engineers could devise to suit every need—religious or otherwise—Islamic products could be created. The process of slicing and splicing allows, for example, the principal components of a bond to be split and sold separately. In sum, the world has reverted to a system of bankers without banks, often based on the principles of partnership finance, where the financier is no longer a lender but a partner.[xxxiv]

Today the fastest growing segments of the industry are outside the range of traditional banking products and in areas of finance that were either initially dismissed as Islamically unacceptable—such as insurance or *takāful*—or that barely existed at the time of the first aggiornamento—micro-lending and Islamic mutual funds. Indeed, investing in Islamically acceptable stocks (those shunning unethical or highly indebted firms, or associated with gambling, the sale of alcohol, and other prohibited activities) are becoming increasingly popular, just like their secular counterparts, socially responsible investments.[xxxv]

These two stages of aggiornamento have resulted in sharply differing perspectives. While the early years of Islamic finance were dominated by oil producing Arab states (primarily Saudi Arabia[xxxvi] and to a lesser extent Egypt and Pakistan), the second aggiornamento reflects the diversity of the Islamic world. A wide range of Islamic products is now available in at least 75 countries. Even countries that have Islamicized their entire financial systems have done so under entirely different circumstances and in vastly different ways.[xxxvii] A majority of the financial institutions do not even belong to the International Association of Islamic Banks (IAIB). And much innovation and scholarship now originates within Muslim minorities outside the Islamic world.[xxxviii]

**B. The Question of Religious Interpretation**

Many scholars at the time of the first aggiornamento, steeped in literal and legalistic interpretations, engaged in unduly narrow interpretations. With the new aggiornamento, the focus has somehow shifted, from literalism to a search for the spirit, or moral economy, of Islam. This section focuses on the adaptive mechanisms that can allow Islamic finance to thrive in the global economy.

In contrast to the first aggiornamento, which had been dominated by literal, legalistic and scholastic interpretations, the *ijti®ād* now underway focuses on the compatibility of modern financial instruments with Islamic principles. Rather than focusing exclusively on *usūl al-fiqh* (the principles of Islamic jurisprudence) and parsing medieval contracts, there is a new emphasis on the spirit of the law, or its moral economy. This modernist slant disavows the view that whatever did not exist in the early days of Islam is necessarily un-Islamic.[xxxix] Challenging common perceptions that Islam is rigid and fossilized, this section discusses the adaptive mechanisms that have allowed Islam to survive over the centuries in a variety of social settings.

It should be noted first that Islamic commandments are not as unbending as would superficially appear. Traditional Islamic injunctions are not framed as simple dichotomies, but along a continuum, thus allowing a certain degree of flexibility. In the early Islamic community, actions (either for the community as a whole, or for every single member of it) could be regarded as obligatory (*wājib*), meritorious (*musta®abb*), morally neutral (*mubā®*), reprehensible (*makrūh*), or forbidden (*®arām*).

Most injunctions also contain dispensations and exceptions, thus showing considerable pragmatism. Travelers and ill persons could postpone their fasting during the fasting month, Ramadan, and those for whom fasting would be an unbearable hardship could dispense it, compensating instead with good deeds such as feeding a poor person (2:184-185).[xl]

As Islam expanded, it came into contact with many different cultures, and this made it necessary for Islamic jurisprudence to produce legislation on problems for which there were no clear legal precedents. The principles of Islamic jurisprudence (*usūl al-fiqh*) provide for a set of elaborate rules for interpreting the *sharī$^c$a*. But the existence of such complex rules did not preclude adaptive mechanisms.

The principle of *talfīq* (patching) would for example authorize judges to choose an interpretation from schools of jurisprudence other than their own if it seemed to fit the particular circumstances of the case. More generally, three principles allow for departures from existing norms: local custom (*$^c$urf*), the public interest (*maÆla®a*), and necessity (*∞arūra*). The *sharī$^c$a* can thus be made to reach an accommodation with societal changes, thus allowing for innovation, exceptions, and loopholes—provided they are properly justified.

In administering justice during the Umayyad era, governors took into account the customs and laws of newly conquered territories; likewise, the cosmopolitanism of the Abbasid era resulted in considerable diversity. With the weakening of Arab influences in later centuries, syncretism was unavoidable. To put it differently, the farther removed in time and space from early Islam and its birthplace, the stronger the influence of indigenous customs is likely to be.

And as Islam encountered new challenges, especially following its 19$^{th}$-century encounters with capitalism and the West, the concept of *maÆla®a*, translated as the general good, or public interest, began frequently to be invoked. On the basis of that classic principle, a jurist confronted with rival interpretations of a passage from the Qur'an or the *®adīth* can choose the one he deems most conducive to human welfare. Islamic modernists such as Mohammed Abduh and Rashid Rida have made *maÆla®a* the key principle for deciding the law where Qur'an and *®adīth* give no clear guidance. The principle of *talfīq*, combined with independent *ijti®ād*, has been extended to allow a systematic comparison of all classic schools of law for reaching a synthesis combining the best features of each. Some *fuqahā'* have even argued that the general interest may override a revealed text.[xli] So Muslim thinkers theoretically have had wide latitude to reason independently from first principles, and a modern Muslim nation could thus enact "a system of just laws appropriate to the situation in which its past history has placed it."[xlii]

A related concept is that of *∞arūra*, or overriding necessity. Otherwise questionable innovations may be justified by the notion, tacitly accepted by all *fiqh* schools, that "necessity permits the forbidden" (*al-∞arūra tubih al-mahzurat*). In its dietary injunctions for example, the Qur'an specifically authorizes transgressions caused by necessity (2:173).[xliii] On various occasions, the Qur'an has disavowed any divine intent to cause hardship (2:286).[xliv] For example, a person who would otherwise starve would be allowed to eat pork. One version of the doctrine holds that a mere "need" (*hāja*) may, if it affects many, be treated as what would be a dire necessity if it affected only one.[xlv] In Iran, the scope of *∞arūra* was considerably expanded. It has been invoked to waive the primary rulings of Islam if the very existence of the state was threatened, or, in the words of the Ayatollah Khomeini, in instances where inaction would lead to "wickedness and corruption."[xlvi]

This has happened frequently in Iran since the Islamic revolution. Most economic policies, including in areas of bank reform, private property, and foreign trade, have been characterized by frequent departures from traditional doctrine justified on the grounds of *zarura* (the Persian transliteration of *∞arūra*).[xlvii]

In the global economy, the overriding necessity of market can prevail in the same way. *Øarūra* has been invoked to justify interest on loans on the grounds that Muslims had to be able to compete with other peoples not subject to the same strictures.[xlviii] Keeping interest-bearing balances in foreign banks could also be justified as consistent with the norms of the international economy. Similarly the necessity of economic development has been invoked in Egyptian *fatwā*s authorizing interest.[xlix] Typically however, *fatwā*s invoking *∞arūra* add that certain types of unlawful profit should be purified, that is, used for religiously meritorious purposes, that Muslims should work toward finding an Islamically-acceptable alternative, and that when this is accomplished, the *raison d'être* for the dispensation will be extinguished.

All this explains why, contrary to the assumptions of the first aggiornamento, Islamic finance is such a diverse phenomenon.[l] A better understanding of the adaptive mechanisms can give decision-makers more flexibility while ensuring adherence to the moral economy of Islam.

## V. CONCLUSION

In conclusion, I would like to single out three research areas that students of Islamic finance steeped in literal and legalistic interpretations tend to shun. The first deals with innovation in global finance: it is essential that new instruments developed by conventional financiers be analyzed for compatibility with the spirit, not the letter, of Islamic law.

The second area is culture. Cultural issues are made even more complicated by the diversity of the Islamic world, yet understanding them is crucial to developing original instruments as well as successfully creating adequate mechanisms for sharing profit and loss.

The third area is the Islamic moral hazard. The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behavior.[li] By the same token, one could identify an Islamic moral hazard in that the very introduction of religion to finance can foster unscrupulous behavior. As we saw earlier, scandals and ethical lapses have plagued many Islamic banks. Yet, in the early years, there was an assumption of virtuous behavior on the part of Islamic banks, their employees, and their customers. In the words of Hamid Algabid, "At the beginning, confidence was the rule. The good faith of the participants could not be questioned, since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith."[lii] In reality, religion can be a double-edged sword, since it often attracts the wrong element while lowering the guard of the bankers and regulators. This is an unsettling issue, but one that needs to be addressed if Islamic finance is to fulfill its potential.

[i] The Organization of Islamic Conference (OIC) summit voted in 1974 in Lahore to create the inter-governmental Islamic Development Bank (IDB), which was to channel aid from rich Islamic countries to poor ones, and become the cornerstone of a new banking system inspired by religious principles.

[ii] http://www.islamicbanking-finance.com.

[iii] Khalaf, Roula. "Dynamism Is Held Back by State Control: As Family Dynasties Stifle Creativity in Most of the Industry, the Islamic Sector Is Showing Signs of the Greatest Vibrancy." Financial Times. April 11, 2000.

[iv] Udovitch, Abraham L. Partnership and Profit in Medieval Islam. Princeton: Princeton University Press, 1970. p. 170-248.

[v] Based on *Al Mausua al Ilmiya wa al Amaliya lil Bunuk al Islamiya* (Handbook of Islamic Banking) 6. Cairo: International Association of Islamic Banks, 1982.

[vi] Sadowski, Yahya M. Political Vegetables? Businessman and Bureaucrat in the Development of Egyptian Agriculture. Washington: The Brookings Institution, 1991. p. 201.

[vii] Kazarian, Elias. Islamic Versus Traditional Banking: Financial Innovation in Egypt. Boulder: Westview Press, 1993.

[viii] Medani, Khalid. "Funding Fundamentalism: The Political Economy of an Islamist State" in Beinin, Joel and Joe Stork (eds.). Political Islam: Essays from Middle East Report. Berkeley: University of California Press, 1997. p. 169.

[ix] Kazarian, *supra*. p. 217-226.

[x] Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 2000. Chapter 8.

[xi] Warde, Ibrahim. "La Derive des Nouveaux Produits Financiers." Le Monde Diplomatique. June 1994.

[xii] A couple of relatively recent examples illustrate the point. In late-19th-century Germany, Frederic Raiffesen, a Protestant, and in early-20th-century Canada, Alphonse Desjardins, a Catholic, created mutual savings societies out of a moral/religious impulse (neither of them was a banker) to save poor farmers from the clutches of moneylenders. See Taillefer Bernard. Guide de la Banque pour Tous: Innovations Africaines. Paris: Karthala, 1996. p. 19.

[xiii] Sadowski, Yahya M. " 'Just' a Religion: For the Tablighi Jama'at, Islam Is Not Totalitarian." The Brookings Review 14(3) (Summer 1996). pp. 34-35.

[xiv] Warde, Ibrahim. Foreign Banking in the U.S. San Francisco: IBPC, 1999. p. 32.

[xv] Warde, Ibrahim. "The Paradoxes of Islamic Finance." Le Monde Diplomatique. October 2000.

[xvi] Galloux, Michel. Finance Islamique et Pouvoir Politique: Le Cas de l'Egypte Moderne. Paris: Presses Universitaires de France, 1997. p. 65.

[xvii] Warde, Ibrahim. Comparing the Profitability of Islamic and Conventional Banks. San Francisco: IBPC Working Papers, 1997.

[xviii] See Ariff, Mohammed (ed.). Monetary and Fiscal Economics of Islam. Jeddah: International Center for Research in Islamic Economics, 1982; particularly Ariff, Mohammed. "Monetary Policy in an Interest-Free Islamic Economy: Nature and Scope."; Uzair, Mohammed. "Central Banking Operations in an Interest-Free Banking System."; and Siddiqi, Mohammed. "Islamic Approaches to Money, Banking, and Monetary Policy: A Review."

[xix] Najjar, Ahmad Muhammad Abd al-Aziz. One Hundred Questions and One Hundred Answers Concerning Islamic Banks. Cairo: International Association of Islamic Banks, 1980. p. 8.

[xx] Ariff (ed.), *supra*.

[xxi] Miller, Judith. God Has Ninety-Nine Names: A Reporter's Journey Through a Militant Middle East. New York: Simon and Schuster, 1996. p. 151.

[xxii] Jacquard, Roland. *Fatwā* contre l'Occident. Paris: Albin Michel, 1998. pp. 157-168.

[xxiii] Filipovic, Miroslava. Governments, Banks and Global Capital: Securities Markets in Global Politics. Aldershot, England: Ashgate, 1997. p. 213.

[xxiv] Warde, Islamic Finance, *supra*. p. 73-89.

[xxv] Mortimer, Edward. Faith and Power: The Politics of Islam. New York: Random House, 1982. p. 177-220.

[xxvi] Numani, Farhad and Ali Rahnema. Islamic Economic Systems. London: Zed Books, 1994.

[xxvii] See Mallat, Chibli. "The Debate on *Ribā* and Interest in Twentieth-Century Egypt" in Mallat, Chibli (ed.). Islamic Law and Finance. London: Graham & Trotman, 1988. p. 69-88; and Mallat, Chibli. "Tantawi on Banking" in Khalid Masud, Muhammad, Brinkley Messick, and David S. Powers (eds.). Islamic Legal Interpretation: Muftis and their *Fatwā*s. Cambridge: Harvard University Press, 1996. pp. 286-296.

[xxviii] In Christianity, it was only in 1515 that the Church, at the Lateran Council, legitimated interest on secured loans. See Warde, Islamic Finance, *supra*. "*Ribā*, *Gharār*, and the Moral Economy of Islam in Historical and

Comparative Perspective." See also Wilson, Rodney. Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought. New York: New York University Press, 1997.

[xxix] This formula served as a basis for the "commandite" system, which became one of the principal financing mechanisms in French law.

[xxx] Warde, Ibrahim. "The Revitalization of Islamic Profit-and-Loss Sharing: Lessons from Western Venture Capital" in Proceedings of the Third Harvard University Forum on Islamic Finance. Cambridge: Center for Middle Eastern Studies, Harvard University, 2000.

[xxxi] Though not itself an Islamic bank, BCCI had in 1984 set up an Islamic Banking Unit in London, which at its peak had $1.4 billion in deposits, and had generally made heavy use of Islamic rhetoric and symbolism. More importantly, however, the collapse of the bank brought Islamic institutions into the international limelight and raised questions about the management and regulation of transnational banks. Of BCCI's $589 million in "unrecorded deposits" (which allowed the bank to manipulate its accounts), the major part—$245 million—belonged to the Faisal Islamic Bank of Egypt (FIBE). This amount was supposed to be used for commodity investments, though there was no evidence that such investments were ever made.

[xxxii] Naim, Moses. "Avatars du 'Consensus de Washington.' " Le Monde Diplomatique. March 2000.

[xxxiii] As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income. In addition, many financial operations—such as the creation and sale of derivatives and other new products—do not directly involve interest. Some financial institutions now derive as much as half of their revenues from fee, as opposed to interest, income. See Warde, Foreign Banking, *supra*. p. 32.

[xxxiv] Udovitch, Abraham L. "Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages" in The Dawn of Modern Banking. New Haven: Yale University Press, 1979. p. 257.

[xxxv] See http://www.islamicbanking-finance.com/funds.

[xxxvi] Another paradox worth noting is that although Saudi Arabia was instrumental in creating the modern Islamic banking system, it is one of the least hospitable countries to Islamic banks. The country has only one Islamic commercial bank, the Al Rajhi group. Dar al-Maal al-Islami (DMI), the largest Islamic group, founded by Prince Mohamed, a son of King Faisal, is based in Geneva and operates worldwide (through, among others, its "Faisal Banks" subsidiaries), yet has no commercial operations in Saudi Arabia. To complicate things further, the DMI group has nonetheless been a significant conduit of Saudi money and influence throughout the Islamic world. One possible explanation for the Saudi ambivalence is the fact that the issue could be politically as well as religiously explosive. Indeed, Saudi Arabia does not officially recognize the notion of interest, yet relies very heavily on interest income from its vast holdings. Recognizing certain banks as Islamic would also make all the other banks "un-Islamic." Saudi banks avoid the use of the word interest, and describe their revenues as "commissions," "service charges," or "bookkeeping fees." See Wilson, Peter W. A Question of Interest: The Paralysis of Saudi Banking. Boulder: Westview Press, 1991.

[xxxvii] See Warde, Islamic Finance, *supra*. pp. 112-131.

[xxxviii] The best known among these centers is the Harvard Islamic Finance Information Program (HIFIP). See http://www.hifip.harvard.edu.

[xxxix] Vogel, Frank E. and Samuel L. Hayes III. Islamic Law and Finance: Religion, Risk, and Return. The Hague: Kluwer Law International, 1998.

[xl] Qur'an 2:184: "But whoever among you is sick or on a journey, (he shall fast) a like number of other days. And those who find it extremely hard may effect redemption by feeding a poor man. So whoever volunteers to do good, it is better for him; and that you fast is better for you, if only you knew."

2:185: "The month of Ramadan is that in which the Qur'an was revealed, a guidance to men and clear proofs of the guidance and the Criterion. So whoever of you is present in the month, he shall fast therein, and whoever is sick or on a journey, (he shall fast) a (like) number of other days. Allah desires ease for you, and He desires not hardship for you, and (He desires) that you should complete the number and that you should exalt the greatness of Allah for having guided you and that you may give thanks."

[xli] Carré, Olivier. L'Islam Laïque, ou, Le Retour à la Grande Tradition. Paris: Armand Colin, 1993. p. 15.

[xlii] Mortimer, *supra*. p. 244.

[xliii] Qur'an 2:173: "Allah has forbidden you only what dies of itself, and blood, and the flesh of swine, and that over which any other name than that of Allah has been invoked. Then whoever is driven by necessity, not desiring, nor exceeding the limit, no sin is upon him. Surely Allah is forgiving, merciful."

[xliv] Qur'an 2:286: "Allah imposes not on any soul a duty beyond its scope. For it is that which it earns (of good) and against it that which it works (of evil). Our Lord, punish us not if we forget or make a mistake. Our Lord, do not lay on us a burden as Thou didst lay on those before us. Our Lord, impose not on us afflictions which we have not the strength to bear. And pardon us! And grant us protection! And have mercy on us! Thou art our Patron, so grant us victory over the disbelieving people."

[xlv] Vogel and Hayes, *supra*. p. 38.

[xlvi] Bakhash, Shaul. "The Politics of Land, Law, and Social Justice in Iran." Middle East Journal 43(2) (Spring 1989). p. 196.

[xlvii] Ibid.

[xlviii] Mortimer, *supra*. p. 245.

[xlix] Galloux, *supra*. p. 43.

[l] See Warde, Islamic Finance, *supra*. Chapter 6.

[li] See Warde, Islamic Finance, *supra*. Chapter 10.

[lii] Algabid, Hamid. Les Banques Islamiques. Paris: Economica, 1990. p. 182.