BUILDING BRIDGES ACROSS FINANCIAL COMMUNITIES

The Global Financial Crisis, Social Responsibility, and Faith-Based Finance

S. Nazim Ali
Editor

Islamic Finance Project
Islamic Legal Studies Program
Harvard Law School

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ISLAMIC FINANCE PROJECT

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Preface

Islamic Finance has reached a particularly formative stage of its development. There has been growing interest in Islamic Finance and a sharp growth in its publicity since the recent political developments in the Muslim world and the growing attention to Islamic law. The recent decision of the Qatar Central Bank to shut all Islamic windows of the conventional banks in Qatar and the post-revolution opportunities unleashed for Islamic finance products in Egypt, Libya, and Tunisia have rekindled the need to strengthen the *shari'a* and regulatory framework of the industry through research and development. Scores of magazines and academic journals are publishing exclusively on the field. Similarly, educational initiatives around the world, including graduate degree programs in Islamic finance, are increasing at a geometric rate. Of particular significance is the landmark initiative of Thomson Reuters in collaboration with other stakeholders in the launching of the Islamic Interbank Benchmark Rate (IIBR) on November 22, 2011. This is a significant milestone in the consolidation of the Islamic money market.

In the midst of these exciting developments, the Islamic Finance Project (IFP) at Harvard Law School seeks to critically reflect on traditional notions of Islamic Finance as well as its potential application to new venues. As such, the Ninth Harvard University Forum on Islamic Finance, held in March 2010, focused on the theme of building bridges across financial communities with the goal of answering the following questions: How can organizations use Islamic finance as a framework for becoming more socially responsible?; What are the initiatives other faiths have and can take toward improving business practices?; What does current academic research suggest about the trends and future direction of Islamic finance after the financial crisis? Through this publication of 11 papers presented at the Forum, we invite you to join us in exploring these pertinent issues.

The Ninth Forum is the continuation of efforts over the past 15 years to create dialogue between practitioners, regulators, and researchers on the salient issues in the field. As the Islamic finance industry expands, the IFP strives to expand its workshops, seminars, and forums to educate and engage the public in the developments of the field. Since the last conference in 2010, the IFP has held a workshop with the London School of Economics and several seminars here at Harvard Law School. IFP has also held a series

of events highlighting the growing importance of the Islamic finance industry in the wake of the financial crisis. These events included an October 12, 2010, roundtable discussion, *Impact of Islamic Finance on Economic Development,* with eminent personalities, such as Ahmad Mohamed Ali (the president of the Islamic Development Bank), M. Umer Chapra, Samuel L. Hayes, and Ibrahim Warde, as panelists. There was a panel discussion entitled *Islamic Finance: Creating an Enabling Environment* on the following day. In 2011, the IFP and LSE co-hosted the fifth annual public lecture *Building Bridges Across Financial Communities* and the 2011 Harvard-LSE workshop *Reappraising the Islamic Financial Secto*r that focused on the need to better streamline the Islamic finance industry toward achieving the objectives of Islamic law (*maqasid al-shari'a*).

To further our objective of informing the public on the latest developments in the industry, the IFP organized a panel discussion on September 26, 2011, with the theme "*Islamic Finance*: *Bankruptcy, Financial Distress and Debt Restructuring*," led by discussant Ibrahim Warde. The panel discussion focused on the latest cases of insolvency issues in the Islamic finance industry. As part of the ILSP Lecture Series there was another public lecture on November 9, 2011, *Dispute Resolution in Islamic Finance: Current Trends and Future Perspectives,* delivered by Umar Oseni, ILSP Visiting Fellow. To keep these dialogues accessible to the public at large, the IFP developed an updated databank that contains articles, books, conference papers, dissertations, and Quranic verses and *Ahadith* pertaining to Islamic finance. These databases are original in content and make up a unique electronic library that is a helpful tool for both researchers and practitioners. The public can also access the databank free of charge.

The Harvard University Islamic Finance Forum remains our most popular event, helping to attain our goal of engendering an advanced and insightful dialogue. Papers for the Ninth Forum were chosen through a rigorous selection process from a large pool of over 40 submissions in response to a call for papers. The selected authors, as well as other renowned scholars and practitioners around the world, came to the conference to discuss these papers and share their opinions on how Islamic finance can bridge new financial communities. The two-day conference was structured around three plenary sessions—Islamic Finance after the Global Financial Crisis, Faith and Finance, and Social Responsibility—that are reflected in the categorization of papers in this book. Although the papers and discussions during the plenary sessions and the six parallel sessions were insightful and thought provoking, they could not all be included in the limited space of this publication. The 11 papers here were chosen by a competitive selection process and further developed through feedback from the audience and

multiple rounds of revisions. We hope they will provide you with a lens into the intellectual exchange of the conference. Banquet speeches delivered by M. Nejatullah Siddiqi and Thomas D. Mullins, respectively, began and concluded the conference and should also be acknowledged here for their valuable contributions.

The forum, and the subsequent publication of this book, would not have been possible without the generous support of a number of institutions and individuals. I wish to thank the sponsors of the Ninth Harvard University Forum on Islamic Finance and of the IFP: Al Baraka Islamic Bank, HSBC Amanah, Islamic Research & Training Institute of Islamic Development Bank, Kuwait Finance House, Rasameel Structured Finance Company, and Al Subeaei Group. They have valued and encouraged our work in this field. I am also grateful to several faculty members of various Harvard schools, especially Noah Feldman of Harvard Law School, Baber Johansen of Harvard Divinity School, and Samuel Hayes of Harvard Business School. I also thank the ILSP staff from whom the IFP has enjoyed tremendous support.

We are especially proud of the level of involvement and commitment to the project exhibited by students in the Harvard community. They have been a wonderful resource in compiling the research database, organizing the forum and seminars, and assisting with research and publications. Special mention goes to Sanjida Rahman, A.B.'10; Hassan Yousuf, A.B.'12; Mudiur Adhan, A.B.'12; and Jennifer Schwalbenberg, J.D.'12 of Boston College Law School, for their work and contributions in the organization of the Ninth Forum.

With due sense of appreciation for their significant contributions, I would like to thank Frank E. Vogel, Ibrahim Warde, Rodney Wilson, and Kristen Stilt for their critical review and advice in the compilation of this book.

Last but not least, I would like to acknowledge Umar Oseni, ILPS Visiting Fellow, for editing the papers as well as providing invaluable assistance in writing the introduction. Sarah Akhtar, A.B.'12, has to be recognized for her outstanding commitment to the project's activities including preparation for the Ninth Forum. She was instrumental in the completion of this book. I appreciate the efforts of Sarah McIntosh, A.B.'12, and Sara Al Saadi, a visiting student from Qatar Foundation, for their assistance in the preparation of this publication. Their respective contributions to this book are greatly appreciated.

S. Nazim Ali
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Introduction

Islamic Finance Project Staff

The Ninth Harvard University Forum on Islamic Finance provided an opportunity for *shari'a* scholars, clergymen and economists to hold deeper critical discussions on how to build bridges across financial communities through the promotion of Socially Responsible Investments (SRIs). This forum took place in the aftermath of the recent global financial crisis whose impact is still being felt across the world. For once, the global financial community agrees on the importance of ethical business in stabilizing the global economy. As part of the efforts to build bridges across financial communities in order to create a new global agenda, the nexus between faith and finance and, more importantly, the need to instill a sense of moral responsibility in global business, are trends emphasized by the contributors to this book. It is not surprising that the *Financial Times* observed that "[i]t is striking that even big-name bankers have been looking back at the crisis through a religious prism."[1] To this end, the recent global economic meltdown has recast the need to evaluate the relevance of faith-based initiatives and SRIs in the global economy. Examining the economic meltdown through a religious prism leads to three related considerations: SRIs, faith-based initiatives and the role of ethics in global finance. There is no doubt that the economic crisis has thrown many business schools into array, which has in turn led to the increasing importance of ethics in the curriculum of such schools.[2] In order to forestall a future economic crisis, the obvious solution begins at the business schools. It is, however, very gratifying to observe that most business schools across the world have begun to integrate ethics into their curriculums.[3]

Given the seismic shift in business thinking, the Islamic finance industry must keep pace with the developments in order to remain relevant in the global economy. These recent developments in the industry speak volumes of the unflinching resolve of the major stakeholders to consolidate the developments of the past decades. Last year there were a number of positive developments such as the launch of the Islamic Interbank Benchmark Rate

The Islamic Finance Project would like to recognize Umar Oseni, Visiting Fellow at Islamic Legal Studies Program, Harvard Law School for his contribution in preparing this introduction.

(IIBR), which is expected to transform the Islamic money market and erase the doubts of skeptics about the *shari'a* compliance of Islamic finance generally. This landmark initiative, which was a result of concerted efforts of Thomson Reuters and other stakeholders in the industry, "provides a robust indicator of the average expected cost of short term interbank market funding for the Islamic finance industry."[4] This initiative marks a watershed in the history of Islamic finance industry, which can, with such developments, collaborate with other financial communities in order to reform and strengthen the global financial system. In order to set the global economy on a more robust trajectory growth, the concerted efforts of all stakeholders, including faith communities, are required.

In light of the above, the selected papers from the Ninth Forum, published in this book, are valuable in building bridges across financial communities through faith-based and social responsibility oriented initiatives in the aftermath of the global economic meltdown. Now is not the time to lament the losses of the recession, but to look into the future with a view toward identifying significant ways of strengthening the global financial system. The faith community can play a significant role in ensuring that ethical values are instilled in the global financial system.

Islamic Finance and Global Economic Meltdown

The aftermath of the global financial crisis led to questions about what went wrong. The last Harvard Islamic finance forum focused on building bridges across faith communities to collectively find sustainable solutions to the crippling financial meltdown. Enhancing global financial stability in difficult times requires establishing necessary synergies among key global players. The potential contribution of Islamic finance to global stability in the aftermath of the global crisis is twofold. First, it can reinforce its collaboration with other faith-based models in order to strengthen the global economy; and second, it can strengthen the global Islamic finance industry and make it a force to reckon with in the global economy.

The Islamic Development Bank (IDB) Group organized a Forum on the Global Financial Crisis in 2008. In response to the recommendations of that forum, a Task Force on Islamic Finance and Global Financial Stability was constituted under the headship of the Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia. One of the key mandates given to the task force was "To analyse the role and relevance of Islamic finance in promoting global financial stability."[5] In its recommendations, the task force proposed eight building blocks to ensure the stability and dynamism of the global Islamic finance industry.[6] These eight building blocks are: developing a comprehensive set of cross-sectoral prudential standards, enhancing

financial resilience of the industry through the development of a liquidity management infrastructure, strengthening financial safety net mechanisms, developing a reliable and effective crisis management and resolution framework, developing efficient accounting, auditing and disclosure standards with prudential governance standards, developing macro-prudential surveillance framework and adequate financial stability analysis, strengthening rating processes, and capacity building in the Islamic finance industry to encourage global financial stability.[7] The last building block, capacity building, relates to the contribution of Islamic finance to the stability of the global economy as a key sector.[8]

The Ninth Harvard Islamic Finance Forum began with a presentation on new perspectives on Islamic finance following the financial meltdown. The presentation by Ibrahim Warde is the first chapter in Part I of this book. The dramatic turn that the global financial crisis took has recast the need for alternative forms of finance within the global financial system as well. Debates continue regarding the resilience of Islamic finance as a miniscule but crucial part of the global financial system. Warde reviews the paradigm shift experienced in the post-2008 debates on the necessity and potential of Islamic finance to transform the global economy. However, the impact of the crisis on Islamic finance is another interesting part of Warde's analysis. He divides the financial crisis into three phases: the decline in U.S. real estate prices and sub-prime lending woes, losses suffered by major international financial institutions and the global economic recession. Islamic financial institutions escaped the first two phases unscathed but felt the effects of the global economic recession.

While Warde does not consider Islamic finance as a panacea to the woes of the global financial system, he agrees that the Islamic sector weathered the financial meltdown better than the conventional sector. This assumption concurs with Chapra's conclusion when he considers Islamic finance as a potent force that can prevent future financial crisis. Chapra writes that "The Islamic financial system has so far been able to gain a very small share of the global financial market and, even if it operates perfectly as desired by the shari'a, it may not be able to create a significant impact on the international financial system in the near future."[9] It is pertinent to observe that there has been an increase in the research work carried out on the relationship between Islamic finance and the global financial crisis from 2008 to 2012. Theoretical propositions on the viability of Islamic finance as the panacea to the global financial crisis aside, research trends have shown minimal or no impact of Islamic finance on the crisis even though most of the factors leading to the meltdown have been addressed in general principles of Islamic commercial law.[10]

As a proposed panacea to the global crisis, Jahangir Sultan and Maher Milly posit that the diversification of investment portfolios during difficult times may help in cushioning the negative effects of the crisis. The focus of their paper is Islamic investment strategies. The paper identifies the need to introduce alternative investment models to the global financial system considering the increasing rate of commercial intercourse among people of different races, religion and cultural leanings. The positive sides of globalization should promote unity in diversity, which may result in the harmonization of best practices in the global economy.

In their empirical research, Sultan and Milly compare three different asset allocation models—conventional, Islamic, and socially responsible investing. The various asset allocations in the Islamic equity investment strategy reveal less exposure to credit market conditions than their conventional counterparts. This is more relevant during periods of economic recession.[11] In the Islamic investment paradigm, there is emphasis on the "exclusion of highly leveraged companies" and "high-level asset-backing," which has shielded, to a large extent, the Islamic finance industry from the negative impact of the global financial crisis.[12] By infusing some of these ethical dimensions of the Islamic financial system into global practices, investment portfolios may be structured in unique ways that make them adaptable to the needs of all stakeholders. There is no doubt the ethical dimension of investments re-emerged during the financial crisis. Therefore, it is possible to harmonize ethical values and economic justice, which form the basis of Islamic investment strategies with the values of socially responsible investing within the general framework of the global economy. This is the thrust of Sultan and Milly's conclusion in which they emphasized that the result of their study should "open investors' minds to the ability to benefit from an investment strategy based on Islamic principles not only amidst financial market turmoil, but also during regular, more tranquil periods." This conclusion reiterates the call for harmonization of prudential principles of investment strategies through an open-minded adoption of principles that have proved their worth and weathered the financial storm in order to create a more stable global financial system.

Meanwhile, Majid Dawood and Huma Sodher study how the Islamic financial system has fared after the financial market turmoil. Their paper focuses on the Islamic finance industry after the economic meltdown, and is a look into the future of the industry. Even though the paper highlights the causes of the economic recession, the challenges facing the Islamic finance industry are part of the aftereffects of the crisis. Four important ways of resolving the challenges were identified: diversification of investment classes, bolstering consumer confidence, maintaining Islamic finance's

appeal as not only a religiously sound but also a financially sound investment method and standardizing the industry.[13] Islamic finance products must not just be *shari'a* compliant, but should also be financially viable and conventionally competitive. The sukuk defaults experienced during this financial crisis sound a note of caution to the stakeholders in the Islamic finance industry. The most recent proposed issuance of $2 billion sukuk by Goldman Sachs has triggered a wide array of discussions among *shari'a* experts in the industry. As significant as this foray into the Islamic financial market is, some experts have warned that the current structure of this offering may breach the rules of Islamic law. In spite of the consultancy role played by the UK-based Dar Al Istithmar, some Islamic finance experts still believe there are a number of issues that must be fixed before the sukuk-structure can conveniently satisfy the requirements of the *shari'a*.[14] Such great challenges, particularly with the sukuk default experienced in the previous years, calls for soul-searching within the Islamic finance industry.

In general, even though the Islamic finance industry did not escape unscathed, it has performed well during the peak of the crisis. A number of reports and academic works have been published on how Islamic finance fared as a small but important part of the global financial system. Even at the peak of the crisis in 2008 and 2009, the Islamic finance industry continued to grow in a historic manner through a marked increase in *shari'a*-compliant products across the world. According to the *Financial Times Special Report on Islamic Finance 2011*, "Islamic finance has passed a significant landmark. Despite turbulence in Europe and rising fears of a global downturn, *shari'a*-compliant assets have surged past the $1 trillion mark, recording another year of double-digit growth, according to research by *The Banker* magazine and Maris Strategies, the research and advisory group."[15] Sustaining the existing best practices in the industry and addressing controversial *shari'a* and regulatory challenges facing the industry are undoubtedly urgent priorities.

***Shari'a* and Regulatory Framework**

Recent developments in the Islamic finance industry have recast the need for effective and reliable *shari'a* and regulatory framework.[16] The ongoing UM Financial Group debacle in Canada has raised many doubts as to whether unsuspecting investors may be swindled because of their piety. The Premier Canadian Islamic Financial Institution is now being liquidated and a series of earth-shattering revelations, shocking for an Islamic financial institution, has been revealed. The insolvency of this Islamic mortgage lender has raised more questions than answers as to the nature of *shari'a*-compliant business in North America, and it went into receivership in October 2011.[17]

The whole debacle calls into question the efficacy of *shari'a* and regulatory frameworks in Islamic financial institutions.[18]

Part II of this book focuses on the need to further strengthen the *shari'a* and regulatory framework of the Islamic finance industry. Of particular interest is the recent directive of the Qatar Central Bank (QCB) to conventional banks operating Islamic windows within Qatar that they close these Islamic windows. Although there have been a series of speculations as to the motive behind the sudden directive, some experts have argued that the move was meant to forestall the co-mingling of Islamic and conventional funds.[19] Others have argued that the sudden ban is due to weak risk management measures in such Islamic windows.[20] Banks responded by simply transferring the Islamic accounts to the conventional parent bank with the consent of the account holders.[21] The implication of this reaction is that most of the customers do not really care about using *shari'a*-compliant products. Though experts welcomed with open arms the step taken by QCB, it would have taken a step further to explain the rationale to the public, which would have influenced customers considering the need for *shari'a*-compliant products.

There is a need for more robust reforms in the *shari'a* and regulatory framework of Islamic finance to be able to proffer some palliative measures in the global financial system. This reemphasizes the need for prudential standards to enhance financial resilience. Strengthening the *shari'a* and regulatory framework will further streamline the trends of the growing Islamic finance industry. Regulatory harmonization and cross-border links in Islamic finance may improve the global economy. To this end, Aly Khorshid advocates for the addition of social responsibility and accountability to the mandate of *shari'a* boards in order to make them more effective both in their Islamic duties and in the overall interest of the Islamic finance industry. Khorshid challenges the growing trend in the appointment of *Shari'a* Board members where few *shari'a* scholars sit on numerous boards. Some board members have become household names, and are being used as brand names to market products. Using practical examples, his paper illustrates how this unfortunate trend may negatively impact the industry in the long run. There is a need for high credibility among the elite in the industry as all products are subject to the prior certification of the *shari'a* boards.

Although *shari'a* board members are accountable to the people who appointed them, whether executive management or shareholders of the financial institution, and above all, of course, to God in accordance with Islamic beliefs, Khorshid believes there is a professional need for more accountability. Accountability to either a higher body or a professional organization with its own unique code of ethics may be necessary to give a

worldwide credibility to the Islamic financial system. The role played by the *shari'a* board in streamlining Islamic finance products cannot be overestimated. Thus, Islamic financial products must be structured in ways that reflect the objectives of Islamic law (*maqasid al-shari'a*) and not be more expensive and high-priced than their conventional counterparts. The lack of expertise among some *shari'a* scholars with regards to the global financial system is another challenge identified by Khorshid. Some have also argued that there is even a general lack of *shari'a* expertise within the global Islamic finance industry.[22] This challenge is being addressed presently with a number of institutions including the Certified Shari'a Adviser and Auditor (CSAA) program introduced by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Chartered Islamic Finance Professional (CIFP) program of the International Centre for Education in Islamic Finance (INCEIF).[23] While these bodies cannot produce a *shari'a* scholar within few months, any applicant to such programs must already have a background in *shari'a* generally.

The Malaysian model of *shari'a* governance, which regulates the appointment of *shari'a* members to Islamic financial institutions, is a good framework worth emulating in other jurisdictions. This sort of regulation is required in any system lest anarchy prevail. For instance, the *Shari'a Governance Framework for Islamic Financial Institutions 2010* issued by the Central Bank of Malaysia clearly provides for the scrutiny of proposed *shari'a* board members' qualifications and experience. The primary objective of the new framework is to enhance "the role of the board, the *Shari'a* Committee and the management in relation to *shari'a* matters, including enhancing the relevant key organs having the responsibility to execute the shari'a compliance and research functions aimed at the attainment of a *shari'a*-based operating environment."[24] The new framework allows the Central Bank of Malaysia to check whether there is conflict of interest among Islamic financial institutions operating in the country while considering the proposals for the appointment of *shari'a* board members. There are also provisions regarding the independence of the board and the competency, confidentiality and consistency of the board. The new framework makes the *shari'a* board members more accountable in their duties. Forms and precedents for *shari'a* reporting are also provided in the appendices to guide the *shari'a* board members as they discharge their duties. This framework, which contains a code of ethics for *shari'a* board members is a major milestone in the *shari'a* and regulatory framework of the Islamic finance industry.

One important aspect of the *shari'a* process, when structuring Islamic financial products, is knowledge of legal drafting.[25] This should form part of the curriculum of *shari'a* certification trainings because most proposed

Islamic finance contracts are drafted by finance experts or legal practitioners and they are couched in terms that may prove difficult for interpretation when such contracts come before the *shari'a* board for approval. Thus, it may be unfair to criticize *shari'a* scholars who certify certain products that may not necessarily satisfy the *shari'a* requirements. Drafting legal documentation for Islamic finance can be very confusing owing to the nature of Islamic finance transactions. This is more difficult when the contracts involve hedging, particularly during economic recession. While considering the rationale and implementation of recent *shari'a* rulings from a legal draftsperson perspective, Robert Rilk recalls the ruling of the Islamic Fiqh Academy on organized *tawarruq* in 2009 as well as the AAOIFI *sukuk* statement in 2008. Unlike the conventional finance market, Islamic finance requires a number of additional considerations when drafting Islamic finance contracts, particularly when the issues involve risk management and hedging.

The parameters of permissible hedging in Islamic finance require the exclusion of all elements of *riba*, *gharar* and *maysir* in the construction of the terms and conditions in a contract. *Tawarruq* has spurred a furor of unending controversy among *shari'a* experts, which is relevant in risk management and hedging.[26] In fact, a number of risk management techniques are based on commodity *murabahah* transactions otherwise known as organized *tawarruq*.[27] An example of such risk management product is profit-rate swap, which was designed to regulate the cash flow between parties in a particular transaction.[28] Although organized *tawarruq* is permissible in Malaysia, it has been proscribed in the Gulf Cooperation Council (GCC) countries.[29] While the organized *tawarruq* controversy rages on, draftspersons are faced with the problem of choice of governing law. This problem is frequently mitigated in Islamic finance contracts as parties often agree to apply the English law. Though recent decisions on this issue do favor the application of English law, a plethora of legal uncertainties remains regarding key *shari'a* terms and conditions in the contract.[30] Meanwhile, in the construction of the contractual terms, Rilk concludes that intention (*niyyah*) plays an important role in determining whether the parties are utilizing the product for hedging or for speculative activities. This is the position of the *Shari'a* Advisory Council of the Central Bank of Malaysia, which emphasizes the fact that the intention of the parties in a *tawarruq* transaction is to avoid *riba*. In order to encourage sustainable innovations within the *shari'a* parameters, product development in Islamic finance must also consider social responsibility. No matter the situation, the aftermath of the recent economic recession has re-established the need to infuse ethical values into the global financial system. This also involves the consideration of

socially responsible investments where the interests of all stakeholders are reasonably protected.

Social Responsibility

The recent economic recession reveals the level of dependence on debt transactions. David Lynch writes that a "widening gap between rich and poor is reshaping the U.S. economy, leaving it more vulnerable to recurring financial crises and less likely to generate enduring expansions."[31] In Europe, many of the countries are already in recession while the ripple effects of the financial crisis are felt all over the world. Given the increase in the poverty rate across the world, particularly in developing countries, there has been a gradual drift toward socially responsible investment (SRI) and more emphasis is now being placed on corporate social responsibility (CSR) and social entrepreneurship (SE). Incidences of corporate misconduct in recent economic crisis, such as Bernie Madoff's case, have rekindled the need to instill ethics into the global financial system. The subprime crisis was partly due to unethical behaviors of stakeholders who were ordinarily required to make informed decisions. For instance, there was tolerance of high risk, which is considered catastrophic in financial decision-making. In such a crisis period, CSR, SRI and SE may provide a good platform to reinvent the economy.[32]

Part III of this book focuses on the above concerns. Mohamad Akram Laldin in his paper examines the three concepts of CSR, SRI and SE within the Islamic finance framework. More specifically, he considers the concepts within the paradigm of *maqasid al-shari'a* and their relevance within the modern Islamic finance industry. While comparing the concepts from the Western and Islamic perspectives, he unravels a number of Islamic principles that are analogous to the Western concepts. What he refers to as the "*maqasidic* dimension" of CSR, SRI and SE is a good basis for further discussions on the role of Islamic finance in enhancing these values. Apart from this discussion, Laldin's paper provides a strong basis to build bridges across financial communities through the harmonization of common practices that can better the lot of the needy in our communities.

Sajjad Shah takes this argument further in his paper, albeit in a more specific manner by proposing an investment evaluation framework for SRI and Islamic finance. By using Markowitz's efficient portfolio theory, which is premised on expected return of investment and expected portfolio risk, Shah incorporates additional elements such as the degree of *shari'a* compliance and the extent of communal benefit. This is meant to extend the conventional model to also cover SRI and *shari'a*-complaint assets, even though the additional benefit comes with costs. But to investors who prefer

shari'a-compliant investments, there is that satisfaction of fulfilling their religious duties as well as the SRI requirement. All in all, one important contribution of the paper to the ongoing efforts in establishing common ethical grounds is the proposed additional requirements, which seek to harmonize the conventional investment evaluation framework with the Islamic finance and SRI requirements.

Responsible planning and prudential management of resources leaves wide latitude for steps to be taken to prevent a future global economic recession. Marcy Murningham, in her paper, examines money and morality as pathways toward a civic stewardship ethic. According to Murningham, personal greed was part of the major causes of the recent economic recession. The panacea to such a crisis, Murningham says, is not just the enactment of "more laws and regulation but revitalization of the system of checks and balances that already exists and a return to core principles at the heart of a stewardship ethic." In proposing ways of further engaging with CSR and SRI and laying the foundation for building a bridge across financial communities, Murningham considers the role of religion and ethics in public life. The moral obligation of wealth from the Christian, Jewish, Islamic and Buddhist perspectives provides a common ground for faith-based investments. This provides an uncommon opportunity to integrate ethical and moral values into business practices. Such synergetic collaborations among faith communities to salvage the global economy, particularly during economic recession, necessitate a blend of faith and finance. Murningham suggests the creation of a series of communities of inquiry and practice to allow for a progressive collaboration among scholars and practitioners from different backgrounds. Apart from face-to-face interactions, these practitioners may utilize digital interactive technologies through virtual engagements. This initiative is expected to establish the legitimate role of morality in economic decision-making.

Faith and Finance

When blending faith and finance, the moral perspective of business and its social relevance have recast the need to think outside the box while bridging financial communities. The aftermath of the recent economic meltdown has rekindled the need to blend faith and finance through value-oriented norms based on shared ethical principles of the faith communities.[33] Some of the ethical values are shared among the faith communities. The new financial architecture should include this ethical discourse.[34] As observed above, there has been a seismic shift in business thinking, which is making inroads into the curriculums of the business schools and professional business organizations across the globe. The importance of ethical investing

blended with values that have their roots in religion are important in a business environment fraught with the injustice, greed and unethical practices that led to the collapse of the economy.

Part IV of this book contains three chapters on different aspects of faith and finance. Ayesha Khalid Khan examines the influence of religious beliefs on individual financial choices. While utilizing a dataset of consumer information from 9,078 individual customers of Islamic and conventional banks in Pakistan, Khan answers the question of whether faith is a luxury for the rich. What she refers to as a "faith premium" suggests that "more religious people derive greater benefits from opening religious bank accounts." One may recall the recent collapse of UM Financial Group in Canada. As the pioneer of *shari'a*-compliant home mortgages in Canada, UM Financial Inc. issued these mortgages to about 170 Muslim borrowers. The company filed for bankruptcy last year and went into receivership, which has raised much concern about the future of Islamic finance in Canada. This is an example of what Tarek Fatah has referred to as "charging . . . devout borrowers a premium for their piety."[35] This "piety premium" has influenced the decision of many Muslim investors in selecting *shari'a*-compliant products particularly in Western countries where there is less regulation by Islamic authorities.[36] Another incidental consequence of the "piety premium" is the cost of *shari'a*-compliant mortgages in North America. This constant struggle to reconcile faith and finance has led many Muslims to pay the additional costs of the "piety premium" in order to convince themselves that they are on the right religious track.[37] In fact, "research into the investment preferences of Muslims shows that most of them want products that benefit their savings, as well as their souls—rather as ethical investors in the West want funds that do no harm, but are also at least as profitable as other investments."[38] As emphasized above, an effective legal and regulatory framework is required in the global Islamic finance industry to prevent untoward practices shrouded in secrecy and deception in the name of religion.[39] If these excesses remain unchecked, unscrupulous elements may take over the market and tarnish the image of the Islamic finance industry. There is nothing inherently bad about the "faith premium" or "piety premium," but fund managers should not exploit the unsuspecting clients. Although people tend to become more religious during economic distress, this does not warrant the ill-disposed abuse of such religiosity for personal gains.[40]

Meanwhile, the diversity of the papers presented at the Ninth Harvard Islamic Finance Forum is distinctly demonstrated in Séamus Finn's review of the Catholic consideration of faith and finance. The principles of the Roman Catholic tradition have unique ethical norms regarding economic justice and concern for the common good.[41] This faith tradition has the

potential to reform the instability created by the financial crisis. Father Finn's perspective leans toward alternative faith-based models where he restates the position of the encyclical on alternative faith-based models of investment, which proposes that "space also needs to be created within the market for economic activity carried out by subjects who freely choose to act according to principles other than those of pure profit, without sacrificing the production of economic value in the process. The many economic entities that draw their origin from religious and lay initiatives demonstrate that this is concretely possible."[42] The set of principles that are grounded in the biblical scripture—subsidiarity, solidarity, corporate governance, common good and moral values—have positively impacted corporations and financial systems built on these Christian beliefs.[43] These shared principles constitute a firm basis for the faith community to infuse ethical values into the global financial system. This proposal seeks to identify the ethical values in the faith community that can transform the global economy.

While Finn focuses on the Catholic consideration of faith and finance, Mohammed Nejatullah Siddiqi examines the value-guided pursuit of interests through faith and finance with particular reference to the Islamic finance model. Siddiqi posits that faith in its purest form has the potential to promote moral values and to correct injustices in the global financial system. This last paper in the book reiterates a trend common to all the chapters, which emphasize the necessity of shifting more toward the ethical values of faith-based financing. Building bridges across financial communities is a *sine qua non* to the much-needed transformation in the global economy.

It is therefore appropriate to conclude these introductory remarks with the comments of Thomas Baxter, President and General Counsel, Federal Reserve Bank of New York, during the opening session of the Ninth Forum on the aftermath of the global financial crisis:

> We need to look for principles of risk management, like a stake in the venture, prudent incentive compensation, that will lead to more disciplined financial decision-making, more ethical behavior by providers of financial services . . . We need wise prudential supervision in the West and in the East, because the financial crises that our children face will be global and will require global solutions.[44]

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Part I:

Islamic Finance and Global Economic Meltdown

After the Meltdown: New Perspectives on Islamic Finance

Ibrahim Warde

The recent financial meltdown marked a turning point in the evolution of Islamic finance. Prior to the meltdown, Islamic finance was often dismissed in conventional circles, even among those who recognized its moneymaking potential. The idea of creating an alternative to conventional finance, and specifically the intrusion of the religious element in what was supposed to be a quintessentially secular realm, struck many as somewhat bizarre, especially at a time when conventional finance was riding high and seemed to provide a universally applicable model. A different kind of criticism was that Islamic finance was simply conventional finance dressed up in Islamic garb. It was thus at best an attempt to "reinvent the wheel"—and an expensive exercise at that—since the additional layer of control and documentation imposed by the *shari'a* boards added costs and generated inefficiencies.

The argument of this paper is that the global financial meltdown has recast the debate over Islamic finance. The Islamic sector resisted rather well to the meltdown. Indeed, those products and practices that were not normally allowed under Islamic finance—debt sales, complex derivatives such as credit default swaps, high leverage, unbridled speculation—were precisely those that led to the near collapse of the global financial system. The meltdown revealed excesses and dysfunctions and resulted in calls for alternatives to conventional finance. Two aspects of Islamic finance—its inherent conservatism and its preoccupation with ethics—made it look attractive and credible and thus established its legitimacy and viability as an alternative form of finance. This paper warns, however, against the temptation to consider Islamic finance as a panacea. Indeed, the industry, still in its youth, faces many challenges that remain, not least of which is that of closing the gap between abstract principles and actual practice.

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The Failing Paradigm

On the eve of the financial crisis, "American-style financial engineering was the global gold standard."[1] The paradigm of global finance, as epitomized by major Wall Street firms, commanded near-unanimous support and was aggressively exported throughout the world.[2] For almost three decades, since the dawn of financial deregulation, other approaches to finance had steadily been losing ground. To cite one example, the once vibrant sector of mutual finance was greatly reduced through a seemingly irreversible process of "demutualization."[3] In that context, the rise of Islamic finance was somewhat incongruous. Islamic banks seemed to be fighting an age-old battle and were usually on the receiving end of lectures essentially asking them to follow the cutting-edge of finance.[4] The discourse was often dutifully repeated within the Islamic world.[5]

This discourse proved spectacularly wrong, starting with the subprime crisis of 2007. The following year, only a massive government bailout saved the financial markets, which were assumed to be all-knowing and self-correcting, from collapse. Financial innovation was supposed to improve efficiency and liquidity, yet it brought forth an outright credit freeze. Risk management was dealt with as if it were an exact science, yet as critic Robert Kuttner observed, "Supposedly, these derivatives on top of derivatives 'spread risk,' but in truth they spread risk the way an epidemic spreads diphtheria."[6]

A number of statements by Alan Greenspan, the high priest of unfettered capitalism and the man dubbed "the maestro,"[7] captured the prevailing conventional wisdom as the bubble was inflating. In 2002, just as he lowered interest rates, he claimed that "bubbles cannot be prevented or defused by financial regulators." In 2004, he asserted that "a national severe price distortion seems most unlikely in the United States, given its size and diversity." In 2005, he added that a decline in home prices "likely would not have substantial macroeconomic implications." That year he also observed that "increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago." In 2006, shortly after he left the chairmanship of the Federal Reserve Board and on the eve of the bursting of the bubble, Greenspan said, "I think the worst of this may well be over."[8]

The near collapse of global finance brought to light the consequences of nearly three decades of unbridled deregulation and the unprecedented "financialization" of the economy and society.[9] Financiers were the main actors and beneficiaries of the new "gilded age" that preceded the meltdown. In the words of Sanford I. Weill, who had assembled the Citigroup conglomerate, "People can look at the last 25 years and say this is an incredibly

unique period of time. We didn't rely on somebody else to build what we built, and we shouldn't rely on somebody else to provide all the services our society needs."[10]

The language is interesting, first because of the building metaphor, but also because it suggests that finance, once seen as providing a service to the economy, had become a self-contained, self-centered and dominant realm. In the years preceding the credit crunch, "financial engineers" were at the cutting edge of finance.[11] Indeed, since the 1980s, investment banks and other financial institutions engaged in a massive effort to hire PhD graduates in physics, engineering, mathematics and other such disciplines to create increasingly complex and highly lucrative new financial instruments. The trend toward abstraction and the heavy use of mathematical symbols had created the illusion of scientific precision.[12] More worrisome, many in the financial community started taking the engineering metaphor literally. To quote finance professors turned bankers Eric Briys and François de Varenne: "On what grounds can one reasonably expect that a complex financial contract solving a complex real-world issue does not deserve the same thorough scientific treatment as an aeroplane wing or a microprocessor?"[13]

Perhaps, as later events would show, the house of cards metaphor[14] would have been more apt, but there are other advantages to the talk about engineering. It is value-neutral and makes preoccupation with ethics or morality superfluous, if not counter-productive. In an amazing display of groupthink, the seemingly irresistible rise of finance was cheered on by an overwhelming majority of every group that mattered—including the financiers themselves, as well as regulators, academics, analysts and journalists. It is no surprise then that the financial meltdown of 2008 seemed to take just about everybody by surprise.[15] The world of finance seemed to proceed on the assumption that, as Alexander Pope would have put it, "whatever is, is good."

It became easy to forget that models were only as good as their underlying assumptions. At the height of the boom, the same finance experts asserted that "there is no divorce between the real economy and the financial economy," just as they marveled at "the vast panoply of solutions offered by international finance," railed at "fallacies, such as the supposedly demonic trend of financial speculation and its destabilizing effects" and mocked those who "express deep concerns and denounce the ascendancy of the financial economy over the so-called real economy."[16]

The period between early 2007 and the summer of 2008 was dotted with scary episodes—the most dramatic being the government-engineered rescue of Bear Stearns by JPMorgan Chase in March 2008. Yet wishful thinking was still in order. There was a common belief that the worst was over and

that the "subprime crisis" had been contained, until the collapse of Lehman Brothers in September 2008, when the financial markets effectively froze and the dominant financial paradigm effectively collapsed.[17]

The financial meltdown was thus, at least in the minds of the principal players, sudden and totally unexpected. To quote Andrew Ross Sorkin, "In a period of less than eighteen months, Wall Street had gone from celebrating its most profitable age to finding itself on the brink of an epochal devastation. Trillions of dollars in wealth had vanished, and the financial landscape was entirely reconfigured."[18] Top officials were at a loss to explain what was going on. While the Lehman drama unfolded, a perplexed George W. Bush, a former businessman and the first American president to hold an MBA, said to Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, "Someday you guys are going to need to tell me how we ended up with a system like this."[19]

The deluge of books praising the magic of the market was suddenly replaced by works chronicling the disastrous mistakes made by financial "geniuses." (Often, the same authors who sang the praises of the infallible market later engaged in a critique of the arrogance of financial theory.)[20] Even Alan Greenspan changed his tune, conceding that he had "found a flaw" in his bedrock belief of "40 years or more" that markets would regulate themselves. "I made a mistake," he acknowledged.[21]

The Impact on Islamic Finance

The recent financial crisis could be divided into three phases. During the first phase, the decline in U.S. real estate prices drew attention to subprime loans, which had found their way onto the balance sheets of major international financial institutions through securitization. During the second phase, losses suffered by such institutions triggered claims for which major Wall Street firms and other companies, such as insurer AIG, were utterly unprepared. Indeed, through highly lucrative and unregulated credit derivatives known as "credit default swaps," high-flying financial firms had, in effect, insured countless institutions (and one another) against defaults, and now they had to pay up. As the world's leading global financial institutions discovered the time bombs on their balance sheets (in the form of toxic assets and unfunded liabilities), they realized that they were essentially insolvent: the ensuing credit freeze caused a global financial meltdown which soon spread to the real economy. The third phase of the financial crisis was thus a global economic recession, which would have turned into a depression were it not for massive government intervention worldwide to the tune of $11.4 trillion, according to the OECD.[22] It is only then that Islamic banks started to feel the effects of the meltdown.[23]

Why did Islamic institutions escape the first two phases relatively unscathed? Quite simply because many of the practices that caused the financial freeze would not pass muster with *shari'a* boards. Indeed, neither the securitization of subprime loans (which is a sale of debt) nor credit default swaps (which are the sale of promises and are rife with *gharar*) are acceptable.

Similarly, negative Islamic attitudes toward short selling were vindicated by the role short selling played in many aspects of the financial crisis[24] and subsequent limits placed on short selling of financial stocks in London, New York and elsewhere. Some old-fashioned principles, such as the distrust of excessive leverage and of open-ended innovation, proved well-founded.[25]

Reassessing Islamic Finance

A central question in the assessment of Islamic finance is whether it truly offers an alternative. The early objective of a partnership-based financial system, which would bring social and economic development to the Islamic world, was not quite fulfilled. Islamic finance chose instead to mimic many aspects of conventional finance (and there is nothing inherently wrong with this since Muslims have the same financial needs as non-Muslims), albeit through Islamic contracts and within boundaries imposed by religion.

Hence, the inevitable and legitimate question: Is Islamic finance necessary? Stated differently, does it add anything of value to the conventional banking system? Before discussing the issue, two points should be stressed. One is that the gap between promise and performance could be attributed to the youth of the industry. Modern Islamic finance only started in earnest in the mid-1970s. Its evolution has been marked by a constant process of trial and error, and its shortcomings may be unavoidable growing pains. The second point is that it would be unfair to judge Islamic institutions too harshly, considering the world's most prominent conventional institutions have not proven to be exemplars of either probity or strategic acumen. Although it could be argued that Islamic finance could still fulfill its original objectives, my argument is that the recent financial meltdown has recast the debate about the role and contributions of the Islamic sector.

The excesses revealed in the wake of the 2007–2008 financial crisis painted a different picture of the state of conventional finance. Differences between conventional and Islamic finance may, by the standards of the early promoters of Islamic finance, be modest; they are nonetheless real. And those differences, as revealed by the recent crisis, now cast Islamic finance in a different light. So, to answer the question asked earlier, Islamic finance does offer an alternative. To be sure, it is mostly by default, since for the past 30 years or so, finance has been moving toward a single model, and whatever

checks and balances existed previously, through regulatory agencies, consumer groups, academics or the media, whether for reasons of ideological hegemony or cooptation, have ceased to function properly.[26] The large Wall Street firms became the superstars and the guiding lights of that system, stressing the goals of efficiency, convergence, leverage and deregulation. Governments stayed out of the way to allow the magic of the marketplace to operate. Yet innovation was not pursued, despite the underlying rhetoric, for the benefit of the economy and society. It was pursued for its own sake—and for the fat fees it generated. It is this unanimity (here we are reminded of Margaret Thatcher's assertion of TINA: There Is No Alternative) that in hindsight made the Islamic sector appear as one of the few organized systems of alternative finance. This explains why the principles, if not the actual practice, of Islamic finance have come to hold undeniable attraction well beyond Islamic circles.

Three elements could be singled out. One has to do with Islamic products and instruments, which despite their relative lack of originality retain specific features. Even as they sought in their broad outlines to mimic conventional products, Islamic products, such as *murabaha*, have specific contractual features stressing ethics and risk-sharing. These can be consequential when problems arise and the debtor is unable to pay. In contrast to conventional finance, where banks have no qualms about taking advantage of distressed borrowers, the attitude of Islamic institutions is that they must in such circumstances forsake some of their profits, typically by extending a *qard hasan* (interest-free loan) to help the distressed borrower.[27]

Second, a number of financial products and practices, often among the most lucrative ones—from selling debt to exotic derivatives or from short selling to highly leveraged transactions—are simply off-limits to Islamic institutions. Nor are practices deemed predatory, such as payday loans or "vulture funds," acceptable. Third are screening mechanisms that prevent Islamic companies from investing in or doing business with companies belonging to non-halal sectors or companies whose financial ratios or ethical practices are not deemed acceptable.

This brings us to the alleged "loss of efficiency" endemic to Islamic finance, particularly due to the extra layer of control and documentation imposed by *shari'a* boards. In conventional finance, efficiency was reflexively associated with innovation, but that was before innovations nearly brought down the financial system. So maybe the *shari'a* boards played a salutary role in the end. The systematic vetting of new products by *shari'a* advisers could be looked at as an "outside the box" perspective, a useful corrective to the groupthink that had overtaken conventional finance. At a time when conventional finance was unable to be self-critical or resist the lure of easy

profits, *shari'a* boards provided badly needed checks and balances, by scrutinizing every innovation on the basis of criteria other than profitability—always the best way of reining in excesses.[28] By insisting on ethical and prudential guidelines at a time when Wall Street was playing pied piper, they may have placed useful limits to the mimicry of conventional finance.

The question of leverage provides an interesting illustration of differences between the Islamic and the conventional sectors. Islam favors equity and is suspicious of debt. The requirement that loans be fully backed by an asset greatly reduces the potential for leverage. The "one-third rule" (limiting the debt-to-asset ratio to one-third) is where the Dow Jones Islamic indexes and other screening mechanisms initially drew the line. In contrast, conventional finance has been agnostic on the issue, since the findings of Modigliani and Miller suggest that the debt-to-equity ratio has no bearing on value. Yet, with the increased focus on profitability and the steady weakening of prudential rules, conventional finance became increasingly partial to debt at the expense of equity. Indeed, the single-minded focus on profitability favored pushing leverage to the limit. It is thus no surprise that conventional firms on the eve of the credit crunch were still, with the acquiescence of regulators, finding creative ways of piling debt upon debt to increase their leverage. In 2004, the Securities and Exchange Commission (SEC) decided to permit investment banks to increase their permitted leverage from 10 to 1 to 30 to 1.[29] Shortly before its collapse, leverage at Lehman Brothers was at 44 to 1, with $748 billion in assets standing atop $17 billion in equity.[30]

More generally, since the dawn of the age of financial deregulation, which roughly corresponds to the entire lifespan of modern Islamic banking, conventional banking was transformed almost beyond recognition. Beyond the question of leverage, a number of changes are worth noting. Since 1978, caps on usury ceilings (usury in the conventional banking sense of excessive interest) were effectively removed, opening the door to considerable abuse.[31] The relationship between debtor and creditor was transformed by the practice of securitizing loans. In 2001, the value of pooled securities in America overtook the value of outstanding bank loans. The market for derivatives, which barely existed before deregulation, grew exponentially, with a corresponding increase in complexity and opacity. According to the Bank for International Settlements (BIS), in 1997, the notional value of derivatives contracts was $75 trillion, or 2.5 times global GDP. A decade later, it mushroomed to $600 trillion, or 11 times world output.[32] The whole incentive structure within the financial industry changed, favoring reckless and short-term behavior, which generated bonuses yet ignored the impact of such open-ended innovation on the economy and society.

In contrast, the Islamic approach favored, in theory though not always in practice, a conservative and ethical approach to finance, two qualities that came to be prized following the financial meltdown. The excesses revealed in its wake were accompanied by a backlash and calls for a return to the basics of banking, to deleveraging and simplifying finance.[33] Whereas finance is prone to overkill and hubris, religion—any religion and for that matter any durable secular philosophical system—stresses temperance and is likely to object to the conceit of omniscience. Nassim Taleb, in response to those who sought comfort in financial models, stated, "It's easier to say 'God knows' than 'I don't know.'"[34]

On the specific matter of ethics, the world of finance had adopted a cynical attitude. As told by a Stanford business school professor, "In the early eighties, the faculty here started getting snotty comments about how they were contributing to greed on Wall Street and training modern day pirates and buccaneers. After a while, it got hard to laugh off. So the faculty said, 'Hey, let's just put an ethics unit in the curriculum. That'll shut everybody up.'"[35] A whole generation of what may be called "non-practicing ethicists" arose, whereby talking a lot about ethics provided cover for the perpetuation of ethical lapses. The same is true about governance, transparency, risk control and other reassuring concepts. In an Orwellian twist, high-sounding principles were invoked, just as they were violated in practice.[36] On the eve of a massive destruction of value, all the talk was about how financial innovations were creating value. Risk management took on the airs of an exact science, just as risk managers were about to prove that they had been clueless all along.[37]

Just as excesses spawned an interest in simplifying finance, the "amorality" of contemporary finance has generated an interest in "moralizing" it. And whereas Western or Judeo-Christian finance had become thoroughly secularized (the religious origin of many financial institutions has long receded from the public consciousness),[38] Islamic finance stood apart in still asking age-old questions about the dangers of making money with money, the need to tether finance to the real economy and more generally questions of ethics and morality. In the quest for a free-enterprise system that is circumscribed by moral norms and codes, religion and Islam—a religion that holds a positive view of economic activities while providing for strict guidelines—became more attractive. The Vatican newspaper *L'Osservatore Romano* recently wrote, "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."[39]

Even secular observers have noted that Islamic finance could be a restraining factor in the rise of transnational criminal networks and other

unsavory phenomena that have come to be associated with globalization[40]—what some have called “rogue economics.” In the words of Loretta Napoleoni, “Above all, Islamic finance represents the sole global economic force that conceptually challenges rogue economics. It does not allow investment in pornography, prostitution, narcotics, tobacco or gambling. Since the fall of the Berlin Wall, all these areas have blossomed thanks to globalization outlaws under the indifferent eyes of the market-state.”[41]

A Cautionary Note

When the financial tsunami hit, bringing conventional finance to its knees, there was a mood of soul searching within mainstream finance. In parallel, there was a sense of triumphalism among promoters of Islamic economics and finance. Some did not hesitate to present Islamic finance as a panacea that would solve all the world’s economic ills and as the model that conventional banks had to adopt to get out of their predicament.[42]

Yet soon afterward, the extension of the crisis from the financial realm to the real economy exposed the vulnerability of a sector that is mostly asset backed, though its inherent conservatism somehow mitigated the effects of the economic downturn.[43] This showed that Islamic finance was not after all a panacea, and that a faith-based system is not automatically immune to the vagaries of the financial system.

On balance however, the Islamic sector weathered the financial meltdown better than the conventional sector. If nothing else, there was an acknowledgement within conventional circles that the principles and strictures of Islamic finance were not without merit. This, in turn, created a renewed sense of self-confidence within the Islamic sector, which also weakened the hand of those who equated progress with uncritical imitation of conventional banks.

In sum, as the financial crisis has brought about a rare moment of reflection and critical thinking, the logic of Islamic finance can no longer be dismissed out of hand. At the same time, it may be dangerous to overstate the virtues of Islamic finance and present it as a panacea, especially since its principles state what is permissible and not what is necessarily advisable. To quote Mahmoud El-Gamal: “The claim that Islam has the perfect solution is questionable in economics, just as in politics.”[44] Caution is also called for to avoid the dangers of moral hazard. Islamic finance is now at a crossroads. It is unclear how Islamic institutions will respond to the new environment, and many other uncertainties remain. How much change in regulation will happen as a result of the meltdown remains an open question, the answer to which will also determine the future evolution of Islamic finance.

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Portfolio Diversification during Financial Crisis: Analysis of Islamic Investment Strategies

Jahangir Sultan and Maher Milly

Introduction

It is still early to determine the full impact of the combined total loss of more than $29 trillion in global equity markets during the recent economic and financial crisis. However, it is already apparent that the demand for safer asset allocation has become a paramount concern among investors.[1] Hence, the question that comes to mind is: what types of investment strategies would have performed well by limiting downside losses for international equity funds during the financial crisis? This study conducts a comparative performance analysis among equity portfolios devised according to conventional, Islamic and Socially Responsible Investing (SRI)[2] investment strategies.

In contrast to conventional or socially responsible investment funds, Islamic equity funds comply with the rules set forth in the *shari'a*, the divine Islamic law. The Islamic asset allocation process is based on Islam's ethical values of economic justice, its emphasis on profit-loss sharing and real asset-backed investments, as well as various constraints with regards to permissible business transactions. The core dimensions of these restrictions relate to charging interest (*riba*), gambling and speculation (*maisir*), and vague or indeterminate contractual agreements (*gharar*). In addition, Islamic funds are prohibited from investing in companies that profit from activities deemed unethical in Islam, such as the sale of alcohol, arms, adult entertainment and pork products.

Our focus on alternative investment models is consistent with the emergence of a new class of investors that, in addition to profit motives, is also driven by their desire to live ethically and invest morally. Compared to the conventional financial system, Islamic finance is a newcomer to the global

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financial world, encompassing somewhere between $750 billion to $1 trillion of investments in firms and projects that are classified as *shari'a* compliant.[3] Yet, over the past few years Islamic investments have become more competitive and consequently attractive not only to Muslim but to non-Muslim investors seeking alternative investment opportunities, which offer investors high ethical but also nominal performance standards. As a result, the number of Islamic mutual funds and exchange traded funds world-wide has increased considerably from merely 8 before 1992 to more than 550 in 2007, with an estimated market capitalization of $300 billion.[4] Numerous traditional U.S.-based financial institutions are joining this development. Similarly, the SRI class of funds is a relative newcomer that has gained popularity in recent years. Since the early 2000s, we have seen a dramatic interest in socially responsible investing that poured billions of dollars into companies known for their efforts to offer ethical investments and projects that promoted environmental sustainability.

Our interest in examining the performance of various asset allocation strategies is timely, given the recent financial market turmoil. The hypothesis tested is that the Islamic investment strategy may be safer during times of economic distress, because Islamic funds have much less exposure to credit market conditions than conventional portfolios. An Islamic investment model might have proven beneficial due to its exclusion of highly leveraged companies and emphasis on high-level of asset-backing. Employing the Greenblatt's stock screening process (alpha screening)[5] and subsequent Markowitz minimum-variance optimization, our study will compare the performance of a *shari'a*-compliant equity portfolio with that of an SRI and as well as a more traditional equity portfolio. Both in-sample and out-of-sample performance analysis will be performed to judge how well these investment strategies may have performed during the recent global financial crisis.

Islamic Mutual Fund Industry

Recent History

To fully comprehend the celerity of the Islamic Fund industry expansion, it is necessary to place it in the context of the development of the Islamic Finance industry as a whole. After a period of slow progress from its inception in the 1970s to the beginning of the 1990s, the Islamic finance industry has undergone a rapid transformation.[6] As the oil business in the region gained traction and dollars started flowing into the oil rich Gulf nations, the demand for a regional financial system based on Islamic principles strengthened significantly since the 1990s. Even though "Islamic assets [only] stood at about $150 billion in the mid-1990s," the Standard Poor's *Islamic Finance Outlook 2008* goes on to state that they have grown at more

than 10 percent annually over the past ten years.[7] In fact, the growth trend of the Islamic finance industry has been accelerating, reaching annual growth rates of 15 percent from 2005 to 2008.[8]

Current State

Within this broad industry development, the Islamic mutual fund industry itself has "expanded significantly, growing at a compound annual growth rate of 22 percent" over the past five years, according to a recent Moody's report.[9] In order to accommodate this industry expansion, the number of Islamic financial institutions increased from only a handful in the 1970s to over 300 by 2007 (Siddiqui, 2007).[10] Moreover, major Western stock exchanges initiated listing Islamic indices, such as the Dow Jones Islamic Market Index (DJIM) and the FTSE Global Islamic Index Series, that would further the industry's development. The *Shari'a* Supervisory Board of the DJ Islamic Market Index (listed in 1999) ensures that the security universe is only composed of *shari'a*-compliant companies. As of Feb. 27, 2009, the index included 2,540 companies from 55 countries with a total market capitalization of $10,691.5 billion.[11] The number of Islamic equity funds and ETFs worldwide exceeded 325 in 2008, mirroring the growing demand for Islamic investment vehicles.[12] Major banking institutions of the West, including UBS, Citibank, HSBC and Deutsche Bank, joined the industry and now offer their own Islamic mutual funds as well as other Islamic financial products and services. According to a recent survey by Ernst & Young, by the end of 2009, while global assets under management (AUM) reached a level of $22 trillion, *shari'a*-compliant investment funds are estimated to manage about US$52.3 billion in investments. In addition, by the end of 2009, there were approximately 700 Islamic mutual funds.[13]

Future of Islamic Funds

The ongoing global financial crisis has affected the Gulf region, around which most of the activities in the Islamic finance industry revolve.[14] Yet, according to the aforementioned size and growth figures, it seems that the Islamic finance industry has proven rather resilient in the face of this worldwide financial debacle and fared relatively well compared to conventional financial industries in the West. This outcome stems from the fact that "to some extent, today's global economic troubles can be traced to excessive leveraged financing activities that diverged from real economic activities." Since "the principles of Islamic finance [...] are firmly rooted in [...] real economic activity," Islamic equity funds, which comply with *shari'a* regulations and avoid highly-leveraged companies, have become very attractive to today's risk-averse investor.[15] As such, the future bodes well for the Islamic finance industry and consequently the sub-sector of Islamic mutual funds.

Besides the apparent attractiveness of Islamic investment vehicles during the current financial crisis, the mere fact that Muslims comprise 21.01 percent of the world's population,[16] while the Islamic finance industry accounts "for only about 1 percent of the financial assets in the overall banking and insurance sectors [...] suggests that there is still ample room for growth on the supply side in the provision of Islamic financial products."[17] The combined gross domestic product of the 57 member states of the Organization of the Islamic Conference (OIC) based on purchasing power parity amounts to approximately $7 trillion,[18] while the six-member Gulf Cooperation Council (GCC) alone is estimated to hold $2.5 trillion in private wealth.[19] In fact, a joint study by the Islamic Development Bank and the Islamic Financial Services Board expects the Islamic finance industry to undergo "an annual growth of 15 percent until 2010 [. . . expanding to] US$1.4 trillion by 2010 and to US$2.8 trillion by 2015."[20] In light of the current global financial crisis and the rising demand for *shari'a*-compliant investments by Muslim as well as non-Muslim investors worldwide, the Islamic equity funds and Islamic finance industry as a whole are poised to undergo further expansion.[21] To achieve this projection, Islamic funds are expected to meet investor expectations in terms of returns by shifting assets away from investment accounts to investment funds. Furthermore, as the E&Y report indicates, as investors are moving away from capital preservation to capital appreciation, the Islamic funds will need to deliver higher returns through strategic allocation of investment funds. In order to appreciate the future growth potential of Islamic finance, it becomes necessary to first understand its fundamental characteristics, structure and origin, which will be outlined in the next section.

Principles of Islamic Finance

Shari'a

In contrast to SRI or conventional investment funds, Islamic mutual funds have to be in compliance with the *shari'a*. As the divine code of law, the *shari'a* serves as "the guide for human action, which encompasses every aspect of human life and [...] operationalizes the understanding of the Divine Will in terms of human actions."[22] The framework of the *shari'a* is based on the Quran, the written revelation of God's Word, and the Sunna, which is comprised of the teachings and practices of the Prophet Muhammad. Deriving its rulings from the Quran and Sunna, the *shari'a* is instilled with divine authority. Hence, the guidelines set forth in the *shari'a* become imperative to all Muslims and govern all aspects of life, whether they are of personal, social, political, economic or financial nature.

The unitary perspective of life in Islam, which includes an economic system, essentially strives to establish harmony, equality and balance within the individual and society as a whole in a worldly context, but also between the individual and God in a spiritual sense. Since the "rules governing permissible and forbidden economic behavior [...], as well as questions of property rights and of production and distribution of wealth, are all based on the fundamental Islamic concept of justice," it becomes evident that the notions of economic justice and equitable distribution of wealth represent two fundamental pillars of the Islamic economic system.[23]

Prohibitions in Islamic finance

In order to assist the development of such an Islamic economic framework, the *shari'a* stipulates certain rules that restrict economic and financial processes, so that business dealings are just and fair and may benefit not only the individual, but society as a whole. The three key prohibitions relevant to Islamic finance relate to the concepts of *riba*, the charging of interest; *gharar,* uncertainty or immoderate risk in contractual agreements; and *maisir*, gambling and speculation.

The prohibition of interest is clearly expressed in the Quran, which states that "God hath permitted trade and forbidden usury"[24] and represents the most striking difference between Islamic finance and the conventional financial system. The actual Arabic word for usury used in the verse is *riba*, which "means [...] any increase over and above the principle amount payable in a contract obligation, not covered by a corresponding increase in labor, commodity, risk or expertise."[25] Accordingly, with the exception of allowed profit sharing, the creditor is only entitled to the principal of the loan, which is further articulated in the same section of the Quran, which reads (in translation):

> O, believers, fear God, and give up what is still due to you from Riba if you are true believer. If you do not do so, then take notice of war from God and his Messenger. But, if you repent, you can have your principal. Neither commit injustice nor should you be subjected to it.[26]

The second prohibition refers to disproportionate *gharar* due to uncertainty in financial contracts. The uncertainty as it relates to the relevant exchanged goods or terms of a particular transaction thus includes any ambiguity in terms of quantity, quality or deliverability of the subject matter.[27] The last restriction of gambling and speculation (*maisir*) is plainly outlined in the fifth Surah (chapter) of the Quran, which states (in translation), "O you who believe! Intoxicants and gambling, sacrificing to stones

and divination by arrows are abominable actions of Satan; so abstain from them, that you may prosper."[28] Therefore, any accumulation or acquisition of wealth derived through gambling, games of chance or speculation is forbidden. Within the context of these constraints, it becomes apparent that Islamic fund management practices and procedures will differ from SRI and conventional funds. The implications of these three fundamental restrictions of Islamic finance on *shari'a*-compliant fund management are further elaborated in the subsequent discussion.

Portfolio Asset Allocation Process of Islamic, Sri and Conventional Funds

General Comparison of Fund Objectives

Although SRI funds were initially conceived in a religious context as well, socially responsible investing has expanded to take into consideration "the so-called 'triple bottom line,' commonly known as the 'three P's rule: people, planet and profit.'"[29] Most recently, assets under SRI management were estimated to be $3.07 trillion at the beginning of 2010.[30] The premise of the "three P's rule" is reflected in a definition of socially responsible investing, which can be found in the *2005 Report on SRI Trends in the United States* released by the Social Investment Forum:

> Socially responsible investing (SRI) is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis . . . It is a process of identifying and investing in companies that meet certain standards of Corporate Social Responsibility (CSR).[31]

Therefore, SRI fund management aspires to establish an investment strategy that results in financial profit, while realizing the commanding responsibility toward our society and environment.

Our selection of Islamic and SRI investment strategies is in line with the recent interest in the performance of faith based investing, with its overarching goal to promote the betterment of society, relative to conventional investment strategies, which lack such ethical motivation. In terms of the portfolio allocation and structure, Islamic investments and socially responsible investing (SRI) funds exhibit strong similarities, whereas traditional mutual funds, represented in our study through a portfolio only subject to an alpha stock selection filter adapted from Joel Greenblatt's methodology, are not subject to any other qualitative or quantitative constraints.[32] The congruence of Islamic and SRI funds stems from the fact that both do not have profit maximization as their sole objective, but rather strive to fulfill a paramount, ethical obligation and a social-utilitarian function. In the case of Islamic funds, the religious responsibilities and regulations outlined in

the *shari'a* take precedence over profit in order to further the establishment of a moral Islamic economic system and a just society.

In contrast, profit maximization is the dominant objective in traditional fund management. Conventional equity portfolio strategies include neither positive nor negative screens, whose purpose it is to align the portfolio with certain ethical, qualitative standards. As such, conventional funds are not often subject to the qualitative screening procedures that are so imperative to Islamic and SRI funds.

Additionally, Islamic funds differ from SRI and conventional ones, since their provisions incorporate quantitative screens that are based on ethical paradigms found in the interpretation of the Quran and the Sunna by some *shari'a* scholars working for the funds. Furthermore, Islamic funds have to comply with certain income purification requirements, which are derived from the teachings of the Quran and Sunna. The distinctions between each of the three fund types are further elaborated in the subsequent sections in the context of the screening and income purification process.

Security Universe Restrictions

The qualitative screening of Islamic and SRI funds is very similar. Both employ negative screens to exclude companies from their portfolios, which they deem as being engaged in unethical business activities. In fact, while Islamic screens eliminate "all banks and insurance companies whose activity is interest-based [...] as well as all companies involved in alcohol, tobacco and armaments manufacturing and trading, or involved in entertainment businesses,"[33] SRI screens preclude companies involved in "alcohol, gambling, tobacco, weapons production or distribution" and actively filter for companies "showing [...] good performance in the areas of animal welfare, board diversity, community relations, corporate governance, environment, human rights, indigenous peoples rights, product safety and impact, and workplace practices."[34] A study by Ghoul and Karam finds that with the exception of "interest income [...], the requirement of certain financial ratio standards, and the objection to pork and music companies."[35] Islamic and SRI screening methodologies are fairly congruent from a qualitative point of view.

Whereas traditional portfolio screening procedures lack a qualitative component derived from ethical norms, Islamic, SRI and conventional portfolio allocation methods rely on quantitative screens that specify certain filters.[36] All three fund types utilize quantitative screens as filters to earn superior alpha (excess returns), which set their portfolios apart from competitors in their respective category. However, Islamic funds employ certain quantitative screens on top of the preliminary qualitative ones to

arrive at a basic investment universe of securities, which is *shari'a* compliant. More specifically, the financial ratio analysis of Islamic funds aims to screen out companies with excessive reliance on debt, where the typical maximum level of total debt to market capitalization is set at 33 percent.[37] Analogous tolerance levels of 33 percent apply to the ratio of the sum of a company's cash and interest-bearing securities to market capitalization and accounts receivables to market capitalization in order to guarantee that the capitalization structure and business activities of every company in an Islamic fund conform to *shari'a* principles.[38]

Income Purification

By investing in conglomerates, Islamic equity funds find themselves in an intricate predicament, as the income streams of a diversified company may partially derive from *haram*[39] business activities. The issue of partial income from objectionable sources does not impact SRI funds as much, because they either simply exclude such companies via their qualitative screens from the beginning on or do not have to worry about certain issues, such as income from interest, at all. Conventional funds do not face this problem in any manner, as they are allowed to invest in companies no matter whether their business activities are considered permissible or not according to a given code of ethics. Yet, the question remains as to whether Islamic funds may invest in such companies at all; and if they are allowed to, how one should manage the portion of total profits derived from *haram* income streams. To avoid this predicament, *shari'a* scholars have come to the general conclusion that an Islamic fund is still allowed to invest in these corporations, as long as the *haram* income component is limited and appropriately "purified."[40]

In general, income from forbidden activities should be kept at a minimum and must be purified by donating a corresponding percentage of the fund's payouts to charity. According to the Malaysian *shari'a* Advisory Council, *riba* income should account for "no more than 5 percent of [...] profits."[41] The directed "purification process is done either by the fund manager before any distribution of income, or by reporting the necessary financial ratios [to] investors."[42] In the case that management does not perform its duty, the Muslim investor has to make sure to dispose the percentage of his returns that was attributable to a company's non-halal business activities to charity. Actually, the latter approach is preferable, as it would not place unnecessary financial burden on traditional investors, thus making Islamic funds more attractive to non-Muslims.[43] In essence, this regulation ensures that companies with minimal income from *haram* activities are not screened out altogether by Islamic funds, which can consequently

tap into a greater investment universe that allows for sufficient diversification. At the same time, it prescribes Islamic funds a manner by which to purify their earnings and maintain their ethical integrity in accordance to *shari'a* standards.

Governance Structure and Composition of Islamic, SRI and Conventional Funds

Although Islamic financial products can be structured in a variety of ways to form equity, commodity, lease-back (*ijara*), cost-plus sale (*murabaha/sukuk*) or mixed funds (Bose & Mcgee, 2008), this study solely focuses on Islamic equity funds. Although the actual portfolio composition of the Islamic fund naturally resembles that of a regular open-ended, long only mutual fund, Islamic equity funds are based on a "*mudaraba*" contractual structure in terms of the fund's management arrangement. *Mudaraba* fund management structures are characterized by the Islamic profit and loss sharing principle, in which "an economic agent with capital (*rabb-al-mal*) can form a partnership with another agent with skills (*mudarib*), with an agreement to share the profits." [44] Under the *mudaraba* contract, losses from an equity fund are generally to be suffered by the capital providers (investors) only. Nevertheless, in the case that the losses can be attributed to negligence or misconduct by the *mudarib*, he may be liable instead of the *rabb-al-mal*.[45]

The structure and portfolio composition of SRI funds and traditional funds are not restricted in terms of specific investment vehicles, as long as these financial instruments passed their screening and filtering process and are in compliance with their investment policy statements. Islamic equity funds, on the other hand, have to conform to a certain fund structure and composition that incorporates consideration for the prohibitions of *riba*, *gharar* and *maisir*.

Due to the prohibition of interest, Islamic funds are not allowed to invest in "any fixed income securities, such as corporate bonds, treasury bonds and bills, certificates of deposit, [and] preferred stocks."[46] Similarly, Islamic funds cannot trade on margin or exploit short-selling processes. For the former, one would be relying on interest-based debt to finance the investment, while the latter entails not only borrowing a security with interest for trading purposes, but also excessive risk due to potentially unlimited losses (ignoring margin requirement calls). These two exclusions stand in stark contrast to SRI and conventional funds, but especially to hedge funds, which make extensive use of these two trading techniques.

Furthermore, the prohibition of *gharar* precludes Islamic equity fund management from a myriad of financial instruments, which are usually employed by SRI and traditional funds. Since *gharar* bans excessive uncertainty or

risk in contractual agreements, Islamic funds are not allowed to utilize any "financial derivative instruments, forwarding contracts, [or] future agreements."[47] Keeping in mind that an option is the exchange of funds for a right and no promise of an actual asset-based transaction, "a right, without an obligation, makes [an option] dependent upon future events and creates *gharar*,"[48] thus rendering it a forbidden financial instrument under *shari'a* law. Forwards and future contracts are equally forbidden, as they rely on a partial and not full payment at the initial transaction settlement and consequently raise the issue of selling promises instead of actual assets. The only notable, widely-accepted exception to the abovementioned restrictions due to *riba* and *gharar* is presented in the form of a *Salam* contract. A *Salam* transaction corresponds to a "deferred delivery [where] money is paid on the spot but the commodity will be delivered at a future date."[49] Expanding this concept, an Islamic equity fund can actually proxy a short-selling transaction via a *Salam* sale as long as it owns the underlying security at the onset of the transaction. Consequently, Islamic equity funds can emulate this particular hedging technique, regularly employed by SRI and traditional funds, without overstepping the boundaries set forth by the *shari'a*. Yet, in contrast to SRI and conventional funds, the strict prohibitions of *riba* and *gharar* are in full effect and apply to all the other aforementioned cases, thus severely restricting the number of permissible financial instruments and ultimately the composition as well as structure of Islamic funds.

Financial Crisis and Islamic Funds

For the purposes of our study, July 2007 was chosen to mark the beginning of the financial crisis. During this month Bear Stearns started releasing data that some of its funds were essentially worthless, while the U.S. government injected a combined $62 billion into the financial system the following month as an emergency intervention.[50] The origin of the financial crisis can be traced back to the sub-prime mortgage problem, which was a result of risky loans being extended to individuals with poor credit histories. These loans were bundled into mortgage-backed securities (MBS) and sold to investors across the world. As interest rates rose, the underlying risky loans of MBS became subject to higher default rates and consequently the MBSs' value dropped significantly. Due to uncertainty and higher default rates, banks tightened lending and the credit crunch ensued, restricting much needed liquidity. As the global financial crisis was spreading, governments across the globe were struggling to turn the world economy around.[51]

At the same time, the Islamic finance system has weathered the financial turmoil much better than its Western counterpart. Islamic banks, operating on a system that prohibits interest, have not suffered as much as Western

banks from the credit crunch. This phenomenon can in part be explained by the Islamic banks' safeguard against the "liquidity problem due to [interbank] lending in the money markets, merger and resales of [debt-ridden] companies" as well as their lending practices that evaluate "complete investment risks instead of mere credit risks."[52]

More specifically, although the financial crisis has negatively affected the performance of *shari'a*-compliant funds, "their five-year total returns have [still] managed to fare better than the S&P 500 and their peers" in the mutual fund industry.[53] For example, while the five-year return on the Russell 2000 index amounted to a 5.20 percent loss, the income and growth funds of the Amana Mutual Funds Trust, one of the most prominent Islamic mutual funds in the U.S., yielded a profit of 5.69 percent and 4.97 percent respectively.[54]

As previously mentioned, the root cause of the current financial crisis can be found in sub-prime lending practices and the dependent secondary market for MBS. In contrast to Islamic principles, "debt braced with high interest was being extended to persons who simply could not afford to pay back loans [-this] was usury."[55] Moreover, the securitization of "mortgage debts, turning them into interest-bearing securities" is strictly forbidden due to the *riba* element and consequently Islamic funds are not allowed to invest in these vehicles.[56] Because of the credit crunch, the financial sector was hit the hardest, as the industry's high leverage level hurt banks, insurance companies and financial institutions. Moreover, the derivative market—and especially the secondary market for MBS—collapsed during the financial crisis as the value of the underlying assets in these markets deteriorated with increased default rates. According to the prohibitions of *riba, gharar* and *maisir*, Islamic mutual funds are forbidden to trade on margin or short-sell by borrowing funds, invest in highly-leveraged firms, MBS, or risky derivates and have thus been fairly immunized from the credit crisis (which negatively affected all these investment vehicles and techniques), ultimately resulting in superior returns for Islamic equity funds in general compared to their conventional counterparts.

Data and Methodology

General Overview

The universe formation and alpha stock ranking process, modeled according to a Greenblatt filter, were carried out in FactSet, utilizing its Universal Screening feature. In addition, fundamental data for each security was retrieved from the FactSet. Historical prices of the relevant securities and indexes were retrieved from DataStream. The alpha ranking scores along with the securities' historical price information were imported into SAS.

Based on the ranking, portfolios composed of the best 50 securities for each asset allocation strategy were exported to Excel. Finally, Excel's Solver add-in was used to perform portfolio optimization and calculate relevant quantitative portfolio performance measures.

Security Universe Formation

In an effort to begin the asset allocation for each of the equity portfolios, first, the appropriate security universes were formed. The initial universe for the conventional, Islamic and SRI fund were proxied via the Dow Jones Global World Index (DJGI), Dow Jones Islamic Market World Index (DJIM) and Dow Jones Sustainability World Index (DJSI), respectively.

Since the indices' components were based on 2009 data, a filter was implemented to only include stocks that actually existed in 2000, the year that marks the beginning of the in-sample period. Similarly, securities, for which the necessary 2006 fundamental data for the alpha generation ranking screen is not available, are excluded from the universes. In order to prevent security overlap among the three equity portfolios, which would deteriorate the strength of the study's findings, the DJSI universe components are excluded from the DJIM and their combined security components are excluded from the DJGI universe. To further establish relevant security universes, from which even larger equity funds could have chosen stocks, firms with a 2006 market capitalization of less than $1 billion are excluded. The resulting universes consisted of 171, 802 and 958 potential securities for the SRI, Islamic and conventional equity portfolio, respectively.[57]

Alpha Screen Ranking

In addition, a quantitative ranking screen, devised according to the methodology presented in Joel Greenblatt's *The Little Book That Beats the Market* (2005), is run on each of the universes to select superior securities. Greenblatt's ranking screen methodology was chosen because he is one of the most prominent investment gurus of our time and his investment strategy has proven consistently successful in extensive back-testing analyses.[58] Greenblatt's investment philosophy is based on the principle of buying good companies at bargain prices. In an effort to aid this process, Greenblatt devised a screen that ranks companies by earnings yield (EY) and return on capital (ROC) ratios. While the high earnings yield filters for undervalued companies, the return on capital ratio yields companies that can reinvest their earnings at a high rate—resulting in potentially high earnings growth—and most likely have a sustainable competitive advantage. The earnings yield and return on capital ratios are calculated as follows:[59, 60]

- EY = EBIT/Enterprise Value
- ROC = EBIT/(Working Capital + Net Plant, Property and Equipment)

Thereafter, the EY and ROC ranks are added together for each security to generate its final combined ranking.[61]

General Approach to In-Sample Optimization and Out-of-Sample Evaluation
For the purpose of Markowitz minimum-variance optimization, this study divides the period from 2000 to 2009 into an in-sample and an out-of-sample period. The optimized portfolios will be determined using data from the in-sample time period, which spans from January 2000 to June 2007 and represents relatively normal global economic activity with regular economic contractions and expansions. Subsequently, the performance of the optimized portfolios will be tested during the out-of-sample period, which spans from July 2007 to April 2009, is characterized by a global financial crisis and hence represents a time of economic distress.

Relying on in-sample period data, the Excel Solver utilizes Markowitz's portfolio theory to form optimized equity portfolios. The Markowitz model's optimization process is based on the following two parameters:

$$\text{Min } \sigma_p^2 = \sum_{i=1}^{n}\sum_{j=1}^{n} w_i w_j \rho_{ij} \sigma_i \sigma_j$$

$$\text{Subject to } w_1 + w_2 + \ldots + w_N = 1$$

$$C = \sum_{i=1}^{n}\sum_{j=1}^{n} w_i w_j \text{Cov}\,(r_i r_j) + \lambda_1\left(1 - \sum_{i=1}^{n} W_i\right)$$

r_p is the return of the portfolio, r_i the return of a particular security, w_i is its weight in the portfolio, cov is the covariance between the returns of the securities, σ_p^2 is the variance of the portfolio, C is the Lagrangian function, λ_1 is the Lagrange multiplier and ρ_{ij} is the correlation between securities. The investor minimizes the variance subject to a target return by changing the weights assigned to each security. Once the optimal weights have been established, the portfolio's performance is evaluated for the out-of-sample time period and appropriate performance measures are computed, as discussed in further detail in the subsequent sections.

In-Sample Portfolio Optimization
For the in-sample portfolio optimization, first the weekly historical prices of the securities in each portfolio for the period from Jan. 3, 2000 to July 2, 2007 are imported from DataStream into Excel. The weekly continuous-compounding returns are calculated using log transformation of prices. Next, the return of the portfolio is calculated for each week. According to generally-accepted calculation procedures, the average weekly standard deviation is annualized by multiplying the weekly portfolio deviation by the square root of the number of weeks in a year, while the average weekly portfolio return is annualized by multiplying by the number of weeks in a year.

The Excel Solver is then used to optimize the portfolio via risk minimization according to Markowitz portfolio theory. The solver is set up to minimize the annualized standard deviation by modifying the weights of the securities in each portfolio. Additional restrictions include a minimum weight of 0 percent for each security, since a negative weight would correspond to short-selling, which is not allowed in the *shari'a*h compliant long-only investment policy. Furthermore, the cumulative weight of all the securities in each portfolio is capped at one, since a weight greater than this value would imply margin trading, which is also not allowed in the selected fund structure. A maximum weight[62] for each security is set at 10 percent, so that the solver devises a portfolio with a sufficiently large number of securities, which benefits from diversification and is less exposed to firm-specific risk. Using the available data and subject to the aforementioned restrictions, the Excel Solver finally determines the appropriate security weights to form optimized conventional, Islamic and SRI equity funds.

Out-of-Sample Forecasting and Performance Measure Calculations
In order to assess the performance of each of the investment philosophies during the financial crisis, the optimized portfolios' performances are evaluated over the out-of-sample period from July 2, 2007 to April 27, 2009. In order to carry out quantitative performance analysis, the annualized mean portfolio return and standard deviation for each equity fund are calculated using the optimum security weights from the in-sample period. The two performance measures are calculated in the same manner as for the in-sample episode, except that the calculations are based on the time horizon from July 2007 to April 2009, characterized by the financial meltdown.

In terms of portfolio management style, it would be incorrect to classify these portfolios as indexed portfolios, because the initial screening method is similar to alpha scoring models that are utilized at portfolio management firms (active management). Thus, the management style of the study's portfolios should be classified as enhanced indexing. It is important to note that although we report the tracking error (TE), $TE = \sigma(r_p - r_i)$,[63] for each portfolio, we do not use this ratio to measure performance. The tracking error would be a critical indicator of performance if we had set out to construct indexed portfolios.

For a more conclusive portfolio performance evaluation, the Sharpe Ratio (SR) is calculated. This is:

$$SR = \frac{(\mu - r_f)}{\sigma_p},$$

where μ is the portfolio's annualized mean return, r_f is the risk-free rate (three-month U.S. Treasury bill rate [average of weekly rates during time periods '00–'07 and '07–'09]) and σ_p represents the portfolio's annualized standard deviation. The Sharpe ratio provides a risk-adjusted performance measure and represents the portfolio's excess return above the risk-free rate per standard deviation of risk.

Interpreting the Sharpe ratio based on the portfolio's data during the financial meltdown from July 2007 to April 2009 is a bit more complicated, because the negative mean returns result in negative Sharpe ratios. Negative Sharpe ratios make conclusions a bit more difficult and sometimes even ambiguous, as a more negative Sharpe ratio can be due to a higher negative return—an undesirable attribute—or a lower standard deviation—an arguably attractive attribute. To avoid contradictory performance results, the modified Sharpe ratio (MSR) is calculated as:

$$SR = (\mu - r_f) / \sigma_p^{\{(\mu - r_f)/Abs(\mu - r_f)\}}$$

where μ is the portfolio's annualized mean return, r_f is the risk-free rate proxied via the appropriate average three month Treasury bill rate, σ_p is the portfolio's annualized standard deviation and *Abs* is the absolute value operator. The modified Sharpe[64] ratio makes comparison of the performances of the conventional, Islamic and SRI equity portfolios intuitive and logical when excess returns are negative. Note that when excess returns are positive, the modified Sharpe ratio is identical to the regular Sharpe ratio.

Empirical Results

Performance Evaluation of Equity Funds (Comprehensive and Size-Based Portfolio Groups)

As indicated in Tables 1–4, the performances of the conventional, Islamic, and SRI investment strategies are evaluated using comprehensive portfolios as well as small-, mid- and large-cap ones, which were constructed to control for potential size bias. Generally speaking, the empirical results confirm the study's hypothesis that an investment philosophy for international equity funds in accordance to Islamic law would have limited downside losses and resulted in risk-adjusted return improvements over traditional and SRI investment methodologies during times of economic and financial crisis.

Comprehensive Portfolio Group

As can be seen in Table 1, the comprehensive Islamic fund outperforms the conventional and SRI equity portfolios in both the in-sample and out-of-sample periods. However, during '00–'07, the performance of the Islamic portfolio is markedly superior with a modified Sharpe ratio (MSR) of

Table 1. Portfolio Performance

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
	Portfolio Group: Comprehensive (all sizes)					
Average Return	0.26%	0.40%	0.22%	–0.63%	–0.57%	–0.69%
Standard Deviation	1.80%	2.09%	1.70%	4.50%	4.86%	4.78%
Annualized Avg. Return	13.38%	20.72%	11.65%	–32.69%	–29.63%	–36.09%
Annualized Std. Deviation	12.96%	15.06%	12.26%	32.43%	35.06%	34.46%
Tracking Error	1.54%	1.93%	1.55%	1.66%	1.66%	1.40%
Number of Stocks	21	23	22	21	23	22
Sharpe Ratio	0.7909	1.1677	0.6943	–1.0644	–0.8975	–1.1009
Modified Sharpe Ratio (MSR)	0.7909	1.1677	0.6943	–0.1120	–0.1103	–0.1307
Improvement in MSR over Nearest Competitor		47.64%			1.50%	
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**2**	**1**	**3**	**2**	**1**	**3**

1.1677, while the conventional one ranks second with an MSR of .7909 and the SRI third with an MSR of .6843. In the subsequent out-of-sample period, the relative improvement in the Islamic fund's MSR over the nearest competitors shrunk considerably from 47.64 percent to 1.5 percent, but is nonetheless still higher than the other two alternatives with a value of –.1103, while the conventional and SRI portfolios have MSRs of –.1120 and –.1307, respectively. Although this outperformance decline might initially cause concerns, the later performance analysis of the size-based portfolios sheds light on the underlying cause and reaffirms the conclusion that the construction of equity portfolios according to Islamic investment principles resulted in return improvements over funds devised in accordance to conventional or SRI methodologies during times of economic distress. The size-based portfolio performance analysis points to the fact that the

outperformance decline is most likely due to the inclusion of securities from each of the three size categories, which happen to exhibit the lowest risk characteristics, but at the same time, suffer from weaker return figures. In accordance to the Markowitz portfolio optimization procedure, these securities would be included in the comprehensive Islamic equity portfolio despite their weak return characteristics, because they contribute to a reduction of the portfolio's overall standard deviation. Hence, in order to correctly assess each of the investment strategies, it becomes necessary to evaluate their performance in the context of comprehensive as well as size-controlled portfolios.

The superior performance of the comprehensive Islamic equity fund is further visually represented in charts found in appendices 1 and 2. The charts display the base-indexed portfolio performance of each of the three investment strategies. In order to construct these base-indexed charts, the prices of each security are indexed with the first price in the relevant time period serving as the base. In this manner, the subsequent security prices are deflated by their relevant base price. Applying the optimized security weights from the Markowitz optimization, the base-indexed prices are added together to yield the portfolio index, which naturally starts at 1, or 100 percent. In this manner, it becomes possible to compare the relative performance of all portfolios over time on the same scale. While the chart in appendix 2 shows that investing in the Islamic fund during the financial crisis would have protected an investor's assets most effectively, the chart in appendix 1 additionally demonstrates that such an investment would have actually outperformed the other two fund investment alternatives by an even larger margin during times of regular economic activity. In fact, over the course of the second investment horizon from '07–'09, the Islamic, traditional and SRI equity fund would have resulted in cumulative returns of –38.42 percent, –42.27 percent and –44.28 percent respectively, while the same would have yielded 653 percent, 397 percent, and 314 percent during the initial investment period. As such, not only did the Islamic equity strategy most effectively shield investors' assets from losses during times of economic turmoil, but it also yielded the highest returns during tranquil market periods.[65]

Size-Based Portfolio Groups

As previously deliberated, an analysis of each of the three investment methodologies utilizing size-based equity funds is chosen to control for potential size bias and complement the performance evaluation of the comprehensive portfolio group. For this purpose, sub-universes are created from each of the three initial universes based on company size, proxied via year

2006 market capitalization figures.[66] As Tables 2–4 indicate, the funds in the small, medium and large cap portfolio groups, devised in line with Islamic investment principles, are most successful in limiting downside losses during the recent financial crisis from '07–'09, clearly outperforming their respective conventional and SRI counterparts. Moreover, with the exception of the large cap Islamic fund, an Islamic investment strategy would have also yielded the highest returns during periods marked by regular economic activity.

In fact, as shown in Table 2, in the small cap portfolio group, the Islamic fund performs the best during the in-sample period with an MSR of 1.0415 compared to MSRs of .7969 for the traditional and .6943 for the SRI portfolio. Over the course of the subsequent investment horizon, the Islamic, conventional and SRI funds exhibit MSRs of –.0607, –.0987 and –.1307, respectively. Hence, the *shari'a*-compliant Islamic investment strategy results in an equity portfolio that exhibits a 30.71 percent and 38.56 percent

Table 2. Portfolio Performance

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Small			
Average Return	0.23%	0.30%	0.22%	–0.61%	–0.38%	–0.69%
Standard Deviation	1.53%	1.69%	1.70%	4.08%	3.92%	4.78%
Annualized Avg. Return	11.92%	15.83%	11.65%	–31.71%	–19.62%	–36.09%
Annualized Std. Deviation	11.03%	12.19%	12.26%	29.43%	28.27%	34.45%
Tracking Error	1.64%	1.83%	1.55%	1.65%	1.86%	1.40%
Number of Stocks	26	18	22	26	18	22
Sharpe Ratio	0.7969	1.0415	0.6943	–1.1399	–0.7588	–1.1008
Modified Sharpe Ratio (MSR)	0.7969	1.0415	0.6943	–0.0987	–0.0607	–0.1307
Improvement in MSR over Nearest Competitor		30.71%			38.56%	
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**2**	**1**	**3**	**2**	**1**	**3**

improvement in MSR over its nearest competitor during times of normal economic activity and financial distress, respectively. Similarly, charts in appendix 3 and 4 reflect these performance characteristics. While the Islamic fund only loses 28 percent of its value during the financial crisis, the traditional and SRI funds lose 40 percent and 52 percent. During '00–'07, the Islamic portfolio would have yielded a cumulative return of 391 percent, while the SRI fund comes in second with 307 percent, closely followed by the conventional fund with 299 percent. These figures further support the conclusion that an Islamic investment strategy would have been successful during times of regular economic activity, but most importantly invaluable to the objective of safeguarding investors' assets amidst financial market turmoil.[67]

An analysis of the medium sized equity portfolios corroborates our aforementioned finding of superior performance of the Islamic strategy during times of economic distress as well as regular development. As such, an in-depth review of quantitative results is omitted in the interest of brevity. Nevertheless, the relevant MSR and additional supporting performance figures can be extracted from Table 3 and appendices 5 and 6. Whilst the Islamic fund again ranks first in the mid-sized portfolio group, it is interesting to note that the relative ranking of the other two has changed, with the mid-sized SRI fund actually performing better than the conventional one during both time periods.

Reviewing the performances within the large-cap portfolio group in Table 4, it becomes clear that the MSR results for the second investment horizon from '07–'09 validate the study's hypothesis of Islamic funds' capacity to protect investors' assets during financial crises. Accordingly, the Islamic portfolio has the highest MSR of –.0588 and suffers the lowest cumulative losses of 31.38 percent during '07–'09, as demonstrated in the chart of appendix 8. At the same time, the conventional and SRI fund yield MSRs of –.0769 and –.0851 and total cumulative losses of 36.55 percent and 36.99 percent, respectively. Yet, this portion of our analysis also offers a cautionary note with regards to our supplementary conclusion that Islamic equity funds may even provide superior returns during times of regular economic activity. Contrary to the findings based on the comprehensive and other two size-based portfolio groups, the large-cap Islamic fund this time ranks third in terms of MSR performance during the period from '00–'07, with a value of .1396. A plausible explanation for this finding is that as firms become larger, they tend to be driven increasingly by overall market conditions and not their own idiosyncratic factors, thus exhibiting risk and return characteristics similar to the corresponding market. While all other portfolio groups demonstrate that investors can profit considerably

Table 3. Portfolio Performance

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Medium			
Average Return	0.16%	0.25%	0.19%	–0.83%	–0.36%	–0.50%
Standard Deviation	1.52%	1.51%	1.53%	4.20%	3.74%	3.65%
Annualized Avg. Return	8.50%	12.87%	9.98%	–43.01%	–18.56%	–26.07%
Annualized Std. Deviation	10.94%	10.89%	11.04%	30.25%	26.99%	26.30%
Tracking Error	1.61%	1.91%	1.59%	1.74%	1.70%	1.80%
Number of Stocks	20	26	22	20	26	22
Sharpe Ratio	0.4905	0.8939	0.6209	–1.4825	–0.7556	–1.0611
Modified Sharpe Ratio (MSR)	0.4905	0.8939	0.6209	–0.1357	–0.0551	–0.0734
Improvement in MSR over Nearest Competitor		43.97%			25.02%	
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**3**	**1**	**2**	**3**	**1**	**2**

by investing in Islamic equity funds even in periods of tranquil market conditions, the analysis of the large-cap fund group indicates that awareness of a particular security's market capitalization class becomes crucial when deciding to adhere to a *shari'a* compliant investment strategy during normal economic times. With regards to the study's initial hypothesis, the analysis of the large-cap portfolio class along with the evaluations of all other portfolio groups comprehensively verifies the finding that the Islamic investment strategy is most effective at protecting investor's capital during financial crises.

Performance Evaluation Excluding Relevant Industries

Besides the performance evaluation of size-based equity portfolios for each of the three investment strategies, additional analyses were performed

Table 4. Portfolio Performance

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Large			
Average Return	0.20%	0.09%	0.18%	–0.50%	–0.42%	–0.53%
Standard Deviation	1.62%	1.55%	1.79%	3.84%	3.43%	4.01%
Annualized Avg. Return	10.56%	4.69%	9.57%	–25.97%	–21.90%	–27.56%
Annualized Std. Deviation	11.71%	11.19%	12.87%	27.67%	24.77%	28.95%
Tracking Error	1.54%	1.78%	1.41%	1.53%	1.84%	1.33%
Number of Stocks	22	23	20	22	23	20
Sharpe Ratio	0.6346	0.1396	0.5002	–1.0050	–0.9582	–1.0154
Modified Sharpe Ratio (MSR)	0.6346	0.1396	0.5002	–0.0769	–0.0588	–0.0851
Improvement in MSR over Nearest Competitor		–72.08%			23.60%	--
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**1**	**3**	**2**	**2**	**1**	**3**

excluding relevant industries from the respective security universes to further test the robustness of our results. Due to the fact that financial and real estate companies[68] suffered the most during the recent financial crisis, securities from these industries are excluded from the relevant universes.

Acknowledging slight nominal differences, the quantitative performance measures essentially mirror the study's previous findings (see Tables 5–8). Of course the superior performance of the Islamic investment methodology can in part be attributed to its prohibition to invest in banks and most real estate companies, whose stocks happened to suffer the most during the credit crunch and ensuing economic crisis. Yet, the results from this supplementary analysis further ascertain the conclusion that, even when controlling for the aforementioned issue, portfolios constructed in accordance with Islamic

Table 5. Portfolio Performance (excluding Financial/Real Estate Firms)

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
	Portfolio Group: Comprehensive (all sizes)					
Average Return	0.28%	0.40%	0.20%	–0.68%	–0.57%	–0.73%
Standard Deviation	1.83%	2.09%	1.69%	4.71%	4.86%	4.76%
Annualized Avg. Return	14.53%	20.72%	10.34%	–35.52%	–29.63%	–37.93%
Annualized Std. Deviation	13.21%	15.06%	12.22%	33.94%	35.06%	34.33%
Tracking Error	1.50%	1.93%	1.57%	1.74%	1.66%	1.51%
Number of Stocks	21	23	22	21	23	22
Sharpe Ratio	0.8624	1.1677	0.5903	–1.1007	–0.8975	–1.1584
Modified Sharpe Ratio (MSR)	0.8624	1.1677	0.5903	–0.1268	–0.1103	–0.1365
Improvement in MSR over Nearest Competitor		35.39%			12.99%	
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Sum	1	1	1	1	1	1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**2**	**1**	**3**	**2**	**1**	**3**

investment principles are more successful than conventional and SRI equity funds in limiting potential downside losses during financial crises.

General Performance Comparison of Benchmark Index Universes
In an effort to analyze the investment strategies from a macro perspective, the performance of the conventional, Islamic and SRI funds is compared to that of their respective indices. Accordingly, first the performances of each of the indices are compared over the course of the two investment horizons. Thereafter, the performances of the constructed equity portfolios are placed in the context of the respective index universes' performance to determine the effectiveness of the chosen quantitative alpha ranking filter and Markowitz optimization model.

Table 6. Portfolio Performance (excluding Financial/Real Estate Firms)

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Small			
Average Return	0.21%	0.30%	0.25%	–0.55%	–0.38%	–0.73%
Standard Deviation	1.49%	1.69%	1.77%	3.93%	3.92% 4.85%	Annualized
Avg. Return	11.13%	15.83%	12.86%	–28.77%	–19.62%	–38.15%
Annualized Std. Deviation	10.76%	12.19%	12.76%	28.32%	28.27%	34.95%
Tracking Error	1.67%	1.83%	1.74%	1.72%	1.86%	1.58%
Number of Stocks	26	18	19	26	18	19
Sharpe Ratio	0.7434	1.0415	0.7623	–1.0805	–0.7588	–1.1441
Modified Sharpe Ratio (MSR)	0.7434	1.0415	0.7623	–0.0867	–0.0607	–0.1398
Improvement in MSR over Nearest Competitor		36.63%			30.01%	
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Sum	1	1	1	1	1	1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**3**	**1**	**2**	**2**	**1**	**3**

The conventional, Islamic and SRI universes are proxied via the modified DJGI, DJIM and DJSI, and the indices' price data is base-indexed to allow for comparative analysis on the same chart.[69] As illustrated in appendix 9, the DJIM index lost 15.93 percent of its value, the DJSI only lost 3.85 percent, but the DJGI actually gained 27.48 percent in value in the time period from '00–'07, which is characterized by regular economic activity. Yet, as displayed in appendix 10, in the recent financial crisis from '07–'09, the DJIM suffered the least cumulative loss, amounting to 42.78 percent, while the DJGI and DJSI lost 48.27 percent and 53.08 percent, respectively. Hence, it becomes clear that although the Islamic index wasn't able to benefit as much as the conventional and SRI during up market, it was able to better protect investors from downside losses during the financial crisis from '07–'09.

Table 7. Portfolio Performance (excluding Financial/Real Estate Firms)

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Medium			
Average Return	0.16%	0.25%	0.19%	–0.79%	–0.36%	–0.45%
Standard Deviation	1.57%	1.51%	1.46%	3.89%	3.74%	3.57%
Annualized Avg. Return	8.24%	12.87%	9.99%	–40.88%	–18.56%	–23.58%
Annualized Std. Deviation	11.33%	10.89%	10.55%	28.03%	26.99%	25.76%
Tracking Error	1.60%	1.91%	1.58%	1.76%	1.70%	1.91%
Number of Stocks	21	26	23	21	26	23
Sharpe Ratio	0.4505	0.8939	0.6501	–1.5237	–0.7556	–0.9867
Modified Sharpe Ratio (MSR)	0.4505	0.8939	0.6501	–0.1198	–0.0551	–0.0655
Improvement in MSR over Nearest Competitor		37.49%			15.94%	
Optimization Constraints						
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Sum	1	1	1	1	1	1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**3**	**1**	**2**	**3**	**1**	**2**

With regards to the in-sample period, the cumulative yields of the comprehensive equity portfolios stand in stark contrast to indices' returns. A comparison between the two groups on the same chart in appendix 11 reveals that the study's alpha screen, devised according to Greenblatt's ranking methodology, and mean-variance optimization model are very effective in the period from '00–'07. All three equity portfolios undoubtedly perform significantly better than the index group. At the same time, it is evident from the chart in appendix 12 that the alpha returns of the same portfolios are significantly less over the second period from '07–'09, as the performance of the equity portfolios becomes more aligned with that of the indices. Although the Greenblatt quantitative ranking filter and Markowitz

Table 8. Portfolio Performance (excluding Financial/Real Estate Firms)

	January 2000–June 2007			July 2007–April 2009		
	Conventional	**Islamic**	**SRI**	**Conventional**	**Islamic**	**SRI**
			Portfolio Group: Large			
Average Return	0.20%	0.09%	0.18%	-0.52%	-0.42%	-0.53%
Standard Deviation	1.62%	1.55%	1.79%	3.88%	3.43%	4.01%
Annualized Avg. Return	10.24%	4.69%	9.57%	-26.80%	-21.90%	-27.56%
Annualized Std. Deviation	11.65%	11.19%	12.87%	27.98%	24.77%	28.95%
Tracking Error	1.53%	1.78%	1.41%	1.52%	1.84%	1.33%
Number of Stocks	21	23	20	21	23	20
Sharpe Ratio	0.6101	0.1396	0.5002	-1.0236	-0.9582	-1.0154
Modified Sharpe Ratio (MSR)	0.6101	0.1396	0.5002	-0.0801	-0.0588	-0.0851
Improvement in MSR over Nearest Competitor		-77.11%			26.62%	
Optimization Constraints						
Minimum Weight	0	0	0	0	0	0
Maximum Weight	0.1	0.1	0.1	0.1	0.1	0.1
Sum	1	1	1	1	1	1
Risk Free Rate	3%	3%	3%	2%	2%	2%
Ranking	**1**	**3**	**2**	**2**	**1**	**3**

optimization procedure are generally successful in creating value in the form of superior portfolio returns relative to the indices' performance, the extent of this advantage decreased during the out-of-sample period.

An extended assessment based on statistical analysis is undertaken to determine the extent to which portfolio returns are driven by market performance. The statistical analysis calculates beta, which measures a portfolio's exposure to general market movements, while R^2 represents the amount of variation in portfolio returns explained by variation in market returns. Accordingly, for each comprehensive equity portfolio, the 388 in-sample and 99 out-of-sample weekly returns are regressed against each strategy-specific index returns, using the ARIMA procedure with 5 lags on the residuals.

Table 9. Statistical Analysis of Comprehensive Portfolio Group

Portfolio Type	In-Sample Period (00–07)		Out-of-Sample Period (07–09)	
	Beta	R^2	Beta	R^2
Conventional	.59	.53	.96	.88
Islamic	.56	.43	1.08	.89
SRI	.56	.57	.97	.92

The figures in Table 9 reveal that the equity portfolios exhibit a relatively moderate correlation with their respective index during the in-sample period, with beta values ranging from .56 to .59, which is further supported by the low R^2 values, which range from .43 to .57 for each of the investment strategies. In the second time period from '07–'09, the correlation strengthens, with beta reaching values between .96 and 1.08 and R^2 values ranging from .88 to .92.

The diminishing nature of the equity portfolios' alpha returns is most likely attributable to two factors. On the one hand, the effectiveness of our initial alpha screen might have deteriorated as the security mispricing gets corrected over time, while, on the other hand, it might indicate that the economic turmoil of the financial crisis simply had a widespread adverse effect on many stocks. Although the scope of this research paper does not include an attribution analysis, in general, the study's results clearly indicate that the alpha screening and Markowitz portfolio optimization procedure were effective at constructing equity portfolios for each investment strategy with superior performances compared to their respective index universe. Furthermore, in light of the increasing correlation between the underlying index universe and the corresponding equity portfolio during the second investment horizon, the argument for adapting an Islamic investment philosophy in anticipation of financial market turmoil becomes even more compelling, especially given the fact that the Islamic index was subject to the least losses from 2007 to 2009.

Conclusion

There is no doubt that the recent global financial crisis has spurred demand for safer investment strategies among today's risk-averse investors. The aim of this study was to determine whether an investment strategy for international equity funds based on Islamic finance principles would limit potential downside losses during financial crises. An Islamic investment model might have proven particularly beneficial due to its exclusion of highly leveraged companies, effectively reducing its exposure to credit market conditions.

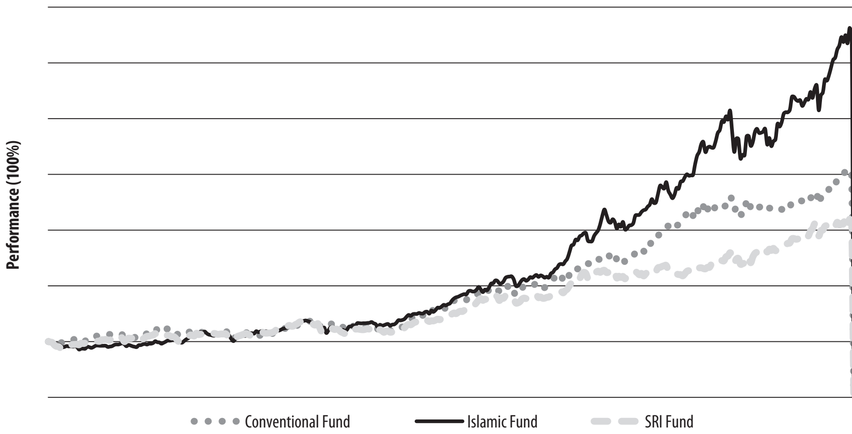
It is important to note that the onset of the recent financial crisis can be traced back to sub-prime lending practices and excessive leverage. Under *shari'a* law, which prohibits *riba*, *gharar* and *maisir*, Islamic funds are forbidden to trade on margin or short-sell by borrowing funds, invest in highly-leveraged firms, MBS, or risky derivatives. These investments collapsed in value during the credit crunch and the financial crisis, while the aforementioned risky investment techniques and vehicles further amplified losses suffered by the underlying assets and securities. Therefore, the study bases its hypothesis on the notion that the principles and rules inherent to Islamic finance would yield *shari'a*-compliant equity portfolios better economic results during times of distress.

For the purposes of our study, quantitative alpha screening and subsequent Markowitz minimum-variance optimization procedures were utilized to construct conventional, Islamic and SRI equity portfolios. In-sample (January 2000 to June 2007) optimized portfolio weights were used to forecast out-of-sample (July 2007 to April 2009) risk and return figures for each of the portfolios. In addition to annual return and standard deviation computations, the modified Sharpe ratio was chosen as the primary comprehensive performance measure, because it determines the risk-adjusted profitability of the various portfolios.

Within this context, the comparative performance analysis of the conventional, Islamic and SRI investment strategies based on comprehensive as well as size-based equity portfolios, confirms the study's hypothesis that the Islamic strategy is most effective at shielding investors assets from losses during economic and financial crises. In fact, with the sole exception of the large-cap portfolio group, the Islamic equity portfolios even outperform their conventional and SRI counterparts during the prior investment horizon marked by normal economic activity. As the results of this study show, an investment strategy based on Islamic principles may be successful not only amidst financial market turmoil, but also during regular, more tranquil periods.

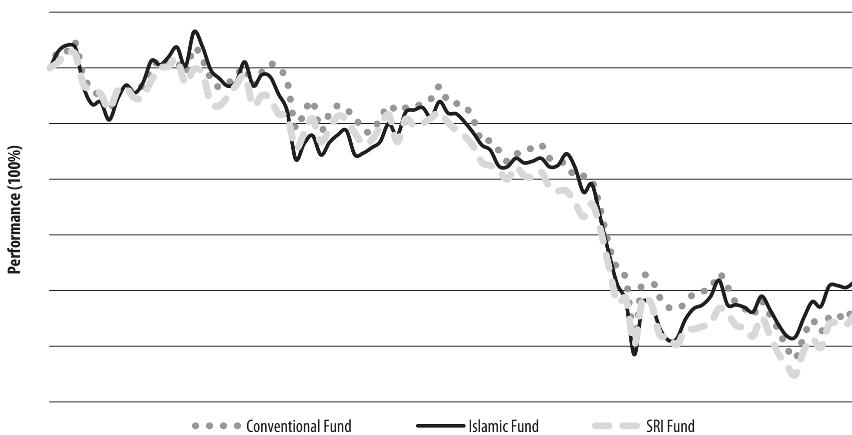
Appendix 1

Indexed Fund Performance (2000–2007 June)
Group: Comprehensive

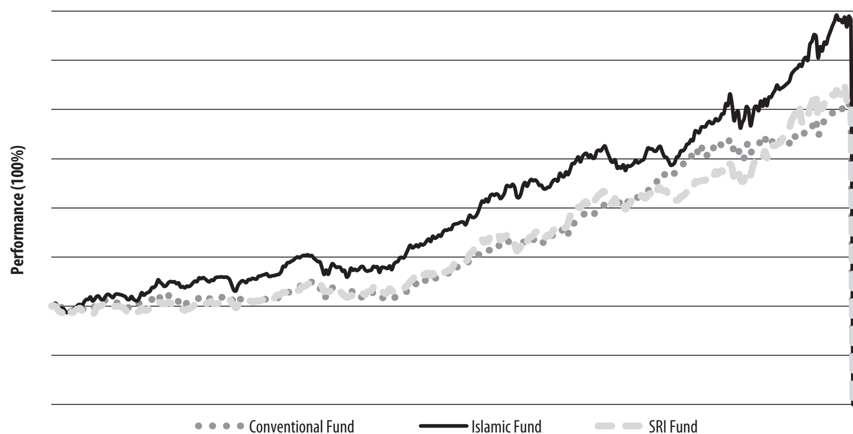


Appendix 2

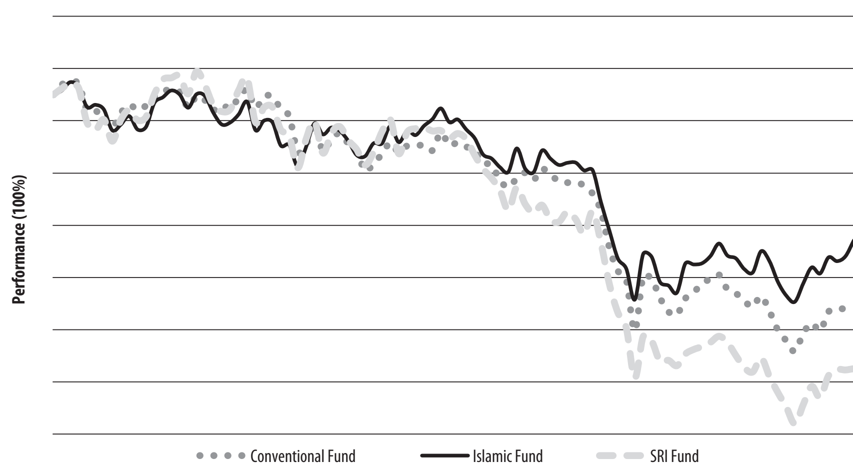
Indexed Fund Performance (2007 July–2009 May)
Group: Comprehensive



Appendix 3

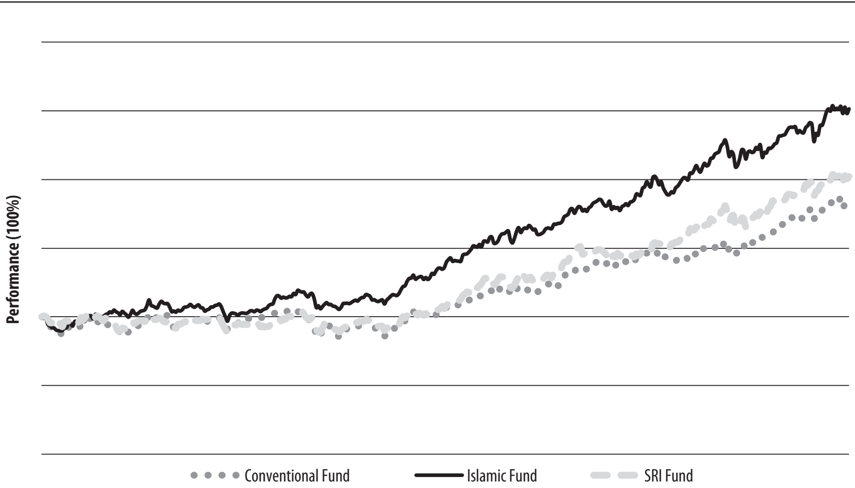


Appendix 4



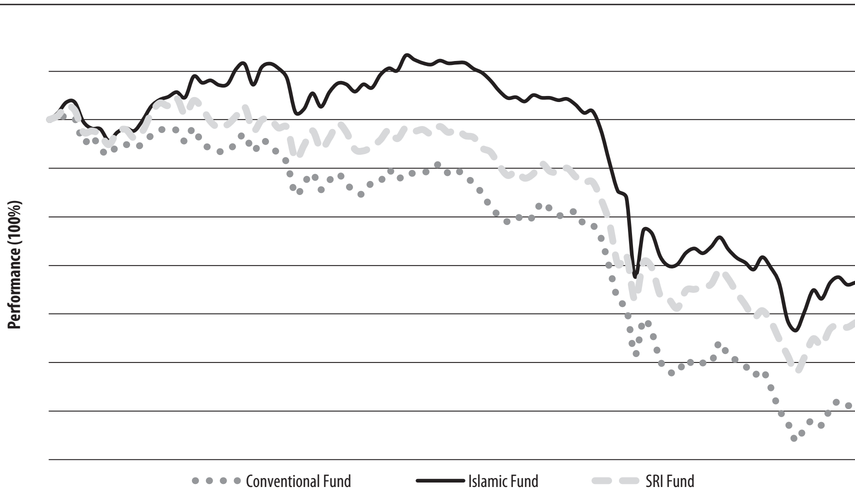
Appendix 5

Indexed Fund Performance (2000–2007 June)
Group: Medium Cap



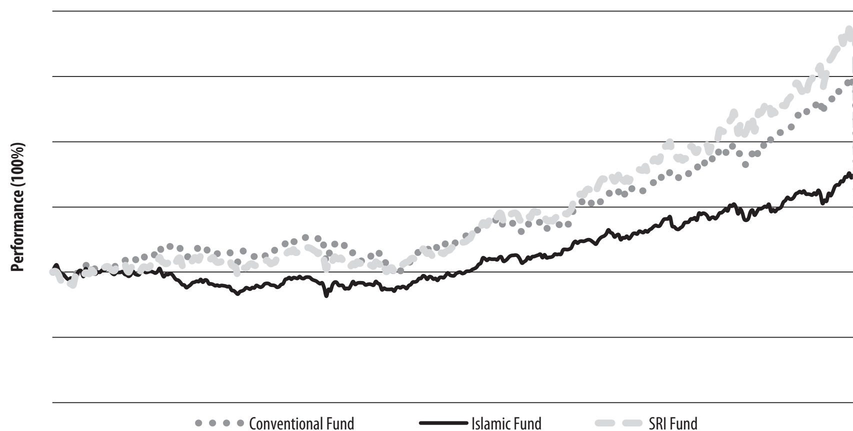
Appendix 6

Indexed Fund Performance (2007 July–2009 May)
Group: Medium Cap



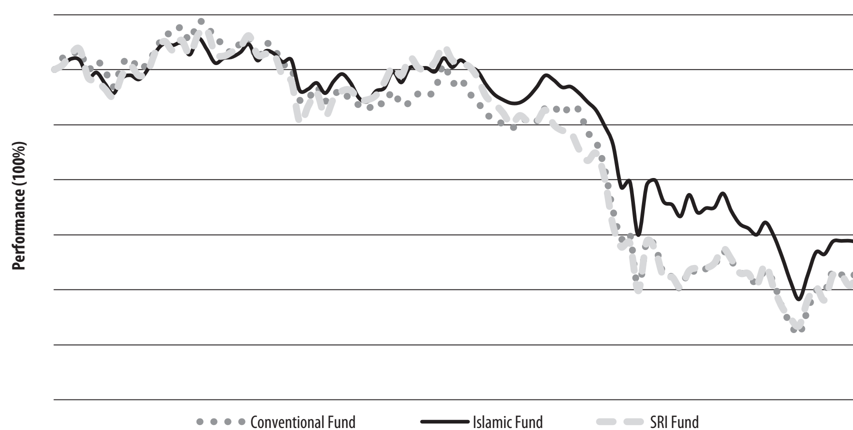
Appendix 7

Indexed Fund Performance (2000–2007 June)
Group: Large Cap



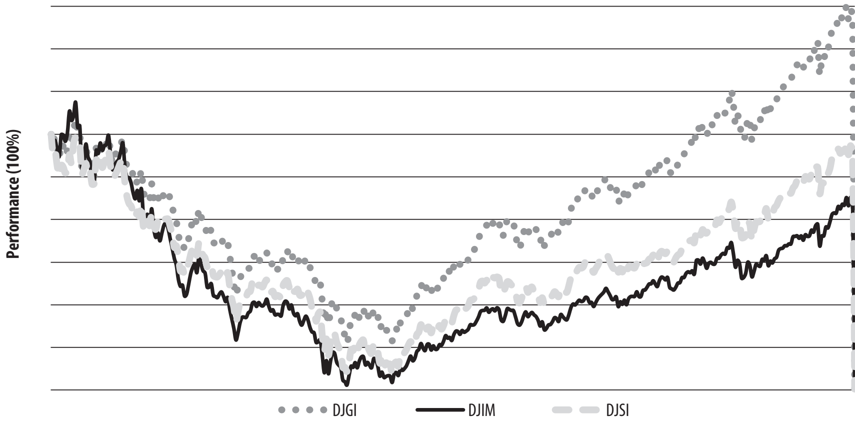
Appendix 8

Indexed Fund Performance (2007 July–2009 May)
Group: Large Cap



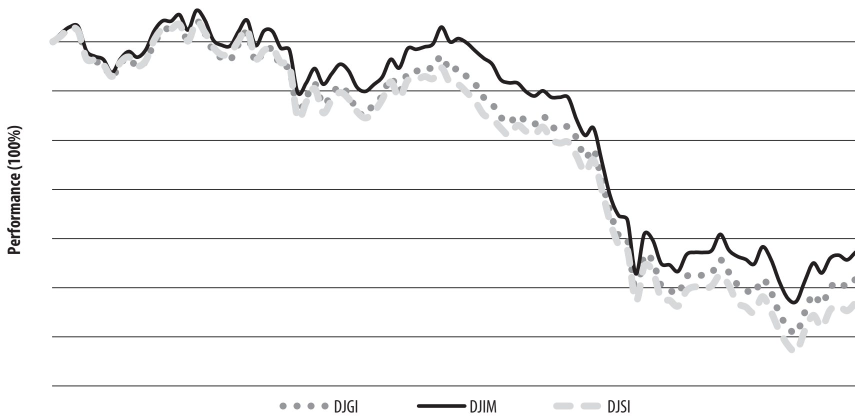
Appendix 9

Benchmark Index Performance (2000–2007 June)



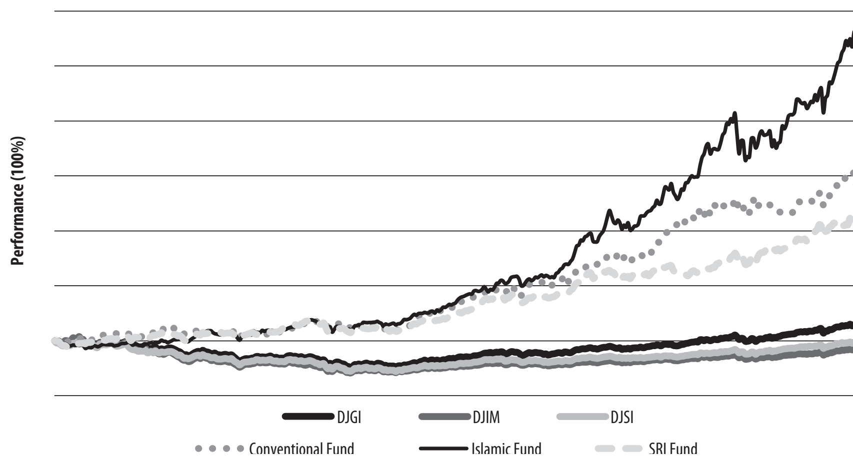
Appendix 10

Benchmark Index Performance (2007 July–2009 May)



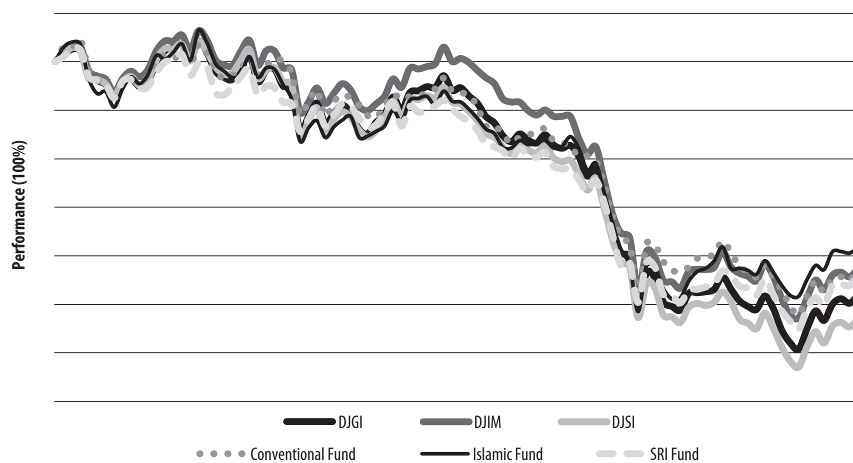
Appendix 11

Performance Overview (2000–2007 June)
Group: Comprehensive



Appendix 12

Performance Overview (2007 July–2009 May)
Group: Comprehensive



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5. As explained in later sections, stocks are screened on the basis of return on capital and earnings yield to determine if they are good investments and whether they are cheap. See Joel Greenblatt, *The Little Book that Beats the Market* (Hoboken: John Wiley & Sons, 2005).
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36. These filters screen stocks on the basis of certain profitability and liquidity ratios, firm size, industry classification, beta, leverage ratio, etc.
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43. This rule can be beneficial for non-Muslims because it gives them higher investment returns (dividends). If the Islamic mutual fund were to dispose of the haram income before paying returns (dividends) to its investors, non-Muslims would receive a lower return—the fund is basically enforcing this purification onto its investors without taking in consideration whether they are actually Muslim. With this regulation though, none of the income for the Islamic fund is purified and the non-Muslim investor thus receives a higher return.
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56. Ibid.
57. Although this SRI universe is relatively small compared to the other two and skewed toward companies with large market capitalizations, it is used as there was no data access to a more comprehensive index that would be acceptable according to socially responsible investing standards and would more closely mimic the composition of the other two universes. Given this particular qualification, the later SRI portfolio performances should be placed in this context for appropriate evaluation.
58. See the appendix in Joel Greenblatt's *The Little Book That Beats the Market* (2006) for a detailed back-test performance analysis. In a recent test conducted by Morningstar (Coumarianos, 2010) the magic formula generated 10.4 percent annualized excess return over 9.4 percent annualized return from S&P500 over the period 1998–2009. Also see http://seekingalpha.com/article/237970-how-does-joel-greenblatts-magic-formula-investing-hold-up.
59. In order to prevent look-ahead bias, the relevant fundamental data, as reported at the end of year 2005 (or latest prior available) financial statements, is extracted from the FactSet.
60. In addition, it is vital to realize that the later performance results are contingent on the underlying assumption of the chosen quantitative Greenblatt stock selection screen, though alternative security selection strategies produced similar results.
61. Higher EY and ROC values are better so that the highest EY stock would receive an EY rank of 1 and the highest ROC stock would get a ROC rank of 1. The EY and ROC ranks are added together—the best stocks will have the "lowest" ranking. For example, if the stock with the highest EY also had the highest ROC, its overall rank would be 1 + 1 = 2.
62. We conducted several experiments to see if the results are sensitive to such maximum weight restriction. A lack of this restriction would have resulted in portfolios with too few securities, which would not allow for sufficient diversification of firm-specific risk.
63. r_p = weekly portfolio return; r_i = weekly index return.
64. The negative Sharpe ratio gives misleading results when excess returns are negative. An investor would not be able to identify whether this is a result of excess returns being negative (which is undesirable) and the volatility is

lower (a desirable property). The modified Sharpe ratio accounts for both. See C.L. Israelson, "A Refinement to the Sharpe Ratio and Information Ratio," *Journal of Asset Management* 5:6 (April 2005).

65. It is difficult to attribute the success of *shari'a* compliant stocks to one particular factor. However, it is possible that the Greenblatt's magic formula ranking of good performing stocks, coupled with low leverage, and correlation within the portfolio, is largely responsible for the Islamic portfolio's stellar performance during up markets.
66. The Islamic, conventional and SRI universes are each divided into three size classes: the "small" group is composed of firms with market capitalization of more than $5.5 but less than $10 billion, the "medium" one includes firms that are larger than $10 billion but smaller than $21 billion, and the "large" group includes firms larger than $21 billion. Since there are no official guidelines on where to draw the line between the size classes, these market cap ranges are chosen to ensure that each universe will be composed of a sufficient number of stocks to allow for efficient diversification and optimization.
67. As indicated in Söhnke M. Bartram and Gordon M. Bodnar, "No Place to Hide: The Global Crisis in Equity Markets in 2008/09," *Journal of International Money and Finance* 28:8 (December 2009): 1246–1292, the global equity market lost about $29 trillion due to the recent financial crisis of 2007–2009. In light of such a huge loss in wealth, the fact that Islamic stocks lost less than their conventional and SRI counterparts is quite reassuring.
68. Financial institutions include banks, S&Ls, asset management firms, insurance companies, and consumer finance firms. Real estate firms include real estate development firms, apartment rental agencies, real estate financing, and other firms with substantial real estate involvement.
69. The base-indexing procedure is basically equivalent to the one employed to plot the performances of the equity portfolios on the same chart.

Islamic Finance after the Global Financial Crisis

Majid Dawood and Huma Sodher

Introduction

Some economists suggest that the recession is over, or nearly over, and that we have begun to recover. However, it is still too early to truly determine how close we are to economic recovery as there is a substantial amount of allocation and valuation to be certified on assets; this is a particular challenge as institutions are not entirely certain of all their assets and liabilities due to the complex nature of the products and transactions. In fact, the latest economic recession in Europe, which may result in a double-dip if not effectively managed, has had a deleterious impact on the global economy. The implications of what has transpired worldwide will therefore be unclear for a substantial amount of time since the effects of the crisis keep reverberating. This situation has encouraged academics and practitioners to explore solutions that aim to safeguard the global economy from such financial turmoil in the future.

The recent crisis is one of the worst financial crises that the world has witnessed since the Great Depression. The Great Depression of 1929 was concentrated mainly in the United States and the current crisis started in the U.S. as well; however, its dominant effect has spread globally, which illustrates the interconnectedness of today's global financial system. Governments and central banks have had to intervene in order to address the turmoil in the markets by acquiring the "toxic assets" of financial institutions, guaranteeing deposits and cutting interest rates, among other measures. During the recent recession, the world has experienced a near complete economic meltdown. We have heard various voices echoing the virtues of a comparatively nascent alternative financial system, such as the Islamic financial system, which constitutes barely 1 percent of the global finance and is still developing.[1] Practitioners, regulators, academics and economists are now vigorously analyzing the Islamic financial system to ascertain its

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resilience to financial crisis. Their analysis is not limited to testing the strengths and weaknesses of the Islamic financial system, but also entails testing whether the Islamic financial system provides a model that could help prevent future financial turmoil in the global financial system.

As the effects of the current economic crisis are well-known, it is more appropriate to discuss its causes in brief and to study the unique features of Islamic finance that offer an alternative system, which may be more pertinent than its conventional counterpart. We have witnessed the fall and failure of major investment banks, and most people are still uncertain of the correct valuation of their true liabilities as the asset values of these banks keep eroding.

The recent crisis is not due to any single factor but rather a multitude of factors and has affected the financial markets across the world. Financial institutions were thought to be too big to fail, and the likelihood of such failure in the global financial industry was absolutely unthinkable. Economists have said that some of the primary factors responsible for the crisis were lax regulations, excessive leveraging, short selling, greed and lack of physical substance in the assets backing of products. Furthermore, the rating agencies rated these products highly because they were heavily insured, and buyers bought them based on the bottom line of their return on investment without understanding the product or looking at the underlying asset. Quite simply, there was no substantial underlying asset. To illustrate the phenomenon, let us consider the example of an asset worth $10 million, which was packaged, re-packaged, derivatized. Before we realized it, the debt was $100 million and the asset was still only $10 million. When the product was unraveled, the underlying asset got impaired. These kinds of phenomena have led to a crisis in confidence, which was more rapid than anyone expected. Large invested sums suddenly vanished, but were they really there in the first place? This was also the case for credit default swaps, as the conventional financial system allowed multiple debt creation on an asset without there being a real underlying transaction. These factors all contributed to the economic crisis.

Economically speaking, banks and other financial institutions provided subprime loans and other toxic market assets under very lax regulations, which ultimately undermined investors' confidence.[2] For some time now, there have been signs of the impending meltdown: industrial production, housing starts and confidence in general have been down, leading to the downward trend in retail as a resuly of lax financial regulations.[3] The Bernie Madoff case is a prime example of a lack of regulation; attempts by investors to draw attention to their concerns were ignored. Madoff's investors were the doyens of the industry.[4]

Causes of Crisis

Some of the crisis' causes also relate to the unprecedented leveraging and poor lending criteria utilized by financial institutions.

Leverage levels that had become the norm permitted the baseless hike in asset valuation and rise in consumption to unacceptable levels, which could not be sustained. For example, before Lehman Brothers filed for bankruptcy in September 2008, its leverage ratio was 30.7:1,[5] whereby a drop of 3.3 percent in its assets value would have eradicated its equity and rendered the company insolvent.[6] This fact raises questions as to why the management was not alarmed by that kind of high leverage through results of Value at Risk (VAR) analysis and other stress testing techniques. And if these techniques were sending alarming signals to the management, why were the regulators, who were permitting such risky business conduct, blind to them? In some ways, the failure of Lehman Brothers was the turning point for the further loss of confidence in the market. It shook the regulators of the industry and brought to their attention the necessity of a supervisory function for the industry.

Another contributor to the crisis was the unregulated trading of uncertain and speculative financial instruments and securities such as derivatives. Before the crisis, industry experts described these as "financial weapons of mass destruction."[7]

Industry practitioners and stakeholders hold the view that structurers, sellers and sophisticated/professional investors of the financial markets were well aware of the nature of products and of the possibility of a downgrade of the products due to poor quality of underlying assets/investments. The professional investors and sellers entered that high-risk market deliberately, as they were completely swayed by lucrative and unprecedented gains arising from those transactions. This view is based on the hypothesis that when bankers were happily involved in advancing NINJA (No Income No Job or Asset) loans to the borrowers, bankers knew they were involved in subprime lending; hence, they should not have been surprised by the outcomes.

It is indeed surprising that these practices by financial markets participants did not end at subprime lending; rather, with the help of smart structurers, the financial markets participants managed to package the subprime assets and securitize them. They eventually converted them to disastrous innovative instruments such as collateralized debt obligations (CDOs), which were insured, rated and sold.[8]

There was also a heavy reliance on rating agencies by all market players, resulting in huge increases in their revenues. For instance, "Moody's revenues from structured finance ratings increased from a little more than $100 million in 1998 to more than $800 million in 2006, representing more than

80% of its total rating revenues."[9] Another interesting point to note is the role of regulators in the financial crisis. When all the facts of the crisis became public, one was left to wonder why these shockingly risky practices (i.e., rating of structured finance products) did not alarm regulators. This is an issue that needs to be rectified to satisfy the masses now suffering the consequences of the crisis. One particular consequence is growing levels of unemployment and insolvencies. When we consider the issue of lax regulations, we should focus not only on the U.S. regulations but also on the regulations of other jurisdictions.

Bearing in mind that various factors contributed to the recent financial turmoil, practitioners, regulators, and academics have a duty to highlight the deficiencies of the financial system on a timely basis by keeping a close eye on markets and introducing corrective measures, mechanisms and regulations in order to prevent a future occurrence of such a crisis. The recent financial crisis illustrates that if the system is run in a laissez-faire style, over a period of time it self-destructs through the financial bubbles. Certain financiers and scholars hold the view that "bubbles have a built-in asymmetric nature: it takes a lot longer for them to emerge, but they implode in short order."[10] Many believe Islamic finance has been protected from such bubbles and may provide the panacea to the financial ills currently experienced in the global economy.

Salient Principles of Islamic Finance

Islamic finance is premised on core principles of Islamic commercial law as extrapolated from basic rules laid out in the Quran and Sunnah. Interest, debt trading, gambling, speculation, ambiguity of contract, high leveraging, selling unowned things and dealing in items such as pork, alcohol, tobacco, weapons/arms and pornography, are forbidden. Short selling is also prohibited in Islam, with certain exceptions such as *salam* and *istisna*' (these contracts are valid only if executed according to the rules and regulations for these contracts stipulated in *shari'a*), where the goods are not readily available and need to be produced before delivery.[11] Furthermore, money is simply a medium of exchange and a measure of value. Money should only be used to finance projects, trade goods and services, and create real economic benefit. It cannot be used as a commodity that can be freely traded with interest (*riba*) as the charge for the commodity.[12]

The interest-based debt contracts prevalent in the conventional system are liable to experience financial turmoil and therefore are subject to instability. However, the recent crisis has highlighted the soundness of the equity and trade-based nature of the Islamic finance system endorsed by *shari'a*.

Islamic finance prohibits the creation of debt through direct lending and borrowing, hence prohibiting excessive leverage, which is one of the root causes of the crisis. The creation of debt, through the sale or lease of real assets (via the *murabahah*, *ijarah*, *salam* or *istisna'* modes of financing) is permitted subject to the following conditions:

- The underlying assets are real and not imaginary or notional.
- The seller or leaser should own the goods being sold or leased.
- The transaction is genuine, with the intention of giving and taking delivery.
- The debt cannot be sold and thus the risk must be borne by the financier.

These conditions help ensure that transactions are related to genuine economic activities and do not let the debt levels rise far above the real economy.

In its ideal form, Islamic finance is expected to raise the level of equity and profit and loss sharing. Some mainstream economists have also favored and advocated this phenomenon. These economists hold the same view that "in an ideal world, equity lending and direct investment would play a much bigger role."[13]

Islamic Finance and Recent Financial Crisis

Islamic finance is concerned with more than just making profits. Every investment proposition should be tested against the *maqasid al-shari'a* (objectives of the *shari'a*), where the primary objective is to benefit people and provide greater justice. Such proposition should not cause any harm to either parties and must bring about mutual satisfaction. Each party to a *shari'a*-compliant transaction is required to share the risk rather than shifting the entire loss to the entrepreneur. Laldin is of the view that currently *shari'a* boards are concerned with the *shari'a* compliance of the products and contracts, and not the economic consequences thereof.[14] This situation, of course, neither guarantees the future of Islamic finance per se nor the resilience of the financial system against financial meltdowns and turmoil. The mere form of these *shari'a*-compliant products and alternative *shari'a* compliant banking system will not bring about the desired results until the substance thereof becomes *shari'a* compliant. The virtues and socio-economic benefits of this alternative banking system must be distilled down to the masses, society and, more precisely, to the economy.

Considering the key principles of Islamic finance, some of which have been briefly mentioned in the preceding paragraphs, it appears that Islamic finance, if practiced in its true spirit and monitored with risk management techniques and regulations customized or developed on de novo basis, will

ensure economic growth and resilience of financial systems across the globe. However, for Islamic finance to become a viable alternative, appropriate and comprehensive legal frameworks are needed, as are standardization, harmonization and a degree of uniformity so that Islamic finance can be applied across multiple jurisdictions.[15]

Although at first it seemed that Islamic banks were more immune to the crisis, they too suffered due to the general diminution in the value of assets, as they function within the same financial system as conventional banks. The impact was less severe because Islamic finance products are asset-based or backed, as is required of Islamic loans and investments. Also, the prohibition on derivatives protects Islamic finance from having toxic products on its books. However, Islamic finance was not completely immune from the negative effects of the crisis. Consultants, researchers and academics believe that various factors contributed to this. One of these factors was the availability of limited range of permissible and profitable investment avenues, making the Islamic financial system "vulnerable to sector-specific shocks."[16] Also, as part of global financial system, Islamic financial systems could not remain insulated from the worldwide fluctuation in valuation of assets.[17]

Islamic finance researchers say that today's Islamic banking system is not crisis-proof, and will not be completely resilient to future financial crises and bubbles. This view is backed by the results of Hasan and Dridi's comparative analyses of the stability and resilience of the Islamic and conventional banking systems before and during the recent crisis.[18] Hasan and Dridi analyzed the performance of several conventional and Islamic banks in selected countries with a dual banking system. They concluded that Islamic banks behaved differently than their conventional counterparts in selected jurisdictions for both pre-crisis and post-crisis selected periods. Hasan and Dridi analyzed selected jurisdictions instead of performing a global analysis, which led to the conclusion that Islamic banks performed better than their conventional counterparts during the crisis. Their analysis highlighted different underlying reasons for better comparative profitability of the Islamic banking system over the conventional banking system in 2008 and the converse phenomenon in 2009 due to a decline in the asset growth rate of some countries such as Bahrain and Egypt. Hasan and Dridi's analysis shows that the adverse effect of the financial crisis in 2008 was limited in the Islamic banking industry due to the business models of Islamic banks, while the weaknesses in risk management adversely affected their profitability in 2009.

The Islamic banking system, if practiced and implemented in its true spirit coupled with appropriate regulations, can be a cure for many of the financial ills created by a conventional banking system based on the

philosophy of money as a commodity. It is evident from the history of financial crises that the conventional banking system's philosophy has resulted in the exploitation of the masses and has debased the common good for the society and economy. The solutions put forth by experts to overcome the shortcomings of current conventional system, are similar to the essential building blocks and principles of the Islamic banking system.

Challenges and Future Course of Action

In some sense, Islamic finance has been protected from the current crisis due, not only to the nature of the requirements of the *shari'a* criteria, but also to the actual size of the Islamic finance industry within the entire global finance market. Janahi holds the view that "Islamic Finance's non-exposure to products such as derivatives was partly due to the fact that many of the Islamic Finance bankers did not understand it and those who did understand it, the Scholars, did not understand it and those that did correctly dismissed them as being non-*shari'a* compliant and therefore un-investable."[19]

The fact that the Islamic finance industry was not exposed to derivate products—protecting it, to an extent, from severe ill-effects of the crisis—does not negate the need for the development of comprehensive legal and regulatory framework. Besides the development of the framework, industry stakeholders must carry out extensive collaborative research to determine an efficient, resilient and innovative range of Islamic finance products.

Regulatory Framework

One of the lessons that the Islamic finance industry can glean from the recent financial crisis is the necessity of designing and developing a comprehensive and dynamic regulatory framework, created specifically for the purpose of adhering to the rules and regulations of Islamic law that are compliant with *maqasid al-shari'a*. The longer it takes to establish such framework, the longer the Islamic financial system will remain vulnerable to negative incentive structures similar to the conventional finance offerings. This is mainly due to the fact that Islamic finance is currently operating in a framework based on the conventional model.

In recent years we have seen the first defaults on *sukuk*.[20] Most of them have been unsecured *sukuk* and investors have begun asking about the assets underpinning those *sukuk*. Where are the assets? Why can't they be liquidated and the investment returned since Islamic finance is supposedly based on tangible assets and real economic activity? These kinds of queries should provoke practitioners, *shari'a* scholars, academics and legislators to address these legal and insolvency issues confronting the nascent Islamic finance industry.

Hence, the recent *sukuk* defaults and disputes have in reality tested the robustness of the Islamic finance system and have identified the areas of requisite legal reforms.[21] It is interesting to note here that despite the fact that the structure of the *sukuk* in question was technically Islamic or *shari'a* compliant, it behaved no differently from a conventional bond. Chapra holds the view that Islamic banking is currently trying to mirror the conventional banking industry by using different *hiyal* (legal stratagems) and thereby replicating some unsuitable conventional banking practices with an Islamic label.[22]

Industry academics and experts have emphasized the need for a functional institutional framework for Islamic finance and the creation of a new architecture in which the system will operate.[23] We cannot wait for financial turmoil to hit the Islamic finance industry before we develop and implement appropriate legal and regulatory frameworks. Besides the rules and regulations, "a unified administrative agency to uniformly and globally enforce the rules of the framework across jurisdictional boundaries" should also be established.[24] We must ensure proper regulation and accountability from those with a fiduciary responsibility.

Research and Development

The recent crisis underscores the fact that the Islamic finance industry was saved from the deadly effects of the crisis initially because of the fundamental prohibitions inherent in the industry, which restrained it from dealing in highly speculative and leveraged products and derivatives. However, recent developments in the Islamic finance industry have made it clear that this industry is not completely free from a potential future crisis; hence, there is a profound need for more research in product development. The lack of research initiative led to the availability of limited *shari'a*-compliant asset portfolio options for Islamic finance institutions. On one hand, the Islamic banks' heavy exposure to the real estate sector did adversely affect the Islamic banks. On the other hand, due to lack of liquid *shari'a*-compliant asset classes, some Islamic banks invested in equities, exposing themselves to the correction of stock markets during the recent crisis. Some of the industry's losses can be attributed to some of the reverse-engineered financial instruments whose *shari'a* authenticity and financial viability have been scrutinized much more since the recent crisis.

In order to sustain and maintain the appeal of the industry, enormous and immediate research endeavors are needed to come up with innovative products for the industry. These products should not only have religious appeal and facilitate the public welfare (one of *maqasid al-shari'a*), but must also have sound financial sustainability, which would ensure growth of the industry throughout the world, regardless of creed and region.[25]

The Islamic finance industry must come up with authentic products that address the long-standing liquidity management issue. Industry players and practitioners have been raising this issue for some time. They have pointed out that the maturity mismatch in Islamic banks is far more distributed compared with conventional banks. The distribution of liabilities is skewed more toward the short and medium term while on the asset side the generally available options are for medium to long term.[26] Furthermore, the industry's excessive exposure to the real estate sector, dependence on commodity *murabaha* structures (developed as a temporary solution, but which as been employed now for roughly thirty years)[27] and negligence of other important sectors like financing of exports and imports, are major inhibiting factors restraining the growth and development of the Islamic finance industry.[28] These inhibiting factors require extensive collaborative research by *shari'a* scholars, practitioners, academics and experts, who must come up with viable and lawful solutions. It should be noted here that institutions like International Shariah Research Academy for Islamic Finance (ISRA) were established to develop future generations of scholars and practitioners. These future generations will be able to tackle the current challenges in the industry, undertake the required research and recommend viable and lawful solutions.[29]

Generally, the risks inherent in Islamic finance are similar to conventional finance; however, in some cases, the risks are more complex than those encountered by the conventional banking industry. Hence, it is incumbent upon the industry stakeholders to contribute to the development of a robust risk management system for the Islamic banking industry. The risk management system should continuously monitor and correct the risks, such as concentration of investment in a particular industry/sector, liquidity and operational risks faced by the industry, etc. Needless to say, regulators must play the key role here, as the academics, practitioners and *shari'a* scholars can only contribute toward the development of an effective and efficient system while the enforcement (through appropriate onsite or offsite supervision techniques) would remain the prime duty of the regulators.

Conclusion

The underlying impetus of this chapter is to analyze ways to make the Islamic banking system more resilient. Studies on Islamic finance thus far have established the fact that the principles of Islamic finance are sound enough to take care of most of the obvious and known flaws in the conventional financial system. However, this fact should not make the stakeholders of the industry complacent, rather it should stimulate them to fill the loopholes of the system in order to provide an even more resilient global banking

system.[30] It is incumbent upon the industry's stakeholders to strive for the development of legal and regulatory framework and risk management techniques for the Islamic finance industry. Furthermore, transparency requirements should be enforced as legal and regulatory requirements as they will strengthen *shari'a* scholars' resistance to the excessive use of *hiyal* to safeguard the reputation of the profession of *shari'a* experts.[31] Transparency of *fatawa* will also prevent the possible transgression of basic *shari'a* principles for trade and finance. These fundamental *shari'a* principles, if properly and strictly adhered to, will guarantee the growth of the global economy and public welfare, and prevent the occurrence of future financial turmoil and crisis.

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Part II:

Shari'a and Regulatory Framework

Adding Social Responsibility and Accountability to the Mandate of *Shari'a* Advisory Boards

Aly Khorshid

Introduction

The period from 2008 to 2010 presented a number of opportunities for the development of the Islamic finance industry. The conventional sector was reverberating after a series of high profile collapse and bail-outs, while the Islamic sector suffered only mild aftershocks. But the challenge of proper *shari'a* regulation remains in the Islamic finance industry. The conventional finance sector has hundreds, if not thousands, of years of experience and government regulation, whereas today's Islamic finance sector is still in its transformation stage. It is fair to say that in comparison, the development of an Islamic financial system has been slow, but Islamic finance has finally become a part of the global financial scene. To this end, the modern Islamic finance industry needs to consolidate the efforts of those who strove for its revival through prudent regulations and proactive response to emerging regulatory challenges in the industry. Therefore, in order to build and sustain the much-needed trust of diverse investors, the Islamic finance industry must strive to add social responsibility and accountability to mandate the *Shari'a* Advisory Boards.

By definition, *shari'a* advisors are specialized jurists, particularly in *shari'a*, *fiqh al-muamalah* (Islamic law of transactions), and Islamic finance and economics. They are entrusted with the duty of directing, reviewing and supervising activities related to Islamic finance in order to ensure that such business activities are in compliance with *shari'a* rules and principles. Currently, however, *shari'a* advisors are rarely held accountable or closely supervised. *Shari'a* board members' qualifications, responsibilities, ethos, commitment and social responsibility may be questionable. Since the management of a financial institution is accountable for its own organization, performance and liability, the *shari'a* scholars should also be held accountable for its organization's function. The skills and work of the *shari'a* scholars

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within a financial institution should be identified and duly regulated. They should be accountable both to the organization they represent and to the communities affected by their decisions. After all, their decisions can and do shape the Islamic finance system.

A significant problem is the manner in which advisors are appointed. The process is based on recommendations, friendships and attendance at the right conferences at the right times; the idea that advisors should have any specific qualifications in either *shari'a* or conventional banking is dismissed in many jurisdictions as an imitation of a failed Western banking system.

But perhaps a deeper problem lies in the small pool of advisors in an ever-expanding sector. Instead of training and bringing in new, young talent, the old guard is spreading itself too thin around boards across the globe. Single members are splitting their time between numerous boards—77 boards in one notable instance. This is a situation that is unlikely to change from within; remuneration makes board membership a lucrative business and gives members something akin to celebrity status as they collect appointments around the world. There is little incentive for those in power to broaden the pool of advisors. This inevitably means that board members' lack of time and commitment affect the decision-making process. Financial institutions use the names of top officials in their marketing and PR materials, ostensibly adding credibility to their institutions, but hiding the fact that the individuals probably devote little time to actually making decisions on their respective boards.

Even if we ignore the effects of this lax attitude on efficiency, risk management and profitability, what about the devout Muslim who is using the bank under the assurance that the strictest Islamic tenets are being stringently observed?. Less-than-angelic bankers do of course exist, but eventually their excesses tend to catch up with them, and they are forced to report to their superiors or to respond to government inquiries and courts. The *shari'a* advisory bodies of their Islamic counterparts, however, are generally not accountable to any supervision by superior bodies, and their resolutions are final. In light of this, some see Islamic banking as amateur, nepotistic and unreliable, regardless of its noble principles.

However, Islamic banking is not a hopeless case. As with so many other Islamic matters, Malaysia is forging ahead while many of the Middle East's bankers bury their heads in the sand. Malaysia has placed limits on board members' excesses, has improved transparency, and has nurtured educated, impartial and enthusiastic advisors, thus making its *shari'a* banking sector a world leader. Indeed the country itself is a model of enlightened business practice within an Islamic framework.

There is still time to change the Islamic banking system in the rest of the world, making it a mature, serious business open to all of the brilliant Islamic financial minds. But this will require a massive shift in the mindset of the world's *shari'a* banking sector. This chapter aims to identify the problems at the level of the *shari'a* boardroom and to suggest workable solutions for *shari'a* banking. This chapter focuses on the significance of accountability in the activities of the members of the *shari'a* board.

Corporate Governance and the Development of Islamic Finance[1]

The recent global credit crises have poised Islamic finance to become an alternative to the conventional system. The Islamic capital markets, *takaful*, and Islamic money markets have come to be regarded as fairer and more just schemes for investors and non-investors alike. Islamic finance is a system that rests on profit and loss sharing and sharing risk between all parties involved, which derives from the conception of fairness inherent to Islamic principles. But in order to work effectively and legitimately, the system requires assistance and advice from *shari'a* scholars who understand and are able to translate the teachings of the Quran generally and Islamic commercial law principles in particular into the 21st century financial and economic systems.

Islamic finance is a nascent industry, with a small share—about 1 percent—of the global market.[2] However, Islamic finance is benefiting from a number of favorable structural and cyclical drivers such as strong growth in the Gulf Cooperation Council (GCC) countries, Asia and Africa; positive demographics of young and rapidly growing populations; and growth in the number of savers/investors who prefer Islamic finance in Muslim countries, partly due to a reawakening of cultural and religious identity.

Corporate governance aims to provide institutions with a body of rules and principles to ensure that good practice guides the overall management of an institution. Corporate governance entrails the whole process of managing a company, from structuring its incentive to ensuring that executive management serves the long-term interests of the shareholders. Islamic banks are subject to an additional layer of governance since the suitability of their investment and financing must be in strict conformity with Islamic law. For this purpose, Islamic banks employ an additional layer of governance, the *shari'a* advisory board. The complex factors involved in balancing power between the CEO, the board, the shareholders and the *shari'a* board members can be considered parts of the corporate governance framework. Tasks include auditing, confirming *shari'a* compliance, selecting officers and advisors, deciding the remuneration of management and advisors, disclosing balance sheets and off-balance information, and ensuring transparency.

Islamic finance is based on ethics, fairness and justice to all people; in principle, no one is privileged or immune from accountability. Even prophets of God have been shown to be accountable to God for their words and actions. Consider this quote from the Quran (Al-Maidah, 5:116):

> And when God will say: O Isa, son of Maryam! Did you say to men, Take me and my mother for two gods besides God he will say: Glory be to Thee, it did not befit me that I should say what I had no right to (say); if I had said it, Thou wouldst indeed have known it; Thou knowest what is in my mind, and I do not know what is in Thy mind, surely Thou art the great Knower of the unseen things.

It is important that Muslim scholars, who represent Islam in the most important issues affecting Muslims and non-Muslims alike—such as dealing with money—are accountable and equitable:

> And from among you there should be a party who invite to good and enjoin what is right and forbid the wrong, and these it is that shall be successful. (Quran, Al Imran 3:104)

The finance industry for Muslims and non-Muslims is no different from any other industry that provides professional services. Muslims have a moral responsibility to their parents, family, relatives and the entire community.[3] Almost all professionals offering consultancy and advisory services are accountable to a code of ethical conduct. They can be fired and may be prosecuted if proven incompetent or involved in fraud. However, one exception is the case of the *shari'a* advisory board. In the Islamic finance industry, there seems to be no code of ethics or accountability and no minimum qualifications required for members, nor is there any requirement of specific experience in the field of finance or Islamic law. Above all, board members do not obey any regulations, nor are they responsible to regulators to ensure that Islamic finance is a credible system, compatible with the conventional finance system.

Advisory services are common to all sectors as they ensure healthy and successful operation and preserve the integrity of the industry. Likewise, *shari'a* advisory bodies are constituted to advise on Islamic finance products and services in order to ensure a high level of *shari'a* compliance. These boards are normally composed of a number of *shari'a* scholars who provide advice and guidance on matters within their specialized field of knowledge. It is impossible to overstate the importance of these bodies, as they not only distinguish Islamic banks from conventional banks, but they also act as the bridge between people's financial aspirations and the words and interpretations of the Quran.

Considering the importance of the role of *shari'a* scholars, particularly for devout Muslims who rely on scholars' interpretations and decisions in order to invest, one would expect the *shari'a* scholars of Islamic financial institutions (IFIs) to be accountable and suitably qualified to conduct their duties in a professional manner. When one considers that *shari'a* advisory bodies can effectively shape the Islamic financial system in a world where financial failure can have globally catastrophic results, it becomes clear that *shari'a* academic and professional qualification must entail more safeguards than nepotism and back-room recommendations can provide.

Why *Shari'a* Board Members' Accountability is Vital

Muslims as believers are first and foremost accountable to the Supreme Being and also to their families and employers. They are accountable to their government, to the electorate, and to one another. This accountability may be based on oath, such as marriage vows, or may originate from lawyers, doctors, judges or many other professionals providing services to the public. The accounting industry, the brokering community, the legal community and the business community are all required to adhere to the highest level of business ethics.

The public expects and deserves accountability from the businesses and other institutions that govern and influence our lives. For instance, members of the legal profession are *accountable*, both to their clients in the regular course of business and to the public when their services further a fraud. Each business, profession and institution must have effective leadership to ensure that its members are held accountable. They should respond to public concerns with conscientious action. The same rule should apply to the Islamic finance industry where all the stakeholders must be accountable to one another and to the general public.

It is clear that the accountability of *shari'a* board members is vital in the Islamic finance industry. There are a number of specific reasons for accountability in the activities of the board. Accountability generally guarantees the confidence of investors and the public in general in the Islamic financial system. Such transparency model from the Islamic finance may also fit into the current setup of conventional financial institutions. Besides, this would also provide personal credibility to the *shari'a* board members. In addition, accountability of the *shari'a* board allows for the creation and structuring of new *shari'a*-compliant products within the global market. This will further strengthen the global respect of *shari'a* rulings on product development. Above all, accountability and transparency are key pillars of corporate governance. So, in order to remain a competitive industry within the global economy, the corporate governance framework of Islamic financial

institutions must be strengthened to reflect prudent policies of accountability and transparency in the duties of the *shari'a* board.

Ethics of the Conventional Financial System[4]

The conventional financial system has evolved over the last two centuries and has contributed a great deal to the development of not only the Western world, but also to a substantial number of developing countries.[5] Borrowing some of the ethics from the conventional financial system and adapting the classical *shari'a*-based ethical norms for business transactions in the modern Islamic finance industry will result in sustainable practices in the industry. In addition, the Islamic system will be able to successfully address some of the problems that the conventional system has been unable to address such as preference for profit maximization as opposed to mutual benefits in commercial transaction. Every financial system should ultimately lead to the well being of people. One of the measures that Islam has adopted to ensure greater justice for all is the principle of risk-reward sharing instead of interest in financial intermediation.

While the conventional financial system is generally considered to be superior in regard to efficiency, certain conventionally structured capital market products, such as derivatives products, have led to the current financial crises. The introduction of the minimal-risk Islamic financial system over the past 10–15 years has added a healthy dimension to the international financial system. In addition to injecting greater justice into the system, it has also helped make the financial system healthier and more stable by providing greater discipline.[6] But with the crystallization of the Islamic finance industry, it seems some of these values are gradually being eroded by untoward noticeable practices in the industry.

A large number of Islamic financial institutions have been established worldwide and Islamic financial services are now available in most parts of the world. These institutions play an important role in catering to the financial needs of a wide spectrum of society. The innovative products that they provided have not only widened the coverage of financial services but also enhanced the financial markets. Nevertheless, the Islamic finance system is still in its initial phase and thus has a long way to go before Muslims can be confident that these institutions have made headway in the realization of the *maqasid al-shari'a* (the "purposes of *shari'a*," encompassing religion, life, lineage, intellect and property).

The conventional financial system has a code of ethics and conduct to which all key personnel, including management, are accountable.[7] More importantly, the board of directors has a code of ethics and conduct, which regulates their decision-making process, as they are accountable to all the

stakeholders in the company. It appears that such a similar arrangement is not available for the *shari'a* boards in Islamic financial institutions. This clear code of ethics must be adopted by the Islamic financial system in order for the Islamic financial system to become institutionalized and properly regulated, not only by its respective regulatory authorities but also by accountable *shari'a* boards. This makes it necessary to regularly evaluate the performance of modern Islamic banking and Islamic financial institutions.[8] The actions of *shari'a* board members should be transparent and members should be adequately qualified in terms of experience and ongoing education.

Shari'a Scholars

Shari'a scholars are the main component of all *shari'a* advisory bodies.[9] A *shari'a* scholar is commonly referred to as a person with experience in *shari'a* or who has a strong background in *fiqh*, *usul fiqh* and particularly *fiqh muamalat*, which outline Islamic commercial law and contracts. However, in the context of IFI, it requires scholars to have reasonable experience in and knowledge about the modern conventional banking and financial system, so that they are able to distinguish the two systems.

Shari'a scholars need to equip themselves with a proficient command of English and Arabic. This will enable them to study and discuss global financial market ethics and principles, and will also allow them to consult the Quran for the solutions to their tasks. They should be able to present and negotiate *shari'a*-compliant products with conventional finance professionals to achieve a common understanding of the two systems.

The scholar must also possess "noble," less tangible characteristics, such as trustworthiness, honesty, responsibility and accountability.[10] The scholar must be able to develop his or her knowledge and skills and have adequate exposure to the global financial market. He or she must be flexible and dynamic.

Shari'a scholars are also responsible to the investors and the clients of Islamic financial institutions, as they are among the principal stakeholders of the institutions. The scholars must also perform their roles with diligence, especially in order to ensure that the products and services offered are in compliance with the highest *shari'a* standards and requirements. *Shari'a* scholars also act as customer advocates to improve the overall *shari'a* compliance mechanism and to comply with the legal requirements and global best practices.[11]

Modern Islamic finance practices require scholars to be alert to the different needs and ever-changing circumstances, be they the legal, tax or regulatory requirements; to assess the economic implications of the products; and to be innovative in overcoming all obstacles to come up with competitive

Islamic financial products. It is vital for *shari'a* scholars to play their roles efficiently, to shape their advisory bodies effectively and to ensure the success of the industry. It is vital to demonstrate that *shari'a* can be applied ethically as well as profitably.

Role of *Shari'a* Scholars

The *shari'a* scholars play an important role in the Islamic finance business. In fact, an Islamic financial institution cannot operate without constituting an in-house *shari'a* board or outsourcing the *shari'a* advisory role to a reputable *shari'a* consultancy firm. All the stakeholders in any Islamic financial institution rely on the advisory role and decision of the *shari'a* board. Therefore, the basic duties of *shari'a* scholars in the Islamic financial institutions include:[12]

1. Advising management and shareholders on *shari'a* matters, and ensuring management accountability to the shareholders and customers;
2. Structuring new *shari'a*-compliant products to internationally-developed standards;
3. Issuing *fatwa*s for *shari'a*-compliant product development, and conducting *shari'a* audits to ensure compliance;
4. Proposing Islamic risk management tools to the management of the Islamic financial institution;
5. Strengthening the corporate governance of Islamic financial institutions;
6. Instilling Islamic finance values into financial institutions' business operations and governance;[13]
7. Ensuring Islamic ethical principles are preserved within the institution, and protecting consumers' rights from abuse and fraud;
8. Ensuring the adoption of Basel II and Pillar II, particularly in regard to the prevention of money laundering and capital adequacy issues within their institutions.[14]

Since the rulings of the *shari'a* board often represent the opinions of other scholars in their respective jurisdictions, they need to be competent and accountable for their decisions.

A role that is harder to define, measure and monitor is their work toward harmonizing *fatwa*s and the global development of Islamic finance. This will happen over a long period of time, but *shari'a* advisors must still consider the work and decisions of each board. These individuals must be professionals who endorse a product after full inspection and with the satisfaction that the product is *shari'a*-compliant. Their role must include ensuring that the Islamic financial system develops as God intended. This will require strict observation of the *maqasid* (principles) of the *shari'a*.

The rapid growth and advancement of Islamic finance has been supported by the desire to develop *shari'a* standards and frameworks for product development. This has been initiated by international bodies such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) or national bodies like the *shari'a* advisory councils of central banks (e.g., in Malaysia, Pakistan and Sudan) and other financial institutions. The task of those organizations is to ensure that the standards for *shari'a* advisors are maintained and followed, in order to achieve a high level of integrity of Islamic finance ethics and principles.

Shari'a **Advisory Boards**

A *shari'a* advisory (or supervisory) board is composed of several *shari'a* advisors. *Shari'a* advisors are defined as follows by the AAOIFI:

> *Shari'a* advisors are specialized jurists, particularly in Fiqh Muamalah and Islamic finance, entrusted with the duty of directing, reviewing and supervising the activities related to Islamic finance in order to ensure that they are in compliance with *shari'a* rules and principles. The views of the *shari'a* advisors shall be binding in the Islamic Finance Institution (IFI) area of supervision.[15]

Therefore, unlike other advisory bodies, the decisions of *shari'a* advisory boards are binding in relation to *shari'a* matters. In this regard, they are not merely exercising an advisory role. Hence, because *shari'a* is the backbone of the industry, in certain countries or institutions this body is called a *shari'a* supervision body, as it better describes the actual and intended role of the body. For instance, the *Shari'a* Advisory Council of the Central Bank of Malaysia oversees and prevails over the *Shari'a* Advisory Committees of all other Islamic financial institutions in the country. It is the highest authority and must be referred to in any adjudication and arbitration process that involves an Islamic finance issue.[16]

Observations of the various *shari'a* advisory boards around the globe indicate that there are discrepancies in the *shari'a* governance systems. The variations are seen in *shari'a* advisory bodies' composition, accountability, procedures and powers, as well as in the qualification stipulations of *shari'a* scholars and the accountability standards applied.[17]

In some countries there is a *shari'a* advisory council at central level. The *shari'a* scholars sitting at the central level are suitably qualified and accountable to the government.[18] Since individual financial institutions employ in-house *shari'a* advisory boards, the central *shari'a* advisory council might also review the decisions or *ijtihad* made by its scholars in various financial

institutions, but it does not review their qualifications or their accountability in terms of their rulings.

The Quran explains that all individuals will be challenged against their own deeds or sins; therefore, no one will be called upon to bear another person's burden.[19] Such an arrangement is not applicable in some jurisdictions, for example, where the decisions (*ijtihad*) or the qualifications and accountability of the *shari'a* advisory board at the institution level are binding and not subject to the review of higher authority. Such a predicament is based on the argument that an *ijtihad* cannot be invalidated by another *ijtihad.* In addition, the decisions of *shari'a* advisory bodies do not constitute an *ijma'* (consensus), the system operating on the basis of collective *ijtihad*, where *shari'a* scholars decide as a group. However, in the event that they cannot reach a unanimous decision, the views of the majority will prevail.

Certain countries or institutions adopt the practice of including experts from other related fields of specialization in the *shari'a* advisory board. Ideally, the composition of *shari'a* advisory boards may include experts in *shari'a*, legal, accounting and finance matters. This will assist the *shari'a* scholars in considering the macro and micro dimensions of the products and policies, and thus allowing them to reach more precise and up-to-date decisions. This is the model adopted by AAOIFI *Shari'a* Board.

There is no strict or fixed number of members on a board. The numbers instead depend on the need and extent of the services required. The AAOIFI Standard recommends at least three members on each board. The Central Bank of Malaysia recommends the same, through its Guidelines on the Governance of *Shari'a* Committees for Islamic Financial Institutions. It is pertinent for Islamic financial institutions to be aware in their selection of *shari'a* advisory board members that these individuals should complement each other in terms of experience, knowledge and qualifications to ensure the effectiveness of the institution and its decisions and to preserve its integrity.[20]

The Demand for *Shari'a* Board Members

The Islamic finance industry is in desperate need of qualified *shari'a* scholars. While in some cases, the same *shari'a* scholars sit on several *shari'a* boards across the world, others are sometimes recruited without due diligence. In fact, there are no reliable references regarding the process for selection. One *shari'a* board member may be asked to recommend two or three other members, and may generally recommend people with whom he is friends or with whom he sits in other boards. This friend may return the favor by recommending him to another board, and so on. In this way, one *shari'a* board member may sit on 77 different boards, another in 54, another in 34 and so on. Table 1 shows the top 20 *shari'a* board members and their engagements.

Having one *shari'a* board member sit on 77 boards is neither efficient nor effective. If we assume that the average number of transactions per year for each IFI is 150, one member is responsible for 11,500 transactions per year. How would the member have the time to travel to and from one IFI to another, and see other clients for further sittings in other boards, either as a member or as the board's chairman? What about finding time to pray and perform normal Islamic duties, to read the news, to keep up to date with global financial developments and to monitor indices? And what about doing research and developing new products? These are, of course, rhetorical questions. Nobody can fulfill any one of these duties to any acceptable standard while so overcommitted. This problem raises serious ethical questions about the *shari'a* compliance of the products with which the board member has been involved. If the products are indeed compliant, we can assume that the member was not needed to fulfill the board's duties, as his or her contribution would be minimal.

A compelling drive for scholars to sit on quite so many boards is the attainment of individual wealth, power and influence. But as we have seen above, the more boards a scholar attends, the less time each IFI is granted individually and thus there will almost inevitably be mistakes. Whatever the individual scholars' reasons are for sitting on numerous *shari'a* boards, the current situation has gone far beyond an acceptable level, to the point where it damages the principles for which Islamic finance stands.

A client who wanted to raise money through Islamic finance for real estate development consulted the author on this matter. The client had 50 percent of the money needed for a project and was offered the remainder by a well-known IFI, whose *shari'a* board members include one of the top 20 from Table 1. The IFI offered a *tawarruq* deal (in fact it was a fixed-interest loan re-named as *tawarruq*) whose multitude of hidden costs made the overall deal more expensive than a fixed-interest loan from a conventional bank. The bank confirmed that each transaction had been examined and approved by the *shari'a* scholars, and the bank manager used the names of the *shari'a* board team to market the products. From this information alone it is clear that important deals that the bank offers are not in accordance to the *fatwa*s passed by the *shari'a* board because no *shari'a* board would approve such deals. The boards are likely not aware of such practices, they are likely not consulted on any deals and they do not have the time to do even a random audit of the transactions conducted by the IFIs. Because of the lack of accountability, *shari'a* board members are engaged in many IFIs and become merely names used for marketing products. This is a fundamental failure of "*shari'a* compliance." Are excessive marketing and profit maximization the reasons IFIs recruit *shari'a* board members who are popular, busy and do

Table 1. Top 20 *Shari'a* Scholars' Engagements across Countries and Regions

#	Scholar Name	ZA	LK	MY	AU	US	UK	CH	DE	NL	JP	GCC/MENA	Sum
1	Sh. Nizam Yacobi			1		7	8	2				59	77
2	Sh. Dr Abdul Satar Abu Ghuddah				3	6	2					61	72
3	Dr Mohammed Ali El Ghari		2	1	4	2	2	3	1		50	64	
4	Sh. Abdullah Al Manee'a											37	37
5	Dr Abdula Aziz Al-Qasser						2					35	37
6	Dr Mohammed Daud Baker		1	2	2	5	3		1		1	22	35
7	Dr Hussain Hassan Hassan						2	1				26	29
8	Dr Essa Zaki Essa											25	25
9	Sh. Dr Ajeel Al-Nashmi											24	24
10	Dr Ali Mohuddin Al'Qurra Daghi					2						21	23
11	Sh. Dr Khalid Mathour											20	19
12	Dr Muhammed Imran Usmani	1			2	7	1		1	1		8	19
13	Sh. Esam Mohammed Ishaq		1		2	1						14	18
14	Sh. Dr Esam Khalifa Al-Enizi					2						15	17
15	Sh. Dr Mohammed Abdul Razak Al-Tababae			1								15	16
16	Justice Muhammed Taqi Usmani	1	1	1								10	16
17	Sh. Ahmed Bazie Al-Yaseen											13	13
18	Prof. Abdulla Mohammed Al-Mulaq					1						11	12
19	Dr Yusuf Abdulla Al-Shubailil			1		1						9	11
20	Sh. Dr Mohammed Sultan Al-Olamaa											9	11

Source: Funds @ Works 2009, www.funds-at-work.com

Notes: ZA: South Africa; LK: Sri Lanka; MY: Malaysia; AU: Australia; US: United States; UK: United Kingdom; CH: Switzerland; DE: Germany; NL: Netherlands; JP: Japan; GCC: Gulf Cooperation Council; MENA: Middle East and North Africa Region.

not have time to look carefully at the transactions labeled *shari'a* compliant? It is clear these kinds of practices would not be allowed in the conventional banking system.

Education

It is also clear that there is no program in place for educating and training the new generation of *shari'a* board members. Shareholders and clients of IFIs expect their investment to be protected by professionals adhering to strict standards of corporate governance. There must be corporate governance protecting the Islamic finance system from abuse and fraud, so that the IFIs are directed, controlled and forced to adopt structures and processes that incorporate the values of fairness, transparency and accountability.

The practical function of corporate governance is to put in place a system that will bring to bear a company's business objectives such as increasing shareholder value and offering efficient, accountable services to clients and to the public at large, whilst managing risk. IFIs share the same practical and business objectives, but are subject to an additional layer of compliance with *shari'a* rules and principles. The objectives of IFI are not only to offer Islamic finance services but also to make a profit in a socially responsible manner.

Sitting on a board demands competence and an understanding of both complex economic concepts and immutable Quranic tenets. The current generation of board members is aging and educating the next generation is vital.

Challenges for *Shari'a* Advisors

Islamic finance is still in its early stages compared to the conventional system, which has valuable experience developed from hundreds of years of practice; the newness of Islamic finance requires *shari'a* scholars to academically and ethically equip themselves well. They need to develop their skills quickly and in line with the rapid advancement of the industry in the increased liquidity and fast development of capital market products.[21] Furthermore, there are still many challenges and weaknesses that need to be settled by contemporary *shari'a* scholars. These challenges include the following:

1. There is a lack of knowledge and understanding among *shari'a* scholars about the global economic system, along with insufficient understanding of the structure, objectives and implications of the products and policies.
2. There is a shortage of new and young scholars. The absence of new *shari'a* scholars is one of the industry's current concerns and has been caused largely by the nepotistic attitude prevalent since the emergence of the industry. Fixing it will require all the relevant authorities to invest in developing and training *shari'a* scholars, as well as maximizing the

efforts of the existing and senior scholars as mentors to guide the young talents to assume their role as catalysts for the further development of the Islamic finance industry. One solution is to expose the young talents to the modern operations and the global practices of Islamic finance in conjunction with providing a solid *shari'a* background. One of the suggested training methods is to allow a junior scholar to attend and participate in the meetings of *shari'a* advisory bodies. However, in order to erode the culture of scholars serving on multiple boards, these young scholars should be encouraged to become deeply involved with and committed to a single board.[22]

3. Innovation of products is key to the development and survival of the Islamic financial system, both regulatory and legal. There is the increasing challenge of balancing monetary and *shari'a* objectives and financial and tax requirements in product development.
4. To ensure clear and transparent decision-making procedures, as well as the independence of *shari'a* scholars, clear and transparent procedures of appointments, qualification and accountability of *shari'a* board members should be guaranteed.
5. Privacy and confidentiality must be assured, as the absence of full disclosure on the part of the financial institutions can prove to be detrimental to the legitimacy of products and can affect the rights of customers.

Not surprisingly, all this brings us back to accountability. *Shari'a* scholars must realize and initiate their responsibilities. Such efforts will, however, fail without the firm support of investors and industry players. AAOIFI recommended that *shari'a* supervisors serve under the company's board of directors and not the management. *Shari'a* board members should be elected by the shareholders in order to ensure the integrity of the board. Scholars must be able to perform their roles without fear of conflicts of interest. It is important to highlight that the development of any banking system is closely associated with distribution and accuracy of information. *Shari'a* standards issued by international bodies such as the AAOIFI, the Islamic Financial Services Board (IFSB) and the Islamic Fiqh Academy are vital.

In December 2009, the Islamic Financial Services Board (IFSB) issued the *Guiding Principles on Shari'ah Governance System for Institutions Offering Islamic Financial Services* (IFSB-10), which is expected to:

1. Complement other prudential standards issued by the IFSB by highlighting in more detail to the supervisory authorities in particular, and the industry's other stakeholders in general, the components of a sound *shari'a* governance system, especially with regard to the competence, independence, confidentiality and consistency of *Shari'a* boards;

2. Facilitate better understanding of *shari'a* governance issues and how stakeholders should satisfy themselves that an appropriate and effective *shari'a* governance system is in place;
3. Provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with *shari'a* rulings; and
4. Provide greater harmonization of the *shari'a* governance structures and procedures across jurisdictions, especially since there are increasing numbers of institutions offering only Islamic Financial Services (IIFS) with cross-border operations.[23]

IFSB-10 emphasizes the need to complement existing international standards of corporate governance systems in order to promote a sound and stable Islamic financial system. In Appendix 5 of IFSB-10, there is an assessment process for the accountability of the *shari'a* board.[24] These are significant regulatory reforms introduced recently to reposition the Islamic finance industry in the global economy. Principle 1.2 of IFSB-10 provides for clear terms of reference regarding the mandate and responsibility of the *shari'a* board. The board is required to have in place well-defined operating procedures and lines of reporting, and must be familiar with professional ethics and conduct. IFSB-10 provides:

> In order for the *Shari'ah* board to have a precise chain of command and accountability toward the respective stakeholders of the IIFS, it has to be equipped with:
>
> (i) a mandate that grants it appropriate powers to carry out its role and functions;
> (ii) well-organized operating procedures with regard to meetings, the recording of meetings, decision-making processes and to whom its decisions will be passed for effective implementation, including processes to review those decisions whenever necessary; and
> (iii) a sound code of ethics and conduct that would enhance the integrity, professionalism and credibility of the members of the *Shari'ah* board.[25]

The above principles are meant to complement the *Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services* (IFSB-9) issued in December 2009. Principles of good business conduct are needed to protect investor interests and to enhance the integrity of the institutions concerned. It is also a requirement under *shari'a* that companies observe principles of ethical business conduct. Furthermore, the principles of certainty and transparency strengthen the validity of a *shari'a*-compliant contract.

The IFSB has issued multiple Standards, Guiding Principles and Technical Notes for the Islamic financial services industry. As of December 2011, IFSB has issued the following Guiding Principles and technical Notes:

1. Risk Management (IFSB-1)
2. Capital Adequacy (IFSB-2)
3. Corporate Governance (IFSB-3)
4. Transparency and Market Discipline (IFSB-4)
5. Supervisory Review Process (IFSB-5)
6. Recognition of Ratings on *shari'a*-Compliant Financial Instruments Development of Islamic Money Markets (TN-1)
7. Governance for Collective Investment Schemes (IFSB-6)
8. Special Issues in Capital Adequacy (IFSB-7)
9. Governance for *Takaful* (Islamic Insurance) Undertakings (IFSB-8)
10. Conduct of Business (IFSB-9)
11. Shar 'ah Governance Systems (IFSB-10)
12. Solvency Requirements for *Takaful* (Islamic Insurance) (IFSB-11).

At first glance those drafts look like impressive examples of deep-rooted, all-encompassing guidelines, and are indeed the result of much discussion and many hours of work. Unfortunately, there is no reference to the number of boards a *shari'a* member can serve in IFSB-3 and IFSB-10, which are directly related to *shari'a* governance.

Conclusion

As the Islamic finance industry develops further, there is a growing need for standardization and professionalism across the industry. Coupled with this is the importance of adopting internationally recognized and robust corporate governance systems that incorporate transparent, fair and ethical working practices. Islamic financial institutions are well placed in this context, since at the heart of Islamic law is a vision of social development, which requires all individuals and businesses to conduct themselves ethically and in a socially responsible manner. The "Guiding Principles" demonstrate how closely aligned the basic principles of corporate governance are with *shari'a* rules and doctrines, and consequently how IFIs are well placed to offer shareholders opportunities to participate in a broader goal of corporate social responsibility.

The prospects for the Islamic finance industry are very bright but the task ahead is challenging. This task includes *shari'a* and regulatory issues and the process of integrating the Islamic finance industry into the global financial system. It requires not only the active participation of the *shari'a* advisors, but also that of regulators, practitioners, economists and legal

experts if a complete and comprehensive system is to be developed. Islamic finance, as one aspect of human life, is a form of *ibadah* (worship) if it is conducted in accordance with the rule of the God. As such, it has to be upheld by all players in the Islamic finance industry. The ultimate reminder is the prophetic saying: "Every one of you is guardian and each of you is responsible for the things or people that are under your care."[26]

The IFSB guide fails to include accountability and qualifications for *shari'a* board members, although accountability is the most important issue. Since the IFSB members are part of the institutions that offer Islamic finance services, it is in their interest to regulate the industry and gain the confidence of the general public and the industry.

The IFI's selection of *shari'a* board members should be made based on the candidate's education in Islamic finance studies, requiring at least a master's degree, but preferably a doctorate. Members should be experts with a *shari'a* background or those who possess good knowledge of *fiqh* and *usul fiqh* (Islamic Law), and legal, accounting and finance matters. The scholar should have a good command of English and Arabic, and possess characteristics such as trustworthiness, integrity, honesty and responsibility. The scholar must have had adequate exposure to the global financial market, and be flexible, dynamic and prepared to face additional challenges. To ensure full attention to each institution, the scholar should not be engaged with many other Islamic financial institutions. This will also help resolve confidentiality and conflicts-of-interest issues. A scholar should accept personal accountability to the organization, its shareholders and the customers of the organization he represents. In short, the *shari'a* board member should be an individual of the highest caliber, both professionally and personally.

The Central Bank of Malaysia's approach must be considered seriously because of their more than 25 years of experience operating an Islamic finance system parallel to the conventional system. They recommend that the appointment of *shari'a* board members have the approval of their central bank, the Bank Negara Malaysia. Islamic banks in Malaysia then ensure that the members are not sitting on several *shari'a* boards. They scrutinize the proposed member's qualifications, experience in Islamic jurisprudence (*usul-al-Fiqh*) and Islamic commercial law (*muamalat*), and they see whether the member is unfit to serve or has been disqualified, and that there is no conflict between the Islamic financial institutions.

The detrimental effects of *shari'a* board members who sit on many IFIs are numerous. This raises questions about the credibility of Islamic finance worldwide and reduces confidence amongst investors and the general public. It makes the Islamic finance system incomparable with the conventional system in terms of transparency, ethics, fairness, justice and honesty. Finally,

it puts *shari'a* board members under extreme pressure, which could lead to very expensive mistakes, both in their *fatwa*s and auditing, eventually leading to the loss of confidence in their rulings.

Conversely, achieving accountability will have far-reaching advantages. Those IFIs whose aims are to profit from new and ethical systems by engaging *shari'a* boards acting for publicity's sake will find it difficult to maintain credibility; they will have to take extra care in engaging *shari'a* board members who are accountable and qualified to make their institutions credible. The authenticity, credibility, seriousness and trustworthiness of *shari'a* board members will improve. Accountability strengthens global respect for *fatwas* issued for product development compliant with the *shari'a*. It introduces *shari'a* auditing standards to the global financial market and strengthens the corporate governance of Islamic financial institutions. It embeds Islamic finance values into financial institutions' business operations and governance and ensures Islamic ethical principles are preserved within the global market. It protects consumers' rights from abuse and fraud from the conventional finance monopoly. It ensures the adoption of Basel II and Pillar II, particularly money laundering and capital adequacy issues within their institutions. The conventional financial system has a code of ethics and conduct to which all personnel, including management, are accountable; therefore, for the Islamic financial system to compete with the conventional financial system, it is imperative to have a code of ethics and conduct, particularly for the *shari'a* boards. This makes it necessary to regularly evaluate the performance of Islamic financial institutions, and have the *shari'a* board members transparent, accountable and adequately qualified.

Endnotes

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2. Ernst & Young, *Islamic Funds & Investments Report. Post Crisis: Waking up to an investor-driven world*, 2010.
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5. Aly Khorshid, *Encyclopedia of Islamic Finance*, 352.
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8. Aly Khorshid, *Encyclopaedia of Islamic Finance*, 28.
9. Mohammed Akram Laldin, *Encyclopaedia of Islamic Finance*, 195.
10. For further elaboration on the required characteristic of *shari'a* advisors, see Amin Muhammad Ali Qattan, *Hai'at Riqabah: Ikhtiyar A'adhauha wa Dhawabituha*, AAOIFI, 7th *shari'a* Conference, May 27–28, 2008, Bahrain, pages 4–6.
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12. Mohammed Akram Laldin, *Encyclopaedia of Islamic Finance*, 198.
13. Zeti Akhtar Aziz, Governor Bank Negara Malaysia.
14. Aly Khorshid, *Encyclopaedia of Islamic Finance*, 115.
15. AAOFI, *Auditing and Governance Standards for Islamic Financial Institutions Governance Standard* (2004–2005), 5.
16. Bank Negara Malaysia, *Guidelines on the Governance of Shari'a Committee for the Islamic Financial Institutions*, 3.
17. Shamsad Akhtar, *Shari'a Compliant Corporate Governance*, keynote address delivered at the Annual Corporate Governance Conference Dubai on November 27, 2006. See the "Shari'a Compliance Framework–Countrywide table," 7.
18. Such arrangement can be found in Malaysia, Pakistan and Sudan where the Central *Shari'a* Advisory Council exists at the Central Bank level. However, the role of the Central SAC might vary from one country to another.
19. No bearer of burden shall bear the burden of another (Quran, Surat Al-Ana'm 6:164).
20. Muhammad Yunus Al Birqdar, *Dhawabit Ikhtiyar A'adha' Hai'at Al Riqabah Al Shari'iyyah fil Muassasat Al Maliyah Al Islamiyah*, AAOIFI, 7th Shari'a Conference, 27–28 May 2008, Bahrain, 17.
21. Mohammed Daud Bakar, *Encyclopaedia of Islamic Finance*, 131.
22. There is an index issued by Filaka/Dow Jones listing over 100 *shari'a* scholars from different parts of the world with their qualifications and portfolio, and Funds@work issues a survey of 200 *shari'a* scholars and their engagements.
23. Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance System for Institutions Offering Islamic Financial Services* (IFSB-10), December 2009, 1.
24. IFSB-10, 31.
25. Paragraph 20, Principle 1.2 of IFSB-10, 9.
26. Imam Al Bukhari, *Sahih Al Bukhari,* Volume 3, Book 41, *Hadith* 592.

Challenging the Parameters of Permissible Hedging in Islamic Finance: Rationale and Implementation of Recent *Shari'a* Rulings

Robert Rilk

Hedging Under *Shari'a* in the Context of the Financial Crisis

The recent crisis of the international financial markets, which is still ongoing, initially began in late summer 2007,[1] with U.S. subprime markets crashing. Suddenly, huge volumes of residential mortgage backed securities (RMBS) lost their valuess at a high pace due to mass defaults of the home owners owing the underlying loans. A second major blow came with the collapse of the century-old institution of Lehman Brothers in September 2008,[2] which caused major damage to both institutional and private investors, demonstrating the power and dynamics of systemic risk.

Ironically, those financial instruments originally designed to shift risk or manage risk, such as Credit Default Swaps (CDS) and Asset Backed Securities (ABS), stood at crucial points of the financial turmoil. These instruments were meant to improve risk profiles by protecting market participants against the default of others or by providing secured cash flows for one while improving the balance sheet of another. Both instruments were used to trade, transform and ultimately shift risks from one market participant to another, in short: contemporary financial risk management. Eventually, such risk management instruments spiraled out of control and caused major damage.

Interestingly both crashes, be it the US-RMBS market in 2007 or the collapse of Lehman in 2008, were followed by confessions of affected investors that they had neither fully understood the inherent risks of the financial instrument involved nor the instrument itself.[3]

Initially, Islamic finance proved somewhat resilient to the first shock waves of the still ongoing economic turmoil due to its underlying precepts and an overall reduced exposure to the more risky edge of the crumbling

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markets. However, as time passed, it appeared that Islamic financial institutions, as an inseparable part of the international financial markets, were by and large as equally affected as their conventional players. A traditionally and geographically significant exposure to crumbling real estate markets, especially in the G.C.C. and the U.S., quickly neutralized the benefits that some Islamic investors had yielded from not having invested in the massively depreciated stock of conventional financial institutions.

In bad weather everybody looks for shelter. In financial terminology, this is called hedging. In the context of the current turmoil, existing protection mechanisms are put under scrutiny while new and more efficient models of risk avoidance, risk reduction and risk shifting are sought.

Islamic finance, unlike its conventional counterpart, has to observe a number of additional requirements according to its specifications—in its overall business in general but more specifically when it comes to risk management and hedging. Among these more specific requirements are the prohibition of *riba*, *gharar* and *maysar* as the most prominent precepts.

From this perspective it is evident that conventional RMBS could not pass any *shari'a* screening as they rely on the trading of debt and would be impermissible under the ban on *riba*. Likewise, CDS are non-investable as these insurance-type transactions involve the shifting of risks against payment of a premium, which, from a *shari'a* perspective, is tantamount to gambling or *maysar*. Therefore *shari'a*-compliant market participants were hedged against direct investments in these instruments, based on their beliefs.

RMBS and CDS aside, risks are to be managed under Islamic precepts as they are under conventional rule. Sophistication in structuring does not necessarily mean better protection. In fact, RMBS and CDS were precisely the most sophisticated risk shifting and hedging instruments present at the epicenter of the current economic crisis. This was a painful lesson on how carefully risk management instruments have to be designed.

With this in mind, Islamic finance more than ever needs to develop efficient, understandable and reliable hedging instruments and mechanisms. As Islamic finance is an industry based on ethics, it is crucial to carefully align proposed hedging methods and hedging products to *shari'a* requirements. Recently, a number of players in the industry, among them predominantly conventional international banks with an Islamic outlet ("window"), have developed highly engineered hedging solutions that some people dispute are not *shari'a* compliant. The debate regarding *shari'a* acceptable and efficient hedging instruments, including these new products, is far from settled.

Lately, Islamic finance standard setting boards have issued various rulings on how the precepts of Islamic finance shall effectively be implemented (AAOIFI *Sukuk* statement, February 2008 and the Resolution 179 [19/5] of

the International Council of the OIC Fiqh Academy on organized *Tawarruq*, April 2009). This means testing various solutions and methods proposed by the industry.

The following discussion will look into prevalent *shari'a* parameters on hedging and discuss the current status of *shari'a*-compliant hedging techniques before elaborating on the recent landmark rulings issued by *shari'a* standard setting bodies and discussing their possible impacts. This paper seeks to demarcate the limits of permissible hedging in Islamic finance according to recent *shari'a* rulings, while recommending implementation of key considerations in recent *shari'a* rulings and existing standards (e.g., AAOIFI *shari'a* Standard on *Tawarruq*). Technical aspects of how such key considerations can be reflected in legal documentation will conclude the paper. In this context the paper argues in favor of relying on the parties' intention (*niyyah*) in order to distinguish hedging from speculation. It advocates *shari'a* boards having a more material involvement in the depth and duration of *shari'a* monitoring.

Prevalent *Shari'a* Parameters Regarding Hedging

Hedging can be described as risk management by protecting an investment against a specific type of risk by neutralizing this risk. As such, hedging is an essential part of any investment activity and is vital for any business that has to deal with fluctuations or expected fluctuations in prices, currency rates, markets, a counterparty's ability to cope with payment obligations, etc.

Because *shari'a* is adverse to excessive risk taking (*gharar*, *qimar*, *maysar* and *riba)*, this prohibits some of the most common ways of hedging in conventional finance, e.g., most forms of derivatives.

Ways of Hedging under Shari'a

Natural hedge/asset-liability-balancing

The most basic *shari'a*-compliant hedge is the balancing of assets and liabilities. This on-balance-sheet hedge can be considered a "natural hedge." Along with risk pooling models (see below) this has been one of the more prominent ways to hedge out risks in a *shari'a*-compliant manner. Some have favored the "natural hedge" in the debate on *shari'a*-compliant derivatives.[4] A number of authors have raised the question whether derivatives, by nature susceptible to speculation, would therefore be needed at all.

However, hedging by using a natural hedge-like asset-liability balancing requires a certain structure of financials. Market participants may or may not have such financials at hand. Practically, they are more likely not to always meet the natural asset-liability equilibrium. Therefore risk pooling as a tool for containing and hedging out risks has been discussed as another option.

Risk pooling

The concept of risk pooling stems from the idea of collective risk sharing and collective risk balancing; each participant brings its specific risk but also its resources that may be used in case a member of the community incurs relevant damage. In this case all pool members would shoulder the burden of such relevant damage rather than the single pool members. For instance, risk pooling solutions have been discussed in terms of portfolio insurance for the benefit of investors in an Islamic mutual fund[5] or as cooperative, not-for-profit mutual arrangements.[6]

The growing sector of *takaful* is a prominent and successful example of such a risk pooling approach, where a decidedly large number of participants with a relatively smaller and less volatile risk profile (compared to, for instance, international financial institutions) are seeking and finding sufficient protection.

Due to structural reasons, risk pooling solutions seem to be less viable for complex risk portfolios. Thus, pooling solutions appear to be confined to "real economy"-linked small-cap or mid-cap businesses or to hedging solutions for individuals. Such reasons can be found in the dynamics of international capital markets, the sophisticated risk profiles of the players involved and also the rather limited number of participants (at least compared to the mass market of common risk pooling markets like *takaful*).

Risk shifting

If risk can neither be canceled out on the individual level, nor shouldered by a larger number of entities through risk pooling, the only way of doing away with excessive risk is to shift it to a third party. While this is conventionally achieved through derivatives, Islamic finance has not been comfortable with such derivatives and has resorted to financially engineered solutions instead.

Risk shifting solutions based on contractual arrangements (arbun, khiyar ash-shart)

It is worth recalling the most prominent reasons why the majority of scholars consider most derivatives non-compliant to *shari'a*. These are:

- the objection of enabling speculation and resulting in win-lose probabilities akin to gambling;[7]
- the perceived lack of physical assets in the reality of today's options contracts, supported by the fact that the overwhelming majority of contracts on the derivative markets are eventually cash settled rather than physically delivered;[8]
- the character of derivatives serving indistinctly genuine hedging needs but also speculative purposes;[9]

- the lack of classical *fiqhi* contracts validly apt to accommodate contractual arrangements similar to conventional derivatives.[10]

On each of the above objections there has been a vivid discussion without reaching any consensus. This can be illustrated in the various opinions pertaining to the objection that none of the classical *fiqhi* contracts could serve as a base case for universally modeling *shari'a*-compliant derivative contracts. Regarding *shari'a*-compliant options, the majority argued that *arbun* could not be used to replicate an Islamic option. Unlike in conventional options, there would be a valid reason for the *arbun*-seller to retain the down payment in case the contract is not fulfilled, while a conventional option would bear a premium akin to unjustly consuming the wealth of others.[11]

Likewise, regarding the application of a stipulated option (*khiyar ash-shart*), some argued such a stipulated option would not be extendable beyond three days maximum, while conventional options contracts require far longer maturities.[12] In contrast, the proponents of permissibility argued as per *khiyar ash-shart* that some *madhhab* indeed allow the stipulation of a longer option period than three days and supported their view with further, more systematic reasons[13]:

- if used for genuine hedging purposes, derivatives would not increase but would limit business risk and therefore be of direct benefit for real underlying economic activities;
- the pricing of an option would not be equal to unjust enrichment but could be justified by using exact formulae including the market price of the underlying reference asset;
- the non-use of derivatives for (genuine) hedging purposes more than its use would be detrimental for the respective party's business and create even more risk instead of reducing it.

The larger debate on the permissibility of derivatives under *shari'a*, however fervent, could not turn away the market's needs for risk managing and hedging solutions. The persistent debates centered around the numerous *fiqhi* requirements on contracts involving a future element like *arbun*, *salam* and *khiyar ash-shart* encouraged the rise of another legal instrument of classical *fiqh,* in this context, *wa'ad*. *Wa'ad* is the unilateral promise, legally binding to the majority of scholars, when employed under a *murabaha* scheme.[14] The requirements on *wa'ad* are far less restrictive than contracts like arbun and salam and helped the industry to employ *wa'ad*-based structures without caring too much whether the trade-offs would bring Islamic hedging products close to conventional hedging products. The industry interpreted as flexibility the apparent absence of cumbersome *fiqhi* requirements on *wa'ad*.

Promise-based (*wa'ad*-based) solutions

Instead of a bilateral contract but a unilateral promise, solutions for Islamic hedging could be designed with financial engineering replicating conventional derivatives not explicitly (i.e., by using *arbun* or *khiyar ash-shart* contracts for replacing, for instance, an options contract) but implicitly by engineering the pay-off of any derivative contract through mutual unilateral promises.

One of the earliest publicly available descriptions of such a *wa'ad*-based financially engineered structure has been documented in a Deutsche Bank Academic Paper in February 2007.[15] Since then the markets have used *wa'ad* more widely to replicate all types of derivates, including FX options, total return swaps and even short selling mechanisms.[16]

An example for a relatively simple transaction is an FX call option in favor of a bank against its client using *wa'ad*:

> Promise to sell a pre-determined amount of currency B for a pre-determined amount of currency A upon Settlement Date; Bank pays non-refundable fee to Client upon Trade Date.

Bank ←———————————————— *Client*

The Client will receive a non-refundable fee from the Bank when issuing the promise (Trade Date). The Bank may decide at its full discretion, according to the respective exchange rate upon Settlement Date, whether to hold the Client to its promise and ask for the specified amount of currency B for the pre-determined amount of currency A. Obviously, the Bank will decide so in case the exchange rate allows the Bank to realize a gain on the currency transaction equal or above the fee paid upfront to the Client. Otherwise the Bank will not exercise the Client's promise but rather send a Cancellation Notice to the Client. In this case the Client will end up with the non-refundable fee.

This structure avoids the above discussions on *arbun*, *bay'al-salam* or *khiyar ash-shart* through the use of the unilateral promise or *wa'ad.* Based on *wa'ad,* the transaction can be structured in a "clean" way from a *shari'a* perspective as neither the maturity beyond three days (objection regarding *khiyar ash-shart*) nor the fee paid the Bank (objectionable when applied under the precepts of *arbun* for such transaction) raise concern under *fiqhi* requirements on *wa'ad.*

By taking a glance at the above-summarized objections against derivatives in Islamic finance we observe that the use of *wa'ad*, although a flexible and overall less regulated instrument in the universe of *fiqh*, has helped to largely overcome at least the more formal, legalistic debate on hedging solutions

offered by the use of *arbun*, *bay' al-salam* or *khiyar ash-shart*. For the most part these difficulties stem from the fact that classical *fiqh* is several hundreds of years older than modern (Islamic) finance and cannot easily accommodate modern financial markets' needs.

However, systematic objections also remain under such application of *wa'ad*. The most prominent systematic objection is the absence of a mathematical or economic measure to distinguish an instrument's use for genuine hedging on the one hand and speculation on the other hand—an objection that alredy accounts for conventional derivatives and led some authors to abandon altogether the concept of derivatives under Islamic finance precepts.[17]

While theoretically there is consensus that hedging shall be allowed and speculation banned, even a summary analysis of theory and practice of hedging shows the incoherency of such a presumption.

Theory and Practice

Various proponents of derivative use under Islamic finance precepts argue that their use for genuine hedging shall be permissible whilst their use for speculation shall be prescribed.[18] Put to the test, this idea lacks clarity of definition and further contradicts market practice.

Such a proposal lacks clarity in definition because it remains fuzzy how genuine hedging purposes could be separated from speculation. Most authors proposing the permissibility of derivative use for "genuine" hedging purposes simply use this term without offering a definition or objective measure for determining such genuineness.[19] Jobst, for instance, suggests the formula "employed to address genuine hedging demand on asset performance associated with direct ownership interest,"[20] without further elaborating on how this could be applied in practice.

Consequently, other authors and scholars have dropped the issue of hedging by derivative use in Islamic finance exactly for this reason. Suwailem convincingly argues that "derivatives make hedging and gambling undistinguishable"[21] and concludes,"The difference between arbitrage, that improves efficiency of the market, and gambling, which destroys market fundamentals, was and still is, a subject of prolonged debate. Although it is easy to agree on the two opposite extremes, no 'analytical formula' is developed to filter out the two in the vast majority of mixed situations in between."[22]

Further, the assumption of a differential treatment of hedgers and speculators is in direct contradiction with market practice. In conventional markets we see a minority of hedgers facing a vast majority of speculators. Relevant publications quote more than 97 percent speculators facing less than 3 percent hedgers in conventional derivative markets.[23]

Apart from the still unsolved matter of how to distinguish hedgers from speculators in theory, there is no reason why in practice the above ratio would significantly differ in Islamic derivative markets. Derivative markets are markets driven by an overwhelming majority of speculators and a minuscule minority of hedgers. In this context it appears even more dramatic, that a majority of speculators is needed in order to provide necessary liquidity to the market. Any derivatives market, be it conventional or Islamic, cannot refrain from allowing speculators to enter the market provided that the market shall be sufficiently liquid in order to allow efficient allocation of risks and accurate pricing.

Eventually, the way primary hedging markets (derivatives markets) function explains the ratio of speculators in these markets. There, every hedger indeed needs its speculator: The existence of complementary hedging needs of maturity, quality and quantity would appear far too rarely to keep a derivative market going. Only in very rare occasions will we see two parties taking part in a derivative transaction with both intending to genuinely hedge their underlying business needs (e.g., a palm oil producer and a company running a power plant with this palm oil, both intending to hedge themselves against price fluctuations occurring until the next harvest season).

That said, we can assume that if an exact "analytical formula" existed that enabled us to determine the fine line between hedging and speculation, its strict application would lead to the prescription of nearly all such transactions in a *shari'a*-compliant derivative market, thereby only exempt in rare cases of complimentary matching hedging needs. This is a scenario that, by lack of sufficient market liquidity, would render Islamic derivative markets impracticable. After all, the beauty of derivatives lies within their flexibility. It is this flexibility that entails their potential for genuine hedging purposes as well as for speculation.

A preliminary finding can be established regarding prevalent *shari'a* parameters and permissible hedging techniques, their theoretical background and the practical challenges they face: the objective parameters of a given transaction do not show whether a party seeks risk reduction or (even leveraged) speculative gains. Hedging can neither be separated from speculation by applying a mathematical or economic formula, nor by circumventing *fiqhi* objections using promised-based structures (*wa'ad*) rather than contract based schemes (e.g., *arbun*, *bay' al-salam* or *khiyar ash-shart*). In the absence of objective measures (of overriding importance from a legal draftsperson's perspective), we have to look at subjective measures to distinguish hedging from speculation: the intention or the *niyyah* of the parties involved.[24]

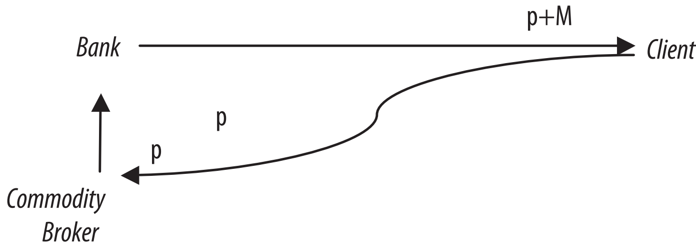
Before elaborating on this, we will glance at how recent landmark rulings of *shari'a* standard setting bodies like the OIC *Fiqh* Council may influence

the permissibility of structured hedging solutions, be them promised-based (*wa'ad*) or contract based schemes (e.g., *arbun*, *bay' al-salam* or *khiyar ash-shart*).

The New Approach of Recent Landmark Rulings

OIC *Fiqh* Council Resolution 179 (19/5): A blow to organized *Tawarruq*?

Reportedly, a certain number of Islamic risk management products, such as profit-rate swaps, rely on commodity *murabaha* transactions for structuring the cash flows between the parties involved.[25] Any such commodity *murabaha*/on-sale transaction will take the following format (arrows indicate asset transfer at market price (p) or at market price plus profit margin (p+M)):



Note: Bank will arrange all dealings with Commodity Broker. Bank will buy the commodities on its own behalf, subsequently sell these same commodities to Client against deferred payment by Client on the amount of p+M. As Client is not interested in the commodities but in the cash, Bank will immediately on-sell the commodities to the market and forward the cash proceeds to Client.

The above transactions, according to AAOIFI *shari'a* Standard No. (30), would have to be classified as Monetization or *tawarruq* as the underlying commodity does not remain with the mark-up paying party (here the Client) but is immediately on-sold to the market in order to obtain cash rather than the commodity itself. Therefore the party paying the mark-up qualifies as *mustawriq*. According to AAOIFI *shari'a* Standard No. (30) 3/1, "Monetization refers to the process of purchasing a commodity for a deferred price determined through *musawama* (bargaining) or *murabaha* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash."

The existence of a standard, here AAOIFI *shari'a* Standard No. (30), indicates substantial practice. Otherwise this standard would not have been issued. The permissibility of such practice certainly has to follow the rules, notably (without the following requirements being an exhaustive list):

- real asset transfer requirement: there should be a real commodity that the seller owns before selling it (3/1);
- operationally the identifying documents for the commodity shall be made available (4/2) and the commodity must be sold to a party other than the one from whom it was purchased on deferred payment terms (4/5);
- documentation-wise the contract for purchasing the commodity on deferred payment terms and the contract for selling it for a spot price to the market afterwards shall not be linked together in a form pre-empting the *mustawriq*'s right to actually obtain the commodity and get it physically delivered (4/6);
- the *mustawriq* shall sell the commodity by himself or through his agent but not through the Bank (4/9).

Importantly, it has to be noted that AAOIFI *shari'a* Standard No. (30) perceives Monetization or *tawarruq* as an exceptional instrument, with a restricted use in situations of established need (5/1). According to No. 30, "Monetization is not a mode of investment of financing. (...) The institution should resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients." In light of these rules it is doubtful whether transactions akin to *tawarruq* would be permissible under *shari'a* without such established need and under less than exceptional circumstances (5/1), even if the further requirements (4/1 to 4/9) were observed.

Market practice from time to time does not even seem to comply with basic requirements as set out in AAOIFI *shari'a* Standard No. (30) 4/1 to 4/9. Therefore the above discussion on whether or not a qualified need in terms of (5/1) could be established or not is often obsolete. Since cash flow modeling in contemporary Islamic finance heavily relies on Monetization arrangements, it currently does not seem feasible to abandon *tawarruq* in general by dropping the matter as a whole. However, the obvious non-compliance to AAOIFI *tawarruq* requirements by a number of market participants may have led the *Council of the OIC Fiqh Academy*, Jeddah, to issue in April 2009 the Resolution 179 (19/5) pertaining to the permissibility of certain forms of "organized" *tawarruq*. The *Council of the OIC Fiqh Academy* deliberately pursues, with this resolution, the goal of "ensuring the actualization of *shari'a* principles (*maqasid al shari'a*)."[26] The Resolution 179 (19/5) approaches its subject by firstly defining what shall be labeled "organized" *tawarruq*:

> Types of *tawarruq* and its juristic rulings: Technically, according to the Fiqh jurists, *tawarruq* can be defined as: a person (*mustawriq*)

> who buys a merchandise at a deferred price, in order to sell it in cash at a lower price. Usually, he sells the merchandise to a third party, with the aim to obtain cash. This is the classical *tawarruq*, which is permissible, provided that it complies with the *shari'a* requirements on sale (*bay'*). The contemporary definition on organized *tawarruq* is: when a person (*mustawriq*) buys a merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent. Simultaneously, the *mustawriq* and the financier execute the transactions, usually at a lower spot price. Reverse *tawarruq*: it is similar to organized *tawarruq*, but in this case, the (*mustawriq*) is the financial institution, and it acts as a client.[27]

Whereas forms of *tawarruq* deemed "classical" shall be allowed, the Resolution 179 (19/5) further elaborates on the rationale of the prescription of what is deemed "organized" or "reverse" *tawarruq*, mentioning that, "it is not permissible to execute both *tawarruq* (organized and reversed) because simultaneous transaction occurs between the financier and the *mustawriq*, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e., in order to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of *riba*."[28]

Applied to the above example of a simple commodity *murabaha*/on-sale arrangement, we can state the following: As the commodity purchase by the Client/ *mustawriq* from the Bank and the commodity on-sale by the Client/*mustawriq* (through the Bank acting as Client/*mustawriq*'s agent) will take place in a very short period of time, while the on-sale price (p) reflecting the market price of the commodity is lower than the deferred price (p+M) to be paid at maturity by the Client/*mustawriq* to the Bank, the first requirements of the OIC ruling ("simultaneous transaction between the financier and the *mustawriq*") seems to apply. Also, the transaction, if performed as described above, seems indeed to create a financial obligation upon the Client/*mustawriq* toward the Bank while the underlying commodity deal is simply reversed. It can be argued that it would be in fact the financial obligation of deferred payment in the amount (p+M) that remains as sole effect from the above transaction. Therefore the second requirement ("*in exchange for a financial obligation*") also seems to be met.

However, OIC Resolution 179 (19/5) is more in line with AAOIFI *shari'a* Standard No. (30) rather than extending AAOIFI's requirements. AAOIFI *shari'a* Standard No. (30) aptly draws the fine line between permitted classical *tawarruq* and forbidden organized monetization. Still, those requirements

must be implemented thoroughly. Therefore important points to be observed are the real asset transfer requirement, the observance of non-identity of commodity supplier and on-sale purchaser and overall the separation of the *murabaha* transaction and the on-sale transaction (including the respective agency Client/*mustawriq*-Bank).

Several players in the market may not pass the requirements of AAOIFI and OIC in how they effectively implement their *tawarruq* transactions. However, the crucial point is not primarily the lack of more *shari'a*-compliant alternatives to such non-compliant market practice in commodity *murabaha*/on-sale transactions, but it is the thorough application of existing required rules. This can be ensured by appropriate legal documentation keeping the *murabaha* transaction clearly separate from the on-sale transaction (including the agency appointment by the *mustawriq*). Further, the above requirements on real asset transfer and the safeguard of the *mustawriq*'s option to ask for physical delivery of the underlying commodity must be properly documented. Eventually, operational implementation is needed instead of reducing vital *shari'a* requirements to mere paperwork.

In conclusion there are two aspects to be learned from OIC Resolution 179 (19/5).

The first aspect is of concrete documentary and transactional dimension: Legally and operationally, AAOIFI *shari'a* Standard No. (30) must be applied in its strictest possible sense.

Current practice of market participants must be scrutinized according to this benchmark. The demand side itself, i.e., the clients, plays an important role in testing and verifying such a benchmark. The *shari'a* supervisory boards involved play a crucial role in this regard. Therefore the clients should insist upon their respective counterparties on full disclosure of documentary and operational details of how a given transaction is conceived and will be implemented.

Secondly, OIC Resolution 179 (19/5) labels organized *tawarruq* as "deception" and recommends to "ensure the actualization of *shari'a* objectives (*maqasid al shari'a*)." In doing so, OIC points to a larger context: the importance of "substance over form" considerations in Islamic finance.

In this context it has to be noted that AAOIFI also uses the same rationale, an example of which is found in *shari'a* Standard No. (25) on Contracts Combining (4/1&2):

> Contracts' Combining should not include the cases that are explicitly banned by *shari'a* like combining sale and lending in one contract.
>
> It should not be used as a trick for combining *riba* such as agreement between two parties to practice *bai'ul eina* or *riba al-fadhl*.

The above illustrates the general effort of AAOIFI to ensure the actual implementation of overriding *shari'a* principles—not only from a formal point of view but also in substance. In the case of *tawarruq*, both AAOIFI *shari'a* Standard No. (30) and the Resolution 179 (19/5) issued by the Council of the OIC Fiqh Academy strive to put a limit to the misuse of this classical *fiqhi* instrument for financing techniques tantamount to *riba*.

The principle of "*substance over form*" or the effective implementation of *shari'a* precepts seemed to be of lesser importance during the first years of the booming Islamic finance niche market. The widespread use of so-called *shari'a arbitrage*, i.e., mimicking conventional products and transaction by use of classical *fiqhi* contracts, led some to speak of this phenomenon as a "*shari'a conversion technology.*"[29]

In this respect the OIC Resolution 179 (19/5) indeed appears as a severe blow to a widespread practice in the international Islamic finance industry applying set rules (i.e., AAOIFI *shari'a* Standard No. (30)) in a far too lax manner. Therefore, players who have been using non-compliant techniques have heard OIC's call and will therefore expedite strengthening their transaction structures, including bettering documentation and resolving operational issues. As Islamic finance is coming of age, the challenge should be to let Islamic finance blossom in its own right based on *shari'a* and *fiqh*, and to work on truly *shari'a*-based financing techniques and investment instruments.

"*Substance over form*" is a concept closely related to another aspect of recent landmark statements: the demand for actualization of *shari'a* precepts and the quality of *shari'a* monitoring, which will be discussed in the following section with regard to the 2008 AAOIFI statement on *sukuk*.

AAOIFI Sukuk *Statement (2008): Raising the Bar for Effective* Shari'a-*Compliance*

The 2008 AAOIFI *Sukuk* statement[30] has been thoroughly discussed in Islamic Finance literature and is well-known. This paper will focus on the AAOIFI *Sukuk* statement's impact on general concepts of *shari'a* in contemporary Islamic finance. From this perspective it is interesting to take a close look at two core aspects of the 2008 AAOIFI *Sukuk* statement: the question of actualization of *shari'a* precepts and the quality of *shari'a*-monitoring with respect to its depth and duration.

Actualization of *shari'a* precepts

The 2008 AAOIFI *Sukuk* ruling set forth detailed requirements pertaining to ownership rights and repurchase values in equity-type *sukuk* structures (i.e., *sukuk al musharaka, sukuk al mudaraba,* etc.). In such structures, according to AAOIFI, *sukuk* holders must fully assume the risks of the

underlying assets in which the *sukuk* certificates represent undivided ownership. The ruling stresses the importance of strict adherence to the requirements of the underlying equity-type structure, be it a *musharaka* or a *mudaraba*. Under these schemes, as per Islamic law requirements, the investment party (i.e., *rabb al mal* and *sharik*) takes a direct equity risk and shall remain invariably exposed to this equity risk over the lifetime of the investment. Therefore, AAOIFI ruled, it shall not be permissible for the *sukuk* issuer to hedge such equity-type *sukuk* holders against the asset price risk by guaranteeing a pre-agreed repurchase value with respect to the underlying asset instead of leaving it to the investors to realize a certain re-sale value at the market conditions upon maturity. In the words of AAOIFI:

> It is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake {now} to re-purchase the assets from *sukuk* holders or from one who holds them, for its nominal is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI *shari'a* Standard (12) on *sharika* (*musharaka*) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI *shari'a* Standard (5) on Guarantees.[31]

Here again, we note the concern to ensure overriding Islamic law requirements beyond the technicalities of structuring fine print and business considerations obviously stemming from conventional finance habits rather than from *shari'a* concepts underlying the transaction.

Depth and duration of *shari'a* monitoring

AAOIFI, in its 2008 *Sukuk* statement, seems to be aware of the importance of effective implementation of *shari'a* rules. Strengthening the rules to be more *shari'a*-compliant in substance is one aspect (and has been outlined above). Another equally important aspect is the existence of appropriate monitoring of an investment from inception until maturity. The duty of any *shari'a* supervisory board involved in a transaction therefore is to "review **all** contracts and documentation related to the actual transaction"—an obligation clearly pertaining to the depth of *shari'a* monitoring—but also to "oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards."[32] The latter is a call for ensuring ongoing and effective monitoring of the investment over its lifetime.

Enhancing substantial *shari'a* compliance instead of merely requiring formal adherence to *shari'a* precepts is a challenge considering the current

status of *shari'a arbitrage*. Requiring effective operational implementation of what has been legally documented, not only upon inception but also over the lifetime of an investment, sets up a new standard in Islamic finance. However, such considerations are crucial if Islamic banking shall be in the position to differentiate itself from conventional finance in the long run.

For the time being, the 2008 AAOIFI statement applies only to *sukuk*. However, given the overriding importance and the weight of the concerns raised, one could interpret this statement as being of larger significance in the standards of *shari'a* compliance in the future.

Recent landmark statements of *shari'a* ruling bodies point toward a new approach in *shari'a* compliance that essentially consists of two aspects. Firstly, there is a need for compliance to *shari'a* precepts in substance (i.e., documentation-wise as well as operationally) rather than only formally. This entails respecting the larger framework of classical *fiqhi* instruments involved in a specific structure (see OIC Resolution 179 (19/5) and 2008 AAOIFI *Sukuk* statement). Secondly, there is a call for enhanced scrutiny in terms of certification and monitoring of *shari'a* precepts for any product or transaction from inception through the entire life of the investment (2008 AAOIFI *Sukuk* statement). The challenge to transform this new approach into practice remains huge.

Apart from more technical issues still to be resolved (we will look into this from a legal draftsperson perspective in the following sections), there remains the problem that there are currently far too few reputable scholars burdened with certifying too many transactions and products. It is unlikely that a small group of people would be able to effectively monitor on an ongoing basis the fast growing universe of *shari'a*-compliant investments. This shortcoming may force increased efforts for the establishment of appropriate *shari'a* compliance mechanisms and human resourcing similar to the organizational framework conventional finance displays in the field of legal and compliance.

Impact of the New Approach on the Permissibility of Current Hedging Techniques

Impact on hedging instruments based on *Tawarruq*

We have seen that current hedging techniques, specifically *shari'a*-compliant derivatives, frequently rely on *tawarruq* transactions enabling the modeling of cash flows upon settlement events. This accounts specifically for Islamic profit-rate swaps (*wa'ad*-based or not) relying on commodity *murabaha* transactions for structuring the cash flows between the parties involved.[33]

As argued above, OIC Resolution 179 (19/5) requires one to stay clear of what is deemed "organized *tawarruq*," since "organized *tawarruq*" transgresses the permitted boundaries of classical *tawarruq*. In this respect, OIC

Resolution 179 (19/5) recalls the requirements of existing *shari'a* standards rather than setting up new requirements. The requirements for classical and thus permissible *tawarruq* are clearly outlined in AAOIFI *shari'a* Standard No. (30). While a number of requirements are to be observed, in the context of current hedging techniques, there are specifically two requirements lacking in what OIC deems "organized *tawarruq*": the lack of real and documented asset transfer and the missing link between *murabaha* transaction and on-sale transaction. Therefore "organized" *tawarruq*, according to OIC, is characterized by a "simultaneous transaction between the financier and the *mustawriq*," resulting in an exchange of financial obligations at the detriment of the Client/*mustawriq* but in favor of the financier—a transaction tantamount to *riba*.[34] OIC considers such a transaction nothing more than a deception.

Henceforth, market participants will have to take AAOIFI *shari'a* Standard No. (30) seriously, specifically in effectively implementing the requirements of real asset transfer between the parties involved (3/1); availability of the identifying documents for the commodity (4/2) and the third-party requirement regarding the on-sale buyer (4/5); ensuring the *mustawriq*'s right to actually obtain the commodity and get it physically delivered (4/6); and the role of the bank as *mustawriq*'s agent in the on-sale transaction (4/9).

As AAOIFI *shari'a* Standard No. (30) considers *tawarruq* as confined to situations of established need, more research and discussions will be needed regarding the permissibility of large-scale *tawarruq*, even if complying with the above transactional requirements. AAOIFI clearly states,"Monetization is not a mode of investment of financing . . ." and cites a concrete situation of such established need, notably that, "the institution should resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients." From this point of view, it would be hard to accept any general consideration stemming from *maslaha* for a large-scale application of *tawarruq* for the use of hedging, as some authors have argued in the past.[35]

The dimensions of *maslaha* are numerous. This topic should be studied more thoroughly than simply using the term and assuming the existence of such public need.[36] Here, practitioners and researchers may benefit immensely from our *shari'a* scholars, who are able to share their wealth of knowledge in order to balance the dilemma between obviously needed *shari'a*-compliant hedging techniques and fundamental *fiqhi* requirements.

In summary, current modes of hedging, as they rely on *tawarruq* schemes, are put to the test by recent landmark statements of OIC and AAOIFI. Specifically the apparent contradiction between an obvious need in the market for flexible and available hedging instruments and the AAOIFI

requirement for a specific (not only general) situation of established need (see AAOIFI *shari'a* Standard No. (30) (5/1)) requires further research by the scholars and by the Islamic finance community. In this context OIC Resolution 179 (19/5) may be seen as an initial, but severe, blow to a practice that has pushed the boundaries of *shari'a* compliance. It also may encourage the development of genuine *shari'a* products for hedging purposes rather than continuing to rely on *shari'a* arbitrage striving to rebuild conventional hedging instruments in a *shari'a*-compliant fashion through the use of highly engineered solutions.

Depth and Duration of Shari'a-*Compliance: Structuring Issues, Legal Documentation and Operational Implementation*

While OIC specifically elaborates on *tawarruq* and therefore the OIC Resolution 179 (19/5) applies only to *tawarruq*-based hedging solutions, the 2008 AAOIFI statement seems at first to apply only to *Sukuk* structures. However, it has been argued above that the rationale of the 2008 AAOIFI statement reflects what has been laid down earlier in terms of AAOIFI *shari'a* Standards and therefore is of larger importance.

It has been argued that regarding the more fundamental aspects of the AAOIFI ruling, we can identify a call for enhanced scrutiny in terms of certification and monitoring of *shari'a* precepts for any product or transaction from inception through the entire life of the investment. Notably the actualization of *shari'a* precepts in a more substance-oriented assessment of overriding *fiqhi* requirements will impact current Islamic hedging solutions. The same applies to the required depth and duration of *shari'a* monitoring.

As an example we may again resort to the commodity *murabaha* in the form of a *tawarruq* transaction, used for settlement purposes in a modern derivative hedging solution. The rationale of the named 2008 AAOIFI ruling will henceforth require the market participants to meticulously comply to what has been laid down in AAOIFI *shari'a* Standard No. (30) in terms of structuring, legal documentation and operational implementation.

AAOIFI has exemplified, in the case of equity-based *sukuk* structures, that the principles of the underlying *fiqhi* instruments (in this case *musharaka, mudaraba,* etc.) are to be observed also when these *fiqhi* instruments are used in another structure (here, a *sukuk* structure). Applying the same rationale, it is evident that regarding *tawarruq*, the requirements must be met not only for AAOIFI *shari'a* Standard No. (30) but also the requirements pertaining to *murabaha* and *murabaha on purchase order*. AAOIFI *shari'a* Standard No. (30) supports this view in (4/1), wherein it states that, "the requirements of the contract for purchasing the commodity on deferred payment basis should be fulfilled, for both *musawama* and *murabaha* transactions, with due

consideration to AAOIFI *shari'a* Standard No. (8) on *murabaha* and on *murabaha on purchase order*." While in practice, *tawarruq* transactions often only fulfill the rudimentary requirements of AAOIFI *shari'a* Standard No. (30), future certifications of such transactions will require the involved *shari'a* boards to take a much closer look into structure, legal documentation and operational execution of any such transaction.

An important challenge emanating from the 2008 AAOIFI statement will be the establishment and resourcing of procedures capable of ensuring a high level of ongoing monitoring over the lifetime of a transaction, enabling the parties to "review **all** contracts and documentation related to the actual transaction" and to "oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards."

Such approach significantly increases the burden on players in the international Islamic financial markets to care about in-depth *shari'a*-compliance, in terms of structuring efforts, legal documentation and their execution in the operational workflow. Given the scope if this paper, the focus will be on the second aspect: the implementation of the above findings and requirements in terms of legal documentation.

Implementation of the New Approach in Legal Practice

Choice of governing law

Practice shows that a majority of international financial market transactions, be them *shari'a*-compliant or conventional, are governed by English law. It is difficult to choose *shari'a* as the governing law of a contract or as an additional source regarding the interpretation of a contract. In conventional and Islamic financial markets, players tend to prefer the English law as the governing law. The acceptance of any local law, e.g., Saudi law or Kuwaiti law, will not satisfy the legal advisors of the transacting parties due to insecurities about what could happen in case of serious litigation on the matter. The expertise of international law practitioners along with the relative reliability of English courts contribute to the preference of using English law for Islamic transactions. International conventional banks featuring an Islamic window operate under English law, as most of them are even headquartered in London.

When documenting an Islamic transaction under English law, it is crucial to remember the basic considerations pertaining to *shari'a.* The most prominent feature in this regard is the recommendation not to include *shari'a* in the governing law clause. English courts have issued several landmark rulings in this respect. One of the most prominent is the case of *Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltd.*[37] In this case,

despite the parties stipulating in the respective governing law clause that the agreement would be "subject to the principles of the *shari'a,*" the Court of Appeals declared such choice of law invalid and held that:

> the general reference in the clauses to principles of the *shari'a* afforded no reference to, or identification of, those aspects of *shari'a* law which were intended to be incorporated into the contract and stood unqualified as a reference to the body of *shari'a* law generally, which was repugnant to the choice of English law as the law of the contract and rendered the contract self-contradictory and meaningless; that the references to *shari'a* law were intended merely to reflect the Islamic religious principles according to which the bank held itself out as doing business and were inadequate to incorporate the principles of *shari'a* law, or any part of *shari'a* law, into the agreements; that, therefore, the validity of the agreements and the defendant's obligations thereunder were to be decided according to English law.[38]

In legal documentation, parties will often prefer English law, even in a transaction that is *shari'a*-compliant, without any additional mentioning of *shari'a* as choice of law, provided the parties intend to stick to an English forum.

Operationally, there is an additional reason why, with respect to the above-discussed commodity *murabaha* transactions/*tawarruq* transactions, the practice of choosing English law appears appropriate. According to market practice, the commodities trades underlying such transactions are executed at the London Metal Stock Exchange (LME).

Besides its location in a well-functioning jurisdiction, this exchange offers various advantages for transaction-intensive, *shari'a*-compliant structures. Firstly, LME commodities are fully *shari'a*-compliant even for trading under a deferred-payment scenario. In short, LME traded commodities do not fall into the category of *ribawi* goods. Goods considered *ribawi* (e.g., gold) would not be admissible for a deferred payment structure such as *murabaha*. A sale on *ribawi* goods would be considered a form of *riba al nasi'a*. A second reason for such preference is the fact that LME trades are tax-neutral since the commodities are stored in bonded warehouses outside the European Union. This avoids triggering EU taxes on sale transactions.

For market practice, operational reasons and requirements emanating from recent landmark judgments, English law appears an appropriate choice of law. Even though *shari'a* is at the core of any Islamic finance transaction, it will preferably be expressed through the structure and the parties' rights and obligations in the body of the agreement.

Accurate Documentation of Shari'a-specific Transactional Requirements
Regarding the discussed commodity *murabaha/ tawarruq* transactions, AAOIFI *shari'a* Standard No. (30) (4/6) provides a practical example of concrete practical relevance:

> The contract for purchasing the commodity on deferred payment basis, and the contract for selling it for a spot price should not be linked together in such a way that the client looses his right to receive the commodity. Such linking of the two contracts is prohibited whether it is made through stipulation in the documents, acceptance as a normal tradition, or incorporation in the procedures.

From a legal draftsperson's point of view the problem lies in contradicting requirements from a *shari'a* perspective on the one hand and the financial institution's risk considerations on the other hand. Whereas *shari'a* obviously requires the draftsperson to clearly stipulate the client's right to effectively receive the commodity upon request, any financial institution involved in such transaction would prefer not to be exposed to a client's potential request of physical delivery. Firstly, this is because physical delivery may be operationally cumbersome and thus beyond pricing considerations on which a specific transaction was based. Secondly, the brokers involved, though specialized in facilitating the implementation of commodity *murabaha* transactions, may not necessarily be experts in international commodity shipping and delivery.

The above operational considerations show that there are numerous implications to be taken into account when drafting a specific transaction agreement. Eventually, such considerations cannot blur the goal of obtaining a set of documents in line with precise *shari'a* requirements, here AAOIFI *shari'a* Standard No. (30) (4/6). Similar considerations will guide a legal draftsperson in the implementation of other requirements of AAOIFI *shari'a* Standard No. (30), which would be beyond the scope of this paper.

The precise documentation of all operational requirements is vital to ensure full *shari'a* compliance. A general reference of submitting an agreement to the "principles of *shari'a*," as in the case of *Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltc.*, will not replace such detailed drafting. It will essentially be the role of the involved *shari'a* boards to effectively monitor the requirements and ask for their strict implementation, a point that will be expanded upon later.

The Investment's Use for Hedging or Speculation: A Case for Niyyah (Intention)
Despite the *shari'a* ban on speculation and excessive risk taking, notably by reason of contravening the prescriptions of *gharar*, *qimar* and *maysar*, the

case of derivatives, conventional and *shari'a*-compliant, shows that their markets rely heavily on participants aiming solely on speculation. This is supported already by the fact that without a majority of speculators in derivatives markets, these markets would lack essential liquidity. Technically, as derivatives always entail win-lose distribution of pay-offs between the parties involved in a specific transaction, and given the rarity of fully complementary hedging needs, the equation of "hedging party" vs. "speculating party" appears to remain a cornerstone of the vast majority of hedging transactions in the market.

As argued earlier in this paper, it does not seem possible to apply an objective measure or a mathematical formula to distinguish between a financial transaction's purpose for hedging or for speculation. However, in the interest of material *shari'a*-compliance one cannot suggest that transacting for addressing "genuine hedging"[39] shall be allowed, without elaborating further on how such 'genuine hedging' could be identified. It has been argued that, in the absence of an objective measure pertaining to the distinction of hedging from speculation, the essential difference could validly be established by taking into account the parties' intention (*niyyah*).

Intention in *shari'a* is a prominent concept in the field of *'ibadat* (rules pertaining to worship and ritual matters) as well as in the field of *mu'amalat* (rules pertaining to social and economic matters including trade). In the field of Islamic contract law, there are several concepts of intent, and a thorough discussion would be beyond the scope and focus of this paper.[40] The goal of this paper is not to re-assess *fiqhi* theory regarding the formation of commercial contracts and the role of intent in this framework. The goal is much more practical: to find, from a draftsperson perspective under English law, a practical proposition on how to document a party's intention to enter into a transaction for hedging purposes rather than for speculation.

Several considerations must be observed in such legal drafting: no party can validly assess nor guarantee a counterparty's intention to enter into a transaction for speculation or for hedging purposes; in the case of fraudulent or deliberately untrue statements it will not affect the validity of the contract but rather trigger the obligation upon the misrepresenting party to purify amounts obtained from such speculative activity.

In a contractual framework under English law, such commitment most suitably would be inserted in the representations and warranties section and could be worded as follows:

> The Client represents and warrants to the Bank that it has entered into this Agreement and any other documentation relating to this Agreement to which it is a party solely with the intention of hedging in compliance with *shari'a* principles.

> The Client confirms to the Bank that it will monitor the existence of such hedging purpose over the lifetime of this Agreement. Further, the Client commits to purify amounts obtained from any speculative purpose in the framework if this Agreement as being advised upon by the Client's *shari'a* supervisory board.

This clause being drafted as self-commitment of the Client will not be invocable by the Bank and thus will only work in the direction of ensuring enhanced *shari'a* compliance without granting a right to the counterparty to assess any misrepresentation in this respect or raise an objection on these grounds.

Obviously, such stipulation will work perfectly in the case of two counterparties displaying complementary hedging needs. In case such complementary hedging needs do not exist, such drafting could result in a party deliberately lying about their intention—without any effect. Admittedly this is an inherent drawback of self-committing clauses, their non-invocability by a third party, i.e., by any counterparty to a transaction. However, also a mere self-commitment is likely to put pressure on the parties engaged in a hedging transaction. Therefore, the respective parties' *shari'a* board's work is crucial in guaranteeing effective adherence to *shari'a* principles.

The Role of Shari'a *Boards*

AAOIFI in its 2008 *Sukuk* statement is very clear about depth and duration of certification and monitoring tasks to be accomplished by a *shari'a* board of a financial institution. In contrast, AAOIFI defines the scope of work for its own *shari'a* board as follows:

(1) Achieving harmonization and convergence in the concepts and application among the *shari'a* supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the *fatwas* and applications by these institutions, thereby providing a pro-active role for the *shari'a* supervisory boards of Islamic financial institutions and central banks.

(2) Helping in the development of *shari'a* approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.

(3) Examining any inquiries referred to the *shari'a* board from Islamic financial institutions or from their *shari'a* supervisory boards, either to give the *shari'a* opinion in matters requiring collective *ijtihad* (reasoning), or to settle divergent points of view, or to act as an arbitrator.

(4) Reviewing the standards that AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic *shari'a*.[41]

Obviously, the scope of required monitoring is dependent on the activities of an organization. To date there is no binding description available of which tasks a *shari'a* board must assume, nor which *madhhab* it has to follow. However, AAOIFI, as one of the most prominent standardization organizations in Islamic finance, certainly is a voice to be heard in the international financial markets. AAOIFI took the stance to require that the *shari'a* board of a financial institution ensure ongoing and in-depth monitoring and full review of transactions and product documentation in order to safeguard the adherence to *shari'a* in form and substance:

> *Shari'a* supervisory boards must not consider their responsibility to be over when they issue a fatwa on the structure of *sukuk*. Rather, they must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards, and that the investment of *sukuk* proceeds and what those proceeds are converted to takes place in accordance with one [or another] of the approved *shari'a* methods of investment as stated in *shari'a* Standard (17) on the subject of Investment *Sukuk*, Article (5/1/8/5).[42]

The required depth and duration of certification and monitoring reflects the current status of Islamic finance where, on the one hand, standardization already exists in the form of acknowledged standards (e.g., the AAOIFI *shari'a* Standards), but where, on the other hand, an internationally accepted *shari'a* judiciary is beyond imagination.

In the absence of comprehensive standardization and in view of the absence of an internationally accepted *shari'a* judiciary, the *shari'a* boards still benefit from a significant amount of discretion. Moreover, the lack of an internationally accepted *shari'a* judiciary means that the parties of the transaction and the respective *shari'a* boards involved are the ones who must assess whether a transaction, its documentation and its operational implementation satisfy *shari'a* requirements over its entire lifetime.

Certainly the burden of AAOIFI's *Sukuk* statement is huge, considering the already immense workload of *shari'a* boards of international financial institutions. Adding the duty of in-depth monitoring to the task of thorough

assessment upon certification may not be practical without putting in place appropriate mechanisms of *shari'a* compliance similar to what exists in conventional finance under the terms of Legal and Compliance. The standards are there but human resourcing and appropriate procedures must be conceptualized and implemented so that the practice does not return to the way it was before the February 2008 AAOIFI statement. In this context, *shari'a* boards of counterparties in a financial transaction may also benefit from one another in receiving each other's input on the *shari'a*-compliance of a certain structure. Transacting parties and their *shari'a* boards should take their tasks seriously and thoroughly scrutinize the documents, flow charts, test trades, fatwas, etc., presented to them. The fact that under current Islamic finance transactions the obligation of in-depth *shari'a*-compliance will be more of a self-binding representation rather than a warranty by the counterparty (see above) shall not lead the parties to refrain from scrutinizing the transactions into which they intend to venture.

Particularly with respect to the current, ongoing crisis, the players involved must be familiar with all details of a transaction, including the structure and its legal and economic implications, to avoid the legal and economic disasters that befell the conventional finance market.

Conclusion

Natural hedges and risk pooling arrangements, though preferable over a stricter *shari'a* perspective, do not seem to fit the purposes of most players in international financial markets. Therefore, more flexible solutions in the form of risk-shifting arrangements have been recently developed. These heavily engineered financial solutions use classical *fiqhi* contracts and instruments (i.e., *arbun, bay' al-salam*, *khiyar ash-shart* or *wa'ad*). These solutions in their very nature serve genuine hedging needs and speculation alike; it has been argued that in the absence of a mathematical formula a legal draftsperson has to resort to the parties' intention (*niyyah*).[43]

From a *shari'a* perspective, such engineered solutions are further put under scrutiny as they help circumvent general *shari'a* principles (*gharar, maysar,* etc.) and aheavily rely on commodity *murabaha/tawarruq* transactions for modeling the payment streams upon maturity. Recent landmark statements by *shari'a* standard setting bodies have tackled these issues, notably the April 2009 *OIC Fiqh Academy* Resolution 179 (19/5) and the February 2008 AAOIFI *Sukuk* Statement. These statements can be interpreted as a new approach on *shari'a*-compliance, notably by calling for documentation-wise and operational implementation of *shari'a* precepts in substance rather than only formally, in line with the *maqasid al shari'a,* as

well as enhanced scrutiny in terms of certification and monitoring of *shari'a* over the entire life of an investment.

The transfer of the above findings in the process of legal documentation is, as far as current international financial market transactions are concerned, largely a matter of English law due to its customary use in such transactions and trading practice in the underlying commodity trades. In terms of governing law, recourse to the principles of the *shari'a* appears not to be a viable choice in an English forum due to applicable case law (e.g., Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltd., 2004). Instead, transactional *shari'a* requirements have to be interwoven in the fine print of the documentation wherever necessary in order to ensure *shari'a*-compliance in substance.

With respect to *murabaha/tawarruq* transactions occurring under engineered risk-shifting arrangements, the strict observance of OIC and AAOIFI *shari'a* Standards, notably AAOIFI *shari'a* Standard No. (30), must be ensured in its various aspects (e.g., real asset transfer, operational requirements, de-linking of contracts). Other parameters still may need further discussion (e.g., regarding the exceptionality of *tawarruq* transactions according to AAOIFI *shari'a* Standard No. (30) (5/1)). Regarding the equation of speculation and hedging, and in the absence of a objective measure, a legal draftsperson may resort to the parties' intentions (*niyyah*) by inserting appropriate legal language in the representations and warranties, as suggested further above. Given the early stage of drafting hedging arrangements under *shari'a*, this suggestion is a mere proposal. Eventually, the wording and use of such clauses may and will evolve before a market practice will be established.

Legal documentation is always bound by its subject matter. Documenting a party's intention presents the challenge of legally documenting what is ultimately beyond control from the draftsperson's perspective (and any counterparty's perspective to a transaction). For this reason the *shari'a* supervisory boards will henceforth play an even more vital role in ensuring that a transaction and the institutions involved comply to *shari'a* requirements.

The recently cited statements of leading *shari'a* standard setting bodies put a double burden on the *shari'a* supervisory boards: first, the obligation of scrutinizing a transaction thoroughly according to the full set of legal and transactional documents as well as per its effective implementation over the entire life of the investment; secondly, the obligation to apply the same level of scrutiny to the institution supervised and its economic goals pursued—some sort of *shari'a* self-regulation or permanent *shari'a* self-control. Such self-regulation may rely on approved standards. Recent landmark

statements have greatly impacted the question of how to align market practice with core *shari'a* principles and have proven that standardization is already a reality. What is lacking is strict implementation in substance rather than in mere form and the means and procedures to thoroughly accomplish this task.

Until *shari'a c*ompliance procedures are implemented in order to take the immense workload off *shari'a* supervisory boards, markets are likely to receive reminders by *shari'a* standard setting bodies to what has been laid down as their benchmark. Likewise, until such *shari'a c*ompliance procedures are common practice, a legal draftsperson will have to do piecemeal work in order to ensure in-depth transactional *shari'a* compliance through the fine print of the transaction documents.

An effective documentary distinction between speculation and hedging entails a commitment by the parties to uphold the goals of *shari'a* and to refrain from pursuing what has—for valid reasons in light of the current crisis—been discussed.

Endnotes

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Part III:
Social Responsibility

Empowering CSR, SRI and SE in Islamic Finance

Mohamad Akram Laldin

Introduction

The financial crisis of 2008 affected lives across the globe, and showed that reexamination of current practices is essential. The crisis highlighted the dangers resulting from excessive leveraging, involvement in speculative and risky financial instruments, and lack of due diligence before undertaking business activity. These concerns, in turn, point to underlying issues within the financial sector: the lack of transparency and ethics, the risk of moral hazard in financial practices and the lack of social responsibility and governance in the management of financial institutions. All of these concerns were further exacerbated by shortfalls in governmental supervision.[1]

However, Islamic finance, which has only experienced rapid development during the last 30 years, was able to avoid the full impact of the recent financial crisis, although it did experience lesser effects. This is in part because Islamic finance operates on the basis of *shari'a* principles, which prohibit interest-based transactions and speculative activities.[2] The assets of the top 500 Islamic banks expanded 28.6 percent to a total of US$822 billion by year-end 2009, with bright prospects for future growth.[3] However, the current practices of Islamic finance are not devoid of criticism; the proponents of Islamic economics and many *shari'a* scholars have proposed that Islamic finance should also serve more socio-economic goals, which are another part of the true objectives of Islamic financial institutions, and are among the expectations of their various stakeholders.[4] Therefore, the current practices of Islamic finance can be further improved and strengthened by empowering the noble and virtuous concepts of Corporate Social Responsibility (CSR), Socially Responsible Investment (SRI) and Social Entrepreneurship (SE), as long as they are in line with *shari'a* principles. This will assist Islamic financial institutions to meet their true objectives and their stakeholders' expectations, as well as maximizing the institutions' benefit to society.

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This paper will discuss how the three concepts of CSR, SRI and SE can be implemented in Islamic finance. The paper will begin by outlining the concepts of CSR, SRI and SE from various Western perspectives, followed by a discussion of such parallel concepts and practices in Islam. Then the paper will explore these concepts within the *maqasid* paradigm and, finally, discuss the opportunities and challenges in applying them to the current domain of Islamic finance.

The Western Perspective on CSR, SRI and SE

CSR, SRI and SE are concepts that are targeted at addressing the continual discontent among the business community with the self-interest and self-indulgence that seem to underpin the Western economic worldview.[5] This discontent has been exacerbated in part by an increasing number of business scandals involving fraud, breaches of trust, misrepresentation and other forms of unethical behavior on the part of large corporations such as Barings, Enron, Arthur Anderson, WorldCom and a number of others.[6] In addition, unethical investment has also led to calls for the reexamination of how businesses and investments are conducted. These concepts have also started to figure prominently in public debate regarding social problems such as poverty, unemployment, pollution, and racial, gender-based and religious discrimination.

Corporate Social Responsibility (CSR)

CSR does not have a unified definition, but the European Commission defines it as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis."[7] Thus, CSR can be defined as corporate activities beyond profit generation, and it may involve protecting the environment, conducting business in an ethical manner and making other significant contributions to society.

CSR requires an institution to be responsible to its stakeholders and address all their interests.[8]Those stakeholders comprise internal and external stakeholders: employees and customers, competitors, public authorities, the communities in which the firm operates and others who could be directly or indirectly affected by the institution's actions. CSR also represents a built-in governance framework that guides the corporation to realize social good and sustainable development. However, subscription to and implementation of CSR is voluntary unless it is part of the corporation's policy or law. CSR requires the corporation to balance the financial and social values of its activities.

Although CSR has its own proponents, it is not without opposition.[9] Some critics point out that CSR may be misused to disguise a corporation's

real activities in order to gain public support.[10] Other opponents consider CSR contrary to the purpose of a business corporation—generating profit—and this would make it, in their view, an unlawful use of shareholders' resources. Moreover, the legal definition of a corporation does not entail obligation toward society; only obligations toward its shareholders and the laws of the government.[11] Thus, getting corporations engaged in sustainable development may not be possible.

On the other hand, the proponents of CSR argue that a corporation is responsible to society and therefore has to be socially responsible and accountable for all its actions.[12] They also argue that CSR does not deny the corporation's prime objective of generating profit, but requires the corporation to be responsible in doing so.

Full implementation of CSR programs entails reform in a corporation's human capital management, investment options, corporate governance, business practices and other activities to ensure that the interest of its stakeholders continues to be safeguarded as well. For instance, regarding human capital management, the corporation must commit itself to a better and safer workplace, fair treatment of workers, provision of enhancement training, etc.

Despite wide global acceptance of CSR, its adoption differs from place to place, since local conditions and authority support differ; therefore, its implementation must overcome or accommodate local problems and issues.[13]

Socially Responsible Investment (SRI)

SRI is an investment strategy that makes social good the main consideration in undertaking investments; it is, in part, the incorporation of CSR in investment decisions. There is no single definition for SRI, but it is generally understood to be the practice of incorporating social, ethical and environmental (SEE) factors in investment decisions. Thus, investors who subscribe to SRI would not participate in any investments deemed harmful to society. From the *shari'a* perspective, that would include investments in production or processing of tobacco, unauthorized weapons, military projects and other activities that directly or indirectly injure the society, including development projects that degrade the environment and factories that produce ozone-depleting chemicals.[14]

SRI initiatives are growing in number and are being promoted by various religious and ethical groups and individual investors. Previously, SRI was limited to select religious groups who aimed at achieving certain social goals or complying with and promoting their religious beliefs. SRI is now becoming more widespread as it is regarded as an initiative that supports CSR and general ethical concerns. Current SRI initiatives include thematic

screening, community or cause-based investing and promoting SRI to shareholders. Regulators of companies conduct screening in order to determine the companies whose stocks are worthy of investment due to the company's involvement in positive business and sustainable development. Various indexes have been developed to meet specific SRI criteria, such as the Dow Jones Sustainability Index, Domini 400 Social Index, Corporate Responsibility Index, FTSE4Good Index, and others. Many studies have been done on the performance of ethical investment portfolios, and the findings show that the return of SRI investment portfolios is competitive with other socially neutral portfolios.[15]

Social Entrepreneurship (SE)

SE is a great initiative to bring social good to society and solve real social and economic problems. There is no unified definition for SE, but it is normally defined as the work of a social entrepreneur who acts as an agent of social change by transforming a problem into an opportunity. Martin, Roger and Osberg characterized social entrepreneurship as having "the following three components: (1) identifying a stable but inherently unjust equilibrium that causes the exclusion, marginalization, or suffering of a segment of humanity that lacks the financial means or political clout to achieve any transformative benefit on its own; (2) identifying an opportunity in this unjust equilibrium, developing a social value proposition, and bringing to bear inspiration, creativity, direct action, courage, and fortitude, thereby challenging the stable state's hegemony; and (3) forging a new, stable equilibrium that releases trapped potential or alleviates the suffering of the targeted group and, through imitation or the creation of a stable ecosystem around the new equilibrium, ensures a better future for the targeted group and even society at large."[16] Individuals or enterprises that utilize effort, talent, creativity and nominal capital to reform the society via entrepreneurial principles and tools are good examples of the empowerment potential of SE. For instance, the Grameen Bank microfinance facility does not merely provide a financial facility but also guides its clients in financial matters, maximizing the social good. Thus, it has assisted its clients and given them tools to better their living conditions.[17]

There are many SE initiatives throughout history, but they are outnumbered by the vast number of socio-economic problems that exist in the world. In addition, SE requires endless commitment and action before its fruits become evident. It requires the social entrepreneur to identify the core of the problem, come up with ways to solve it, monitor the process, as well as support the clients, without hoping for a huge short-term return on all the capital, energy and time invested. The main aim is to make a positive impact on society, especially with regards to improving living conditions.

All of these concepts bring good to the society through economic instruments. CSR requires business corporations to strike a balance between business and social benefits, and it acts as a check and balance for the corporation's stakeholders. SRI, on the other hand, provides investors with criteria of social good to guide their investment options, while SE mobilizes the investment of an individual's or a group's capital, energy, time and talents in order to maximize social good. Although various challenges remain, these concepts remain promising. Many parties, individuals and corporate bodies have committed to these initiatives, leading to a larger impact in society.

It should be clear that these strategies depend upon the willingness and initiative of individuals and corporations. This willingness is dependent upon conviction, conscience and a sense of responsibility to the society. They are all voluntary in nature unless made mandatory through legal and regulatory mechanisms.

CSR, SRI and SE from an Islamic Perspective

Having understood the noble concepts of CSR, SRI and SE from various Western perspectives, it is pertinent to understand the Islamic position on such concepts and recognize parallel concepts and applications in the *shari'a*. The following discussion will examine the parallels between concepts in the *shari'a* and the concepts of CSR, SRI and SE discussed earlier.

Corporate Social Responsibility (CSR)

The concept of CSR is not alien to Islam, as numerous Islamic principles support its implementation and achievement. However, it is considered as part and parcel of the human role of *khalifah* (vicegerent) and servant of God, whereby humans are charged with the duty of managing the earth and its inhabitants according to the rules of God (*shari'a*). *Shari'a* entails human compliance to the Islamic system of belief, morality and dealings, which all support CSR principles and permissible initiatives. Thus, the Islamic view on CSR is more comprehensive and holistic, since Islam encourages humankind to pursue worldly gains and social good as well as rewards from God, namely success in the worldly life and the hereafter.

The Shari'a *Basis Of CSR*

Broadly speaking, in Islam CSR is closely related to the concept of *tawhid* (Unity of God), from which the important concepts of vicegerency (*khilafah*) and justice or equilibrium (*al-'adl wal ihsan*) are derived. The Quran[18] emphasizes this when it says:

> Those who remember God standing, sitting and lying down, who reflect deeply on the creation of the heavens and the earth, (saying):

> 'Our Lord! You have not created (all) this without purpose You are far above that! so protect us from the torment of the Fire.' (3:191)

The above verse provides a fundamental principle of responsibility and governance, implying that everything created by God has a purpose, and that human beings are created to be the world's vicegerents (*khalifah*). The concept of *khalifah* is stated in the Quranic verse that says:

> And (remember) when your Lord said to the angels: 'Verily, I am going to place *khalifah* (vicegerent) on earth.' (2:30)

Having entrusted humankind as vicegerent, God constantly monitors and is involved in human affairs, and He is aware of everything at all times. In addition, this divine monitoring system will act as the check and balance to ensure that every human being is discharging his or her duties as prescribed by God.

In another verse God emphasis the important of doing good, which is part of the CSR. He in effect says:

> So whosoever does good equal to the weight of an atom shall see it. (99:7)

The principle of *tawhid* makes it clear that God knows everything and that all mankind is answerable to Him and required to do good; this principle is the foundation of the CSR model in Islam. In addition to the above verses, many other verses have a direct or indirect relationship with the issue of CSR. Among them:

> And help one another in goodness and piety . . . (5:2)

> O you believers! Do not betray God and the Messenger, or knowingly betray your trusts. (8:27)

> O you who believe! Fulfill [your] obligations. (5:1)

Essential Ingredients of Corporate Governance

Broadly speaking and as defined above, CSR is closely related to corporate governance, a concept that was developed as a result of increasing awareness of the importance of protecting the rights of all stakeholders, including minority shareholders. There are four essential ingredients of corporate governance: transparency, accountability, disclosure and fairness.[19] None of these four ingredients are new to Islam, as they are articulated either in the Quran, the Sunna or in principles embedded in Islamic law.

Transparency means timely and accurate disclosure on all material matters, such as financial situation, performance and ownership. The Quran

has explained at length the importance of transparency in carrying out a transaction. For instance, verses 282 and 283 of *Surah al-Baqarah* detail a step-by-step process to be undertaken when carrying out a transaction involving debt:

> O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. No scribe should refuse to write: let him write as God has taught him. Let the debtor dictate, and let him fear God, his Lord, and not diminish anything of what he owes. But if the debtor is of poor understanding, or weak, or is unable himself to dictate, then let his guardian dictate in justice. And get two witnesses from among your own men. And if there are not two men (available), then a man and two women, such as you agree for witnesses, so that if one of (the two women) errs, the other can remind her. And the witnesses should not refuse when they are called on (for evidence). Do not disdain to write the debt down, whether it be small or big, for its fixed term: that is more equitable in God's sight, more reliable as evidence, and more convenient to prevent doubts among yourselves. But if the merchandise is present and you hand it over, then there is no sin on you if you do not write it down. But take witnesses whenever you make a commercial contract. Let neither scribe nor witness suffer any harm, but if you do (such harm), it would be a crime on your part. Be mindful of God, and He will teach you. And God is the All-Knower of each and everything.
>
> And if you are on a journey and cannot find a scribe, something should be handed over as security, but if one of you entrusts the other, let the one who is entrusted discharge his trust (faithfully), and let him be mindful of God, his Lord. Do not conceal evidence: whoever does so has a sinful heart. And God is All-Knower of what you do. (2:282–3)

The passage above highlights the importance of proper recordkeeping in debt transactions, so that no party involved suffers injustice. The message of these verses can be extended by analogy to all other transactions and generalized as a management ethic: the principle of transparency and disclosure in an organization shall not be compromised.[20]

The second ingredient of corporate governance is accountability, which means ensuring that management is accountable to the board and the board is accountable to shareholders. When discussing the basis of corporate governance, the verses cited above are sufficient to address the importance of accountability in Islamic teachings. In addition, Prophet Muhammad was

reported in one *hadith* to have said, "Each one of you is a guardian, and each guardian is accountable for everything under his care."[21]

In the contemporary context, this tradition implies that all persons involved in an organization are indeed accountable for all their actions. The level and scope of accountability are determined by the respective organizational chart.

As for the third ingredient—disclosure—the rules of contracts in Islam emphasize the importance of full disclosure by the contracting parties. One of the pillars of the contract in Islam is the existence of the subject matter of the contract, and a condition for the subject matter is that the contracting parties must know all the details related to it. For instance, if a person is entering into a sales transaction, the contracting parties must know the object of sale and all its particulars or the contract may be void. This requirement is clear evidence of disclosure as a necessity of Islamic financial transactions. This ingredient can also be extended to organizational management. At an organizational level, all dealings must be disclosed in detail to the relevant authority, such as the board of directors or regulators. The absence of such practice can be considered a violation of *shari'a* requirements and as such is considered a sin.

The last ingredient is fairness, which is inclusive of the protection of shareholders' rights, treating all shareholders including minorities equitably, and providing effective redress for violations. In this respect, the Quran clearly emphasizes the principles of fairness and justice, even against one's enemy, when it says:

> O you who believe! Stand out firmly for God and be just witnesses, and let not the enmity and hatred of others make you avoid justice. Be just: that is nearer to piety, and fear God. Verily, God is Well Acquainted with what you do. (5:8)

Thus, a balance must be established between financial profit and public good. The responsibility to promote and implement CSR is not merely a responsibility to society; it is, in fact, a fundamental *shari'a* obligation.[22] Therefore, the responsibility to promote and apply CSR is not discretionary but, to a certain degree, *compulsory*, so long as the CSR principles are in line with the *shari'a*. The *taqwa* (God-consciousness) paradigm will motivate prioritization of social good and prevention of harm, even if financial gains need to be compromised.[23]

The currently instituted *shari'a* advisory and supervisory bodies should play the role of promoting CSR application in the Islamic finance industry (IFI). Members ought to focus not only on meeting *shari'a* legal requirements but also on upholding the noble values and objectives of *shari'a*, such

as those invested in CSR concepts. Only then can it be said that an act or policy is fully *shari'a* compliant. Thus, the *shari'a* board should have a wider *shari'a* governance function in the IFI.

Support for CSR implementation in Islamic finance is evident in AAOIFI's newly introduced Governance Standard on Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions, which imposes the implementation of CSR and the duty of disclosure on Islamic financial institutions and provides various guidelines for the implementation mechanism.[24] The guideline prescribes mandatory and recommended actions that are to be undertaken by financial institutions in relation to policies on CSR and their disclosure. The mandatory actions for financial institutions include installing, implementing and disclosing policies for screening clients, policies for responsible dealings with clients, policies on earnings and expenditures prohibited by *shari'a*, policies on employee welfare and policies on *zakat*. The recommended actions include installing, implementing and disclosing policies for *qard hasan* (benevolent loan), policies for reduction of adverse impact on the environment, policies on investment quotas based on social, developmental and environmental criteria, policies on par excellence customer service, policies for micro and small business and social savings and investments, policies for charitable activities and policies for *waqf* management.

The call for CSR implementation is also supported by the survey conducted by Dar Al Istithmar and Dinar Standard with the support of AAOIFI on application of CSR by Islamic financial institutions. The survey shows that IFIs have made some efforts and display a certain amount of commitment to realizing CSR, although there is great room for further improvement.[25] Among the key findings of the survey were that all respondents (Islamic financial institutions) affirm having a policy to screen prospective clients. Most of them also affirm having an organizational policy that deals with client responsibility. Most respondents similarly affirm having policies on various aspects of employee welfare. A majority of institutions also have policies for charitable activities. However, only 55 percent of all respondents affirm having some policy for investment quotas on social, developmental and environmentally orientated investments, with environmental investment quotas receiving the least attention. Lastly, it was found that not many respondents have a policy to manage *waqf* properties and *zakat* on behalf of their clients.

Socially Responsible Investment (SRI)

The concept of SRI is actually an integral part of Islamic economics, which is based on the principle that wealth is an *amanah* (trust) from God and as such it has to be managed according to the guiding principles provided by

the Quran and *Sunna*. Islam emphasizes fair distribution of wealth, achievement of social justice and welfare-enhancing activities. SRI initiatives such as thematic investment, shareholders' advocacy and community investment are not contrary to *shari'a*; they are considered noble acts that assist in shared prosperity and the practice of socially responsible finance.

Various *shari'a* texts support encouragement to perform SRI in order to achieve social welfare and fair distribution of wealth. The Quran states:

> Whatever gains God turned over to His Messenger from the people of the townships belong to God, to the Messenger, and to kindred, orphans, the needy and the traveler in need this is so that they do not just circulate among those of you who are rich . . . (59:7)

> God commands justice, the doing of good, and generosity toward relatives, and He forbids what is shameful, blameworthy and oppressive. He instructs you so that you take heed. (16:90)

> Give relatives their due, and the needy, and travelers; do not, squander your wealth wastefully. (17:26)

Prophet Muhammad also said:

> None of you truly believes until he likes for his brother what he likes for himself.[26]

> You see the believers in their mutual mercy, love and kindness resembling one body; if any part of the body is not well then the whole body shares with it in sleeplessness and fever.[27]

As for the duty of ensuring that wealth is invested in a manner compliant with *shari'a* requirements, stocks are subjected to a screening process to determine whether or not the activities of a company comply with *shari'a* requirements. In the current practice of Islamic finance, stocks and companies' activities have to undergo strict screening before they are endorsed for a *shari'a*-compliant investment portfolio. The screening requires prospective investment avenues to pass the religious, social and moral filters; thus, it is stricter than the requirements placed under generic SRI.[28]

The following are examples of the necessary steps before a stock is approved as *shari'a* compliant:

Dow Jones Islamic Market Indexes Screening Process[29]

DJIM's screening process involves two stages:

1. *Screens for Acceptable Business Activities*

In this stage, companies whose primary activities are impermissible shall be excluded from the index. Among those activities are conventional financial

services (banking, insurance, etc.), the production or sale of alcohol, pork-related products, entertainment (hotels, casinos or gambling, cinema, pornography, music, etc.), arms, defense, tobacco and any other activity discouraged under Islam.

2. *Screens for Acceptable Financial Ratio*
After eliminating companies that profit from unacceptable business activities, Dow Jones Indexes evaluates remaining companies using several financial screens, or ratios. These ratios are established by the *Shari'a* Board to exclude companies that have unacceptable levels of debt or earn impure interest income.

According to the financial ratios, each of the following amounts must be less than 33 percent:

- Total debt divided by trailing 24-month average market capitalization
- The sum of a company's cash and interest-bearing securities divided by trailing 24-month average market capitalization
- Accounts receivables divided by trailing 24-month average market capitalization

Companies that pass these screenings are included in the Dow Jones Islamic Market Index Universe.

The Malaysian Screening Methodology[30]
The Securities Commission of Malaysia applied standard criteria to the activities of the companies listed on Bursa Malaysia. Subject to certain conditions, companies whose activities are not contrary to *shari'a* principles are classified as *shari'a* compliant. On the other hand, companies are classified as *shari'a* noncompliant if they are involved in the following core activities:

a. Financial services based on *riba* (interest);
b. Gambling and gaming;
c. Manufacture or sale of non-*halal* products or related products;
d. Conventional insurance;
e. Entertainment activities that are impermissible according to *shari'a*;
f. Manufacture or sale of tobacco-based products or related products;
g. Stock broking or share trading in *shari'a*-noncompliant securities; and
h. Other activities deemed impermissible according to *shari'a*.

The screening process also takes into account the amount of interest income received by the company from conventional fixed deposits or other interest-bearing financial instruments. In addition, dividends received from

investment in *shari'a*-noncompliant securities are also considered in the analysis. The percentage of noncompliant activities contributing to the company will be analyzed against the following benchmarks:

1. Five percent for clearly prohibited income, e.g., *riba*-based companies, gambling, liquor and pork;
2. Ten percent for prohibited elements that affect most people and are difficult to avoid, e.g., tobacco-related activities;
3. Twenty-five percent for the generally permissible elements that still involve non-*halal* that are not easily identifiable, e.g., hotels, resorts, share trading and stock broking.

If the company's involvement or its contributions from these activities supersedes the above benchmarks, the stock of the company shall not be considered *shari'a* compliant.

For companies with activities comprising both permissible and impermissible elements, two additional criteria are considered:

a. The public perception or image of the company must be good; and
b. The core activities of the company should be important and beneficial to the nation and the country, while the impermissible elements are a very small proportion and involve matters such as *umum al-balwa* (common plight and difficult to avoid), *urf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

Therefore, the different activities of the company will undergo both quantitative as well as qualitative screening before the final decision is made as to whether it is *shari'a* compliant.

Having said that, although such a filter is in place, most of the investment vehicles endorsed are just those related to responsible and safe investments. Not many investment vehicles are aimed at fulfilling the needs of the society, serving social welfare or engaging in environmentally friendly activities. Therefore, there is a need to expand the considerations of the stock screening process beyond screening *haram* activities. If a company is known to engage in activities detrimental to the society at large or the company is not environmentally friendly, it should be excluded from the compliant list.

Social Entrepreneurship (SE)

The Islamic call for humans to perform good deeds ('*amal salih*) and to assist fellow human beings supports the concept of social entrepreneurship (SE). An individual or group's SE initiative is a great contribution to the society, as it brings prolonged benefits to the society as well as addressing

core problems and basic needs. This is supported by various *shari'a* texts. The Quran states:

> Help one another in righteousness and piety, but do not help one another in sin and rancor. (5:2)
>
> Be quick in the race for forgiveness from your Lord and for a Garden whose expanse is that (of the whole) of the heavens and of the earth, prepared for the righteous, those who spend (freely) whether in prosperity or in adversity; who restrain anger and pardon (all) men; for God loves those who do good. (3:133–134)
>
> It is not righteousness that you turn your faces toward East or West; but it is righteousness to believe in God and the Last Day and the Angels and the Book and the Messengers; to spend of your substance out of love for Him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves; to be steadfast in prayer and practice regular charity; to fulfill the contracts which you have made; and to be firm and patient in pain (or suffering) and adversity and throughout all periods of panic. Such are the people of truth, the God-fearing. (2:177)
>
> Those who recite the Book of God, establish regular Prayer, and give secretly and openly from what We have provided for them, may hope for a commerce that will never fail: for He will repay them in full and give them extra from His bounty. He is Oft-Forgiving Most Appreciative. (35:29–30)

Prophet Muhammad also said:

> A Muslim is a brother of another Muslim, so he should not oppress him nor should he hand him over to an oppressor. Whoever fulfills the needs of his brother, God will fulfill his needs; whoever brings his (Muslim) brother out of a discomfort, God will bring him out of the discomforts of the Day of Resurrection, and whoever screens a Muslim, God will screen him on the Day of Resurrection.[31]

In the Islamic finance sphere, various *shari'a* partnership contracts support SE initiatives. They allow the sharing of existing resources to be mobilized or invested to obtain shared returns. Partnership ventures (*shirka*) in Islam can exist with the capital of monetary contribution (*mal*), assets (*milk*), labour (*'amal*), reputation (*wujuh*) or a combination of monetary contribution and labor, such as in *mudaraba*. For instance, the *mudaraba* contract allows for the combination of the entrepreneur's labor with monetary capital

to create a business venture for profit, to be shared between the capital provider and the entrepreneur according to their agreement. *Sharikah al-wujuh* is a partnership based on the creditworthiness of the partners without any monetary capital injection. Therefore, via existing resources or capital, not necessarily monetary, an enterprise may be created to acquire more gains and to spread the benefit of these gains to the shareholders.

SE can also be initiated when an Islamic financial institution receives a viable project proposal from a potential entrepreneur. It can venture into a *mudaraba* contract in which the IFI provides the startup capital for the enterprise. This will allow the Islamic financial institution to participate in the creation of new business and job opportunities. In addition, an IFI may invest in a social enterprise and fund its activities as part of its philanthropic initiatives or social obligations. This can be in the form of capital injection as part of a partnership, or by a voluntary donation, or the IFI may provide a *qard hasan* (benevolent loan) to the social enterprise.

Notwithstanding Islamic financial institutions' contributions and participation, there are other Islamic sectors that may assist in the development of SE initiatives. Achievement of social justice and welfare is also part of the Islamic state's responsibility, as it is the guardian of all Muslims, particularly the poor and the needy. Traditionally, the responsibility of the state is executed through the *Baitul Mal* (Islamic Treasury), which assists in distributing state resources and *zakat* to those in need. At present, the challenge to the *Baitul Mal* is to ensure that the assistance, whether monetary or other, reaches all deserving recipients.

Another important institution in Islam, *waqf* (charitable endowment), can assist in SE initiatives by mobilizing *waqf* property so that the social entrepreneur can utilize it to achieve social good and to ensure the maximum benefit out of the *waqf* property. There are actually many ways to empower *waqf*, and many potentials of *waqf* can be explored.[32] These include developing *waqf* assets through SE initiatives.

In addition, the *takaful* industry may be empowered to assist in providing better health and education to the poor. However, the *takaful* contribution or premium must be affordable to the poor or the government should introduce incentives to assist the needy to obtain *takaful* coverage.

Voluntary donations in the form of *sadaqa* (donation), *hibah* (gift) and other forms of *tabarru'* (charity) may be channeled via social enterprises apart from the common practice of delivering them directly to the needy.

CSR, SRI, SE: The *Maqasid* Paradigm

Understanding how these concepts (CSR, SRI and SE) fit into the objectives (*maqasid*) paradigm requires an understanding of the *maqasid al-shari'a*

and their underlying principles, which are realizing benefit (*maslaha*) and repelling harm (*mafsadah*).

Maqasid al-shari'a *(The Objectives of the* Shari'a*)*

There are inherent objectives behind the revelation of *shari'a*, which were explained by Muslim scholars who analyzed and examined *shari'a* rules and the texts of the Quran and the Sunna.[33] Various texts of the Quran and the Sunna indicate direct and indirect purposes of *shari'a* rulings. The scholars' findings are not complete, as they involve the wisdom and secrets behind God's rules, but the main objectives of *shari'a* are securing benefit for the people and protecting them against corruption and evil.

Scholars of the objectives of *shari'a* provided many definitions of *maqasid*. Ibn 'Ashur defined *maqasid* as the purpose and wisdom behind the enactment of all or most of the *shari'a* rulings.[34] 'Allal al-Fasi defined *maqasid* as "the end sought behind the enactment of each of the rulings of the *shari'a* and the secrets involved."[35] Imam al-Ghazali detailed the *Maqasid al-shari'a* as follows: "The objective of the *shari'a* is to promote the well-being of all mankind, which lies in safeguarding their faith, lives, intellect, posterity and wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable."[36]

These definitions explain that the objectives of the *shari'a* are the ends sought by each of the rulings of the *shari'a* and the wisdom behind such rulings. The comprehensive ends include development of the world and preservation of a system of co-existence and maintenance of good on earth through the betterment of people, who are obliged to live their lives justly and virtuously and to act and think for the good of the world.

Thus, scholars need to consider the *maqasid* of *shari'a* when deriving legal rules and providing guidelines for people to conduct their lives according to *shari'a*. It is essential that the legal rulings be consistent with the *maqasid* of *shari'a*, that is, the intended purposes behind its laws, especially because the *maqasid* allow flexibility in application of *shari'a* and highlight *shari'a*'s dynamism.

Classification of Maqasid al-shari'a

The different injunctions of *shari'a* aim at protecting the interests of mankind (*masalih*) and repelling harm (*darar*). These objectives of *shari'a* can be divided into three categories, namely, the essentials (*daruriyyah*), the complementary (*hajiyat)* and the embellishments *(tahsiniyyah)*.[37] All the different injunctions of *shari'a* aim at realization of one or more of these objectives.[38]

1. *The Essentials (*al-Daruriyat*)*

The essentials are those matters on which the religious and worldly affairs of the people depend; their neglect will lead to total disruption and disorder

and could lead to an evil ending. These must be protected, whether by the individual or by government authorities. These values including the five fundamental matters in life, namely upholding and protecting religion (*al-din),* life *(al-nafs),* dignity or lineage *(al-'ird),* intellect *(al-'aql)* and property *(al-mal).*

2. *The Complementary (*Al-Hajiyyaat*)*

The complementary interests, or *al-hajiyyaat,* are a supplement to the five fundamental matters. They are interests whose neglect leads to hardship for the individual or community, although it does not lead to the total disruption of normal life. Examples of such interests in *mu'amalat* include the permissibility of trading and other kinds of transactions such as leases (*ijara*), *mudaraba*, etc.[39]

3. *The Embellishments (*Al-Tahsiniyyaat*)*

The embellishments, or *al-tahsiniyyaat*, are interests whose realization leads to improvement and the attainment of that which is desirable. The disappearance of *tahsiniyyaat* would not interrupt normal life; however, it might lead to discomfort. Examples of such application in *mu'amalat* include the prohibitions against selling items that have no material value and the prohibitions against selling public properties.

Scholars have agreed that the essential interests (*daruriyat*) shall take priority over other interests. They are followed by the complementary interests and lastly by embellishments. This is because the basic and essential interests of human beings need to be addressed first before attempting to attain higher facilities or luxuries in life.

Underlying Principles of Maqasid al-shari'a

The aim of *shari'a* is to realize the well-being of humankind, which involves attaining public good or interest (*Maslaha*) and preventing harm or evil (*darar*). Therefore, it is essential to discuss these two concepts as outlined by the *shari'a*.

I. Maslaha *(Public Interest)*

Maslaha is a legal concept used in Islamic jurisprudence to promote public benefit and prevent evil. Imam al-Ghazali defined it as the consideration that secures a benefit or prevents harm and is harmonious with the aims and objectives of *shari'a*.[40] Thus, what constitutes *Maslaha* (pl. *masalih*) or public interest cannot be determined by the unaided human intellect; it must be with the guidance of *shari'a*. The legal texts of the Quran and Sunna have identified certain *masalih* that are approved or disapproved by *shari'a*, and *shari'a* scholars are allowed to make efforts to identify other *masalih* which may be acceptable so long as they are not in contradiction with *shari'a*.[41]

The *maqasid* paradigm has categorized *maslaha* into three categories to be achieved according to their priority: essentials, complementaries and embellishments. This means that even upon achievement of the third-level *maslaha*, efforts to maintain the first- and second-level *maslaha* need to be continued and given emphasis. This principle can help in corporate decision-making, regarding which objectives should be given priority in a certain situation or moment. It provides an ethical filter in the face of conflicting interests, helping to determine which interest should take priority, as the different degrees of *maslaha* outline their levels of importance. It also assists decision-making in CSR, SRI and SE initiatives regarding which sector is to be given preference.

Maqasid may require Islamic financial institutions to support activities that bring benefit and good to the society although this may sometimes involve sacrificing some of their resources and profits. It also calls for the inclusion of positive investment portfolios or those that support the SE cause in investment choices, which may include investments in sectors such as education and health care.

The promotion of *maslaha* is further guided by a variety of legal maxims,[42] for example:

1. Al-mashaqqah tajlibu al-taysir: "Hardship calls for facility."

2. Dar'u al-mafasid awla min jalb al-manafi: "Repelling harm is preferred to the attainment of benefits."

II. Darar *(Prevention of Harm)*

Similar to *maslaha*, what constitutes *darar* must follow *shari'a* guidelines. As a matter of fact, *shari'a* has outlined various rules on dealing with situations of *darar*. They have been summarized in the following maxims:[43]

1. *La darara wa la dirar*: "Harm shall not be inflicted nor reciprocated."
2. *Al-dararu yuzal*: "Harm should be removed."
3. *Al-dararu yudfa'u bi qadr al-imkan*: "Harm should be repelled as far as possible."
4. *Al-dararu la yakunu qadiman*: "Harm must not be sustained."
5. *Al-dararu la yuzalu bi mithlihi*: "Harm cannot be displaced with its like."
6. *Yutahammal al-dharar al-khas li daf' al-dharar al-"am*: "To repel a public harm, private damage is tolerated."
7. *Dar'u al-mafasid awla min jalb al-masalih*: "Repelling harm is preferred to the attainment of benefits."

These maxims show that *shari'a* places great emphasis on the prevention of harm and achievement of *maslaha*. The principles of *maqasid*, *maslaha*

and prevention of *darar* also provide guidelines to CSR, SRI and SE practitioners in decision-making as well as in conflict resolution. Thus, whenever a subject matter gives rise to benefits and harm at the same time, the prevention of harm is to be given priority over attainment of benefit. In CSR, these principles serve as guidelines for decision-making and should be part of an institution's governance policy. They also support the practice of excluding negative, harmful and illegal investment portfolios as well as the practice of community investing in SRI. Similarly, they encourage the initiation of SE projects and social welfare centers that aim to alleviate the problems of disadvantaged members of society. Therefore, both principles strongly encourage the implementation of CSR, SRI and SE.

CSR, SRI, SE and Maqasid al-shari'a *in Islamic Finance*

This section will discuss the concepts of CSR, SRI and SE from the *maqasid* dimension. It will shed light on how the *maqasid* can guide these concepts and their application in Islamic finance.

CSR: The *Maqasidic* Dimension

The objectives (*maqasid*) of *shari'a* allow flexibility, dynamism and creativity in social policy. In the context of CSR, realization of *maslaha*, which is the foundation of *maqasid al-shari'a*, has to be seen as a consideration of public interests rather than merely individual interests. It provides a framework for making decisions and a mechanism for adapting to change, especially for corporations willing to commit to CSR. In propagating the concept of CSR, the three categories of *maqasid*, as prescribed by the scholars and explained earlier, can be the guiding principles, particularly in giving priority to the areas related to CSR that should be emphasized. The division of *maqasid* into *daruriyat, hajiyyaat* and *tahsiniyyaat* creates a framework and a general ethical filter, providing administrators with three levels of priority to resolve the ethical conflicts that inadvertently emerge when applying CSR programs and initiatives. The levels also reflect the different degrees of importance in terms of fulfillment of responsibility. The essentials constitute the most fundamental responsibilities to be fulfilled, as compared to the complementary and the embellishment categories. Therefore, as the priorities move from the level of essentials to embellishments, the impact of decision-making and the implementation of adequate processes will be less fundamental, albeit more virtuous, so as to attain social good and well-being. It is assumed that individuals and corporations will strive for the next level of priorities as soon as the prior level goals have been fulfilled.

In order to illustrate the above argument, we shall analyze the different levels of the decision-making process based on the above priorities. On the first level of priority (the essentials), managers are expected to strive to

preserve their stakeholders' essential needs and the public good in general. For example, under the CSR precept, IFIs must protect their employees' basic needs by providing adequate remuneration and safeguarding their safety and health in the workplace as well as providing adequate facilities for them to practice their religious requirements. This will reflect their responsibility to safeguard the values of life and religion. In addition, they must confine their operations to those that safeguard the above-mentioned essential values. Accordingly, corporations have a moral and social responsibility to avoid activities that may cause disruption and chaos in people's lives, even though such activities might bring higher profits to the organization.

After fulfilling this level of responsibilities, the priority will move to the second level, the complementary. Here, it is deemed beneficial to remove difficulties that may not pose a threat to the survival of the normal order. For example, managers may want to extend their commitment to social responsibility by offering continuous training and programs for their employees. The latter is not essential per se, for neglecting it does not threaten the employees' continued existence. However, assuming such a responsibility fulfills the complementary interest of advancing the workers' intellectual capability. In some cases, such an effort may be considered one of the essentials, particularly if neglecting such an effort might lead to the disruption of the core function of the organization. For example, Islamic banks must provide their employees adequate *shari'a* training concerning the products offered in order to ensure that stakeholders are satisfied with the "Islamicity" of the products.

The final level of priority is fulfilling the embellishments. Corporations are expected to engage in activities or programs that improve public life. Donating to the needy, offering scholarships to poor students, and providing correct and clear information regarding all products are some of the examples of CSR commitment with respect to realizing the goals of this level.

SRI: The *Maqasidic* Dimension

The *maqasid* would require Islamic financial institutions to approach Islamic investment from a perspective wider than the legal contractual relations of *fiqh al-mu'amalat*. The *maqasid* approach would look into all aspects of *shari'a* investments and prioritize investments in relation to the plethora of public interest (*maslaha*) for the specified time and place. It would promote investment strategies that are not driven solely by profits but also by ethical or religious motives.

For instance, economic or sociological experts may decide that investments in education, food supply and health care should be prioritized for a certain country, as these are necessities (*daruriyat*) of the people of the

respective places. On the other hand, investment in housing might be of complimentary status, while investment in recreation and tourism would have less priority, as they are considered embellishments (*tahsiniyyaat*). With or without government encouragement, Islamic financial institutions should make significant investments in priority areas. This will create new jobs, business projects and wealth, as well as foster entrepreneurship. The other example worth mentioning here is in the area of fund raising through instruments such as *sukuk*. At present, most of the *sukuk* issued are used to fund mega-projects, such as tourism resorts, which may not necessarily benefit large segments of society.[44] Furthermore, the current trend tends to focus on investing funds in well-to-do countries rather than assisting less fortunate countries. This is partly because the likelihood of good return may be higher in wealthier countries, and investment strategy is often heavily weighed toward returns rather than need. Such strategy must be reviewed, as *shari'a* should serve the public interest in investment rather than merely focusing on the return factor.

SE: The *Maqasidic* Dimension

The *maqasid* dimension helps enhance the current SE frameworks by providing guidelines on how SE will best contribute to the society. It assists in identifying the critical areas that should take priority and the relevant SE that need to be established in certain areas at specified times and situations. The various categories of *maqasid*, namely *daruriyat*, *hajiyyaat* and *tahsiniyyaat*, shall be the main guidelines. For instance, these can indicate the areas that need to be the main focus of social entrepreneurs. Although food supply, living conditions and health care may be identified as areas that should take priority, the *maqasid* dimension will guide social entrepreneurs in providing education as well so the underprivileged will be able to themselves work for better living conditions. For example, although individuals may be provided with food in the initial stage, they may also be taught ways to plant and produce food or obtain microcredit to embark on small businesses. They will hopefully then climb the ladder from the stage of necessity to the complementary stage, if not the embellishment stage. Therefore, Islamic financial institutions should not only give financial assistance to the poor but also come up with a structured plan or strategy to assist them to achieve better living conditions.

Opportunities and Challenges

The effort to implement CSR, SRI and SE using the *maqasid* of *shari'a* in the Islamic financial sphere will expose the industry to new challenges, as some reform will be necessary. Notwithstanding that, various opportunities, some of which are discussed below, will also open for the industry.

Enhancing the CSR, SRI and SE initiatives would distinguish Islamic financial institutions as providers of ethical banking and deflect the criticism against them. It would help Islamic financial institutions promote and practice the *maqasid* of *shari'a* in a strategized and structured way. The Islamic finance industry would serve its true purpose of achieving socio-economic objectives and responsible and ethical finance. Although financial institutions are commercial entities, they would also assume social responsibility and promote the agenda of social welfare and social justice.

Furthermore, it would also demonstrate that Islamic financial institutions have a comprehensive governance framework that encompasses ethics and social responsibility apart from a corporate and *shari'a* governance framework. All of these are actually part of Islamic financial institutions' duties as prescribed by the *shari'a*. The objectives of *shari'a*, as well as the Islamic system of belief, morality and law of dealings, should be the main reference in the governance structure, thus creating a holistic and comprehensive governance framework.

Islamic financial institutions would be recognized as agents of change in the society, playing vital roles in socio-economic and social welfare sectors. It is time for Islamic financial institutions to transcend the function of financial intermediaries and become real contributors to socio-economic agendas.

One crucial element for realizing the Islamic finance industry's initial promise is the challenge of developing Islamic microfinance. Its conspicuous absence or underdevelopment highlights the IF industry's distance from its supposed social role, as Islamic financial institutions should not only be involved in philanthropic activities but should also should be active in providing microfinance to the public. Without microfinance services, Islamic finance will be deemed incomplete. Some have suggested that a new form of Islamic bank needs to be established: Islamic social banking.[45] A number of studies have been conducted, in which researchers have proposed various models to implement Islamic microfinance; indeed, it is high time that the viability of these models be assessed and serious effort be made to introduce viable Islamic microfinance services.[46] Offering Islamic microfinance is not impossible, for the early history of the Islamic finance industry witnessed the initiative of Mit Ghamr Bank in Egypt, which provided Islamic microfinance services to its customers.

Apart from that, Islamic finance must be wary of bad corporate governance. We have already seen examples of governance failure in IFI, the Dubai Islamic Bank (DIB) cases being ready examples.[47] Islamic financial institutions need to instill both a strong *shari'a* governance framework as well as a CSR framework within their structures. The incorporation of CSR

with Islamic specifications should assist in ensuring good governance of Islamic financial institutions. Understanding and internalizing the *taqwa* paradigm would restrain IFI staff from transgressing Islamic law or its code of ethics.

It has been emphasized on many occasions that *shari'a* advisory and supervisory bodies will need to play a central and significant role in implementing the noble objectives of *shari'a*, the concepts of CSR, SRI and SE, as well as the governance of Islamic financial institutions. In considering a product's endorsement, they should examine the social impact of the product, not merely the economic impact or its legal status under the *shari'a*. They also need to use their utmost diligence to assess and uphold the *maslaha* that they think needs to be given priority when confronted with conflicting and competing interests.[48] They also have a responsibility to guide Islamic financial institutions to fulfill the true spirit and objectives of *shari'a* and not to merely comply with the letter of Islamic law. Thus, there is a need for a paradigm shift and change in the practice of the *shari'a* advisory and supervisory bodies. IFI's delivery of services also should be enhanced. It will require the members of *shari'a* boards and advisory services to give more time and attention to Islamic financial institutions and to play more proactive roles. It is worth considering the appointment of permanent *shari'a* members who will dedicate their full time and thinking to supervising and shaping the institutions to fulfill the true functions the *shari'a* demands of them.

Conclusion

The above discussion illustrates that there is a close link between CSR, SRI and SE and Islamic finance, as the former can assist Islamic financial institutions in serving their real functions as outlined by *shari'a*. This assistance corresponds with the opinions of proponents of Islamic economics. However, the concepts of CSR, SRI and SE require some modifications to comply completely with *shari'a*; in fact, *shari'a* has a more holistic overview of these concepts, considering them as part of Muslims' religious obligations and not merely of social utility. Therefore, there is a vital need to implement and give credence to these concepts in current Islamic financial practices and systems. Many benefits are anticipated from this shift, financially, socially and economically. The implementation will not be without obstacles, but it also has the potential to provide IFI with many positive opportunities and bright prospects.

Endnotes

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Investment Evaluation Framework for Socially Responsible Investing and Islamic Finance

Sajjad H. Shah

Most modern investment decisions involve maximizing return for the level of risk an investor is willing to take. This is because such decisions primarily involve the consideration of return and risk, which are germane to the profitability of the business. There is the general assumption that investors are averse to risk but seek to maximize profits.[1] Finding equilibrium between return and risk has been a major challenge for finance experts.[2] The efficient portfolio theory not only provides the theoretical foundation for modern portfolio management but also provides a concrete and precise relationship between financial risk and return, which enables one to determine the minimum expected return of an investment asset commensurate with the risk inherent in it.

Though it seems too general to model the risk/reward aspects of an investment asset, all the assets in investment must be viewed solely within the two-dimensional world of financial risk and return. The newly emerging financial fields of Socially Responsible Investing (SRI) and Islamic Finance (IF) are concerned with more than the financial risk and return aspects of an asset. An equally, if not more, important aspect of an investment is the degree of social benefit/religious compliance, which an asset must provide to merit inclusion in a portfolio. This paper first looks at efficient portfolio theory as it is used in conventional asset management and then assesses its applicability to SRI and IF.

Efficient Portfolio Theory

Efficient Frontier

Markowitz's efficient portfolio theory is based on *expected return on investment* (function of securities' returns constituting the portfolio) as well as the *expected portfolio risk* (variability in the returns of the portfolio that is measured as a standard deviation of the portfolio's returns over a period of time). The expected portfolio risk is also a function of the risks of underlying

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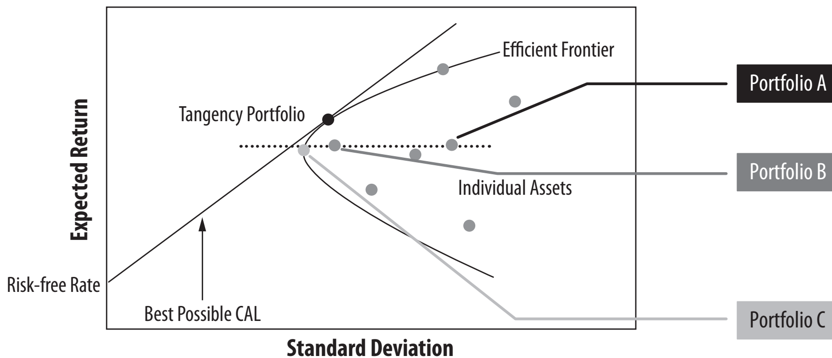
Figure 1. Efficient Frontier[4]



securities, although this is not a linear function due to the risk correlation among different securities resulting in diversification.[3]

Given the different combinations of securities in the market, different investment portfolios can provide a certain expected portfolio return. For the same level of expected return, multiple portfolios might be formed that differ in only the measures of risk. Two such portfolios are shown below as portfolio A and portfolio B in Figure 1. Efficient Frontier. Both portfolios offer almost the same level of return but differ in the risk. Assuming the investors are rational and prefer lower risk for return, portfolio B is preferred over portfolio A, as it offers the same return with lower risk.

If all the possible portfolios are plotted, there will be one unique portfolio for each level of return, which offers the least amount of risk. In efficient portfolio theory, such a portfolio is termed an efficient portfolio. Plotting all such efficient portfolios in the return and risk space provides a hyperbola as shown below by the "Efficient Frontier" curve of the Markowitz efficient frontier in the diagram below.

Capital Market/Allocation Line (CML/CAL) and Capital Asset Pricing Model (CAPM)

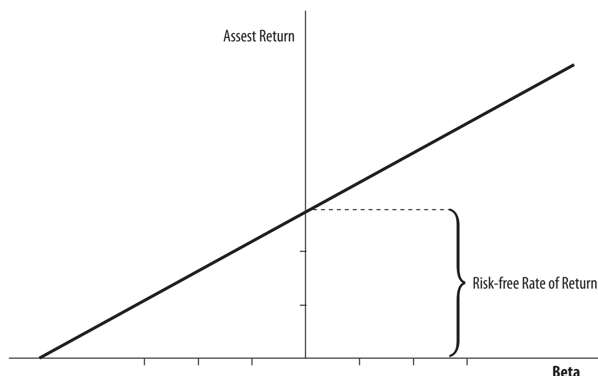
Using the efficient frontier concepts, the Capital Asset Pricing Model (CAPM) was developed and is extensively used in finance to determine a theoretically required rate of return for an asset. There are numerous applications of CAPM. Using CAPM, an investment asset's return rates can be calculated, including discounting the cash flows of the asset and thus assessing its suitability for inclusion in a portfolio.[5]

CAPM uses the concept of Capital Market/Allocation Line (CML/CAL) by forming a portfolio with two asset classes: a risk-less asset (cash or fixed income bond asset) and a risky portfolio from the efficient frontier. The

risky portfolio is at the intersection of the efficient frontier and the tangent drawn from the risk-free rate to Markowitz's frontier, shown as "Tangency Portfolio" in Figure 1. Efficient Frontier. Almost infinite combinations of the risky portfolio and risk-less assets can be derived by varying the proportions of each asset class. The risk-free asset proportion can even go beyond 0 (negative) by assuming that such an asset (cash or fixed income bond) can be borrowed to purchase the risky assets, such that the overall portfolio has a proportion of risky assets that exceeds 100 percent. The tangency line joining the risk-free asset to tangent on the efficient frontier is known as CML/CAL. The tangency portfolio is known as the market portfolio or super-efficient portfolio as it provides the highest Sharpe ratio (a measure of the amount of return above the risk-free rate that a portfolio provides for each unit of risk it carries). Any combination of the portfolio and the risk-free asset will produce a return above the efficient frontier, thus providing a larger return for a given amount of risk than a portfolio of risky assets alone on the frontier.

Based on this understanding, CAPM uses the concept of the market portfolio and the asset's risk relative to the market portfolio risk, as measured beta (β). The plot of the return of each security against β (asset risk dependent on the market or systematic risk) gives the familiar SML diagram an alternate representation as in Figure 2. Security Market Line.

Figure 2. Security Market Line[6]



Using this line to calculate the expected return of a certain asset is a simple exercise of the application of line equation. The familiar CAPM formula from this line is:

$$\frac{E(R_i) - R_f}{\beta_i} = E(R_m) - R_f$$

Where

§ $E(R_i)$ is the expected excess return on the asset;

§ R_f is the risk-free rate of interest such as interest arising from government bonds;

§ β_i (the beta coefficient) is the sensitivity of the expected excess asset returns to the expected excess market returns;

§ $E(R_m)$ is the expected excess return of the market, sometimes known as the market premium or risk premium (the difference between the expected market rate of return and the risk-free rate of return).

A more common form of the CAPM formula provides a way of calculating the expected/required return of an asset:

$$E(R_i) = R_f + \beta_i\,(E(R_m) - R_f)$$

Investment Evaluation Decisions Within IF and SRI Arenas

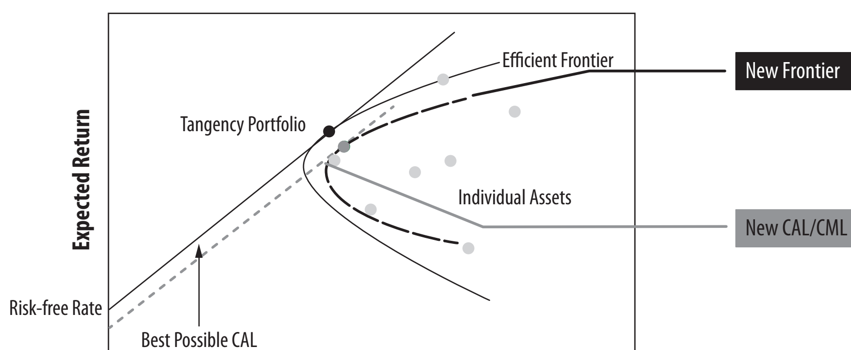
Investment decisions for SRI and specifically for IF need additional parameters beyond the traditional concepts of risk and return.[7] The compliance with *shari'a* constraints is as important, if not more so, during the investment selection and evaluation process as the concepts of risk and return. There is similar variable for SRI to capture the social benefit of an investment asset beyond risk and return.[8] Currently, different investors might use different factors, some qualitative and some quantitative, to capture this additional attribute for these investment assets; however, there is no industry-wide common model/definition to accommodate this. Despite this, the additional factors of SRI or IF are still taken into consideration while selecting an asset for a portfolio. Various players see these factors as an integral part of their internal calculations in assessing the suitability of an asset even if they do not externally communicate these factors.[9] The remainder of this chapter will look at one possible way to incorporate factors beyond financial risk and return within SRI and IF.

The Impact of Compliance Constraints on Efficient Frontier

SRI and IF introduce another concern regarding investments: the benefit of an investment to the society. Because of this benefit, SRI and IF limit the number of possible assets and portfolios, as illustrated in the diagram for constructing Markowitz's efficient frontier. It is possible that some of these portfolios/assets lie on the efficient frontier and with these investment vehicles unavailable to investors, the frontier is pushed inward. For instance, some of the less optimal portfolios from the original universe are optimal under the new constrained investment universe, which is a subset of the original set.

The parabolic shape of the efficient frontier is the result of different assets in various portfolios, and due to the subset of permissible investments in IF, new diagram for the efficient frontier will most likely be a parabola but with reduced width. One such depiction is drawn below in Figure 3. Efficient Frontier Under Constraints of IF or SRI, with respect to the original efficient frontier. The broken curve line is represented in deep black color. This logic is based on a qualitative argument as opposed to strict mathematical rationale, which might be investigated in future work.

Figure 3. Efficient Frontier Under Constraints of IF or SRI



Based on the new frontier, the market portfolio has also shifted to the right and downward, as indicated by the point of tangency between the new frontier and the line passing through the origin of the graph. The case of a line passing through the origin, as opposed to risk-free rate, is more applicable to Islamic finance and not related to SRI. In the case of IF, as there is no place for fixed interest or a risk-free rate, a portfolio consisting of risky and risk-less assets within the IF world consists of pure cash, although after adjusting for inflation it would have a negative rate of return, and risky investment of market portfolio. In this case, the optimal overall portfolio consists of different proportions of these two asset classes (some holdings of cash and some assets comprising the market portfolio) and CML/CAL is the line from the origin to the market portfolio on efficient frontier. In the case of SRI, the line will extend from the risk-free rate to the new market portfolio. Due to this difference between cash assets and risk-free assets within IF and SRI, all the portfolios on CML/CAL with risks lower than that of the market portfolio have lower expected returns for IF portfolios as compared to SRI. This is the result of no return for a cash asset in IF versus the risk-free asset of SRI.

In the case of Islamic finance, the benefits offered by a risk-free asset, such as cash, are primarily the risk reduction with no return earning opportunities; hence, the CML line is quite steep. However, there are few implications of this fact, which might not be as important in traditional Markowitz portfolio theory.[10] There is an assumption in original theory that investors can lend and borrow in an unlimited fashion, but this has limited applicability in the real world because the CML/CAL line goes well beyond market portfolio (as in the case of the market portfolio point investor who borrowed funds to purchase more than 100 percent of the risky asset). In the case of IF, this assumption of unlimited borrowing is even less accurate as there are no return opportunities for liquid assets. Therefore, there is even less possibility of portfolios further away on the upper side of the market portfolio. Even portfolios heavily concentrated in liquid assets, such as cash, will be less attractive due to the limited role of cash, and the fact of risk reduction without the upside potential of return. For IF, the more realistic portfolios on CML/CAL are the ones lying on the left of the market portfolio.

Compliance Constraints Costs

As is clear in Figure 3, both the efficient frontier and CML/CAL have shifted down and to the right for IF and SRI investment options due to the additional constraints of compliance with *shari'a* or other social objectives. This shift can be termed a financial cost of this additional constraint.[11] The extent of this cost is dependent upon the number of investments left out during the compliance stage and upside potential of those investments. The greater the number and the higher the potential of these investments, the higher the costs for compliance will be to these markets. The cost can be either in terms of smaller returns or lack of risk-reduction vehicles available to the investor. However, a significant part of the concern is the smaller return expectation, as risk can be reduced by replacing some of these unavailable securities with other compliant securities to enhance diversification for reducing risk. This is particularly true as the number of assets needed for a reasonably well-diversified portfolio is not very large—usually less than 50 such assets are sufficient due to the lack of correlation among these assets.

One model to measure or estimate such costs of investment opportunities with lower potential returns and/or limited risk-reduction opportunities involves using the historical data over sufficient time periods. As a first step, one must find the differences between the historical returns on the market portfolio (on may use proxy from market indices like the S&P 500) and on a comparable compliant index (like KLD for SRI, Dow Jones Islamic Market Titans 100 Index for IF, etc.). The average of such difference over

sufficient time periods can be a good proxy for the cost of compliance. The other part is the long-term fixed income security, risk-free asset returns, as this represents lost opportunity when cash is held in compliant portfolios instead of the fixed income risk-free asset.

The forward-looking estimation of such costs based on the more traditional, fundamental factors (like inflation, term structure, etc.) can also be derived by using the regression and historical costs as described in the previous paragraph.[12] If one regresses the historical cost on the historical values of fundamental economic variables (inflation expectations, term structures, etc.), the resulting regression model could predict the future costs of these compliant investments above and behind the usual risk/return profile provided by efficient frontier and CAPM concepts. Such a model can provide a basis for calculating the expected return from an investment opportunity within SRI/IF and enables one to assess the relative attractiveness of different investments.

CAPM Model Implications

CAPM model relates the expected/required return rate with the relative riskiness of an asset to market portfolio. For IF and SRI, the additional constraint of compliance might result in a reduction in expected return or an increase in the riskiness of a portfolio. There can be two ways to incorporate this additional factor in the CAPM formula depending on whether the market portfolio and its premium are for the conventional market or if they are based on the market index specific to IF/SRI.

CAPM model using the market portfolio from unconstrained investment space
If the calculation is based on a market portfolio from the conventional unconstrained practice, where there is no constraint of adherence to one's moral or religious values, (such as the S&P 500 for the U.S. market), then the costs of additional compliance constraints can be included in the traditional CAPM formula to calculate the required rate of return from certain compliant investment as follows:

$$E(R_i) = R_f + \beta_i\,(E(R_m) - R_f) + (\mathrm{dc} * \mathrm{CC})$$

Where the additional terms in the CAPM equation are as follows:

§ dc is the degree of compliance, a coefficient varying from 0 to 1 with 0 for non-compliant assets, 1 for compliant and other values for partially compliant. The actual values in the range (0–1) can also vary from IF and SRI as IF might have stricter criterion for compliance with less room for partial-compliance scenarios, whereas within SRI some investment opportunity might be offered to partially achieve

social/moral objectives. The 0 end of the range will cause the above equation to make the required rate of return from an asset the same as from the conventional financial world.

§ CC is the cost of the compliance, which might be pooled across asset classes. One way of estimating such costs is described above from the historical data analysis. Although the above method provides a single value of the cost across all compliant assets/portfolios, the same procedure can be applied to either asset classes (assets with similar characteristics) or even to individual assets, especially if the asset has enough history and a comparable non-compliant asset in the marketplace. In this way, CC can be thought of like β, which is also usually calculated by looking at the historical returns of the asset and then regressed over the corresponding market index.

Hence, this updated version of CAPM can be used to calculate the expected or required return from a compliant asset as long as the coefficient of compliance (dc) and cost of compliance can be determined. The coefficient of compliance is a subjective value assigned by the relevant screening mechanisms (*shari'a* board in the case of IF) of the investment processes. However, certain objective rules can be devised to calculate a value of dc for a new investment. For IF, such rules can be based on factors such as the degree of involvement in forbidden activities, speculation, hedging, etc. Some of these factors can be obtained from the financial statements of the company.

Although the CC can be based on the historical performance of investment or similar investments, the predicted CC values, like any other prediction model based on the historical data, might not reflect the true cost incurred going forward.

CAPM model using the market portfolio from IF/SRI investment universe

This second method uses the market portfolio from the IF/SRI and includes the market premium of such a portfolio in the CAPM equation.[13] So the CAPM formula remains similar to the conventional form:

$$E(R_i) = R_f + \beta_i(E(R_m) - R_f)$$

However, the market risk premium $(E(R_m) - R_f)$ is for the market portfolio specific to IF/SRI. This is the new tangency point in Figure 3, between the updated CML/CAL line and new frontier, which is shown as a green line. This formula is even further simplified for IF, in which the line passes through the origin, as there is no fixed interest rate asset (risk-less) in IF. So the updated equation for IF using this second method is further reduced to:

$$E(R_i) = \beta_i * E(R_m)$$

This shows that the return contribution to the overall portfolio (consisting of cash and risky portfolio) comes from the risky portfolio with no contribution from the cash portion of the portfolio. Furthermore, this contribution is filtered by the beta (β_i) of the risky portfolio.

Limitations of the Updated Efficient Frontier and CAPM Model for IF and SRI
The above rationale for looking at the efficient frontier as constrained by the IF and SRI is mainly based on qualitative observation and analysis as opposed to mathematical foundation. There is a need to look at the updated frontier using more rigorous and mathematical bases that may comprise a good topic for future study. Another weak assumption of the updated model might be the shape of the updated frontier, which may not form an exact parabola, though it will be close to it. A mathematical model for such a shape may present a challenge during future work. Given the fact that the Markowitz model lacks some basic investment assumptions that are based on IF principles, the updated model might not be comparable to our traditional understanding and application of the efficient frontier model.

The updated CAPM model needs the consideration of two new concepts: coefficient of compliance (dc) and cost of compliance (CC). The value for dc is quite subjective, whereas the value of CC is dependent on historical data. This data either may not be available for relatively newer investments or may not reflect the actual situation going forward. Despite these challenges, the proposed model can provide a realistic and straightforward framework for calculating the expected returns from different investment opportunities within SRI and IF.[14]

Conclusion

It is necessary to extend the concepts of efficient frontier and risk-return tradeoffs that are the tenets central to the conventional investment evaluation and selection process. The emerging fields of SRI and IF necessitate looking beyond the financial risk and return of Markowitz's paradigm to evaluate optimal investment decisions. SRI and IF incorporate additional elements, like degree of values, *shari'a* compliance and the extent of communal benefits.

Due to these additional considerations, one model proposed here is to extend the conventional model to include SRI- and IF-compliant assets. This additional benefit comes with costs in terms of reducing the expected return from the compliant asset. Combining all these concepts results in the extended version of CAPM. However, there is need for a more rigorous mathematical treatment of an extended version of CAPM, as presented

above, as well as testing with the real-world data to assess the applicability of the extended concepts of compliance and cost of compliance.

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11. Of course, this cost has some benefits, not necessarily directly financial benefits, which this analysis has not taken into account. Such benefits might include the satisfaction of the compliance to one's religious tenets, in case of IF, or sense of achievement for some moral/societal benefits in the case of SRI.
12. Marc R. Reinganum, "A New Empirical Perspective on the CAPM," *Journal of Financial and Quantitative Analysis* 16:4 (1981): 439–462.
13. IF/SRI indices like KLD and Dow Jones Islamic Market Titans 100 Index can be proxies for such a portfolio.
14. Somewhat similar difficulties exist even in the conventional financial model where the betas and others parameters are calculated based on historical data that may or may not reflect present or future performance of the investment vehicle.

Money and Morality: Pathways Toward a Civic Stewardship Ethic

Marcy Murninghan

Introduction

The worst may be over on Wall Street, but the hope remains that the crisis in global finance—what many called the second-worst financial crisis in the history of the world— will move issues of ethics and values to the forefront of public concern and, presumably, decision-making and practice. That still hasn't happened, but there are signs that serious consideration of the normative side of economic decision making—and even the purpose of capitalism—may take place in 2012.[1]

Until recently, discussions of ethics and values have remained well in the background, as politicians, finance ministers, regulators, policymakers, lawmakers, corporations and institutional investors, and the media worked to remedy and restore capital markets to a healthy state. What is disturbing about their efforts is that much of what has taken place since the 9th Harvard Forum failed to deliver on the promise of restoring trust and integrity to the marketplace. Within the U.S., unemployment remains high (hovering at 9 percent, although trending down to 8.5 percent in December 2011),[2] companies and CEOs continue to reap high rewards,[3] and ties between Congress and Wall Street are tighter than ever, enabled in part by a Supreme Court ruling allowing unlimited corporate political campaign spending.[4]

At the time this paper was presented, in March 2010, the global economic crisis was underway and continued to worsen, but the massive instabilities were yet to come. Beginning in late 2010 with a fruit seller in Tunisia, a ripple of protest turned into a flood. The recession continued its dampening effect (now extended to the Eurozone), authoritarian governments throughout the Arab world were toppled, and those who play by their own self-serving rules were confronted by collective outrage. The peoples' cry of "*Enough!*" produced regime change in places where political conflicts previously were muffled by fear and brute force. (Whether or not the new regimes are any better is another question, as we're seeing in Iraq and Egypt;

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perhaps counter-revolution is part of the yin yang force found in physics and nature.) In other places, such as Spain, Greece, Israel, France, Britain, Russia, China and Syria, protesters sick of economic disparities and corruption called for reform.

In late 2011, these political and economic events combined to drive the emergence of the global Occupy Wall Street movement, particularly within the United States where street protests of this kind hadn't been seen since the civil rights movement or the Vietnam War. At issue: how financial engineering has split society into pieces, with vast wealth, privileges and status accorded to the top 1 percent and the felt entrapment and struggles of everyone else. Occupy Wall Street protestors turned out in droves throughout the world, while those who stayed home continued to wonder why cheaters and lawbreakers never get punished, despite the collateral damage.

So where are we now? In this essay, I argue that efforts to reform our financial systems should also involve the broader goal of restoring an ethical and civic moral dimension to economic life. This can happen through reframing and re-visioning what capitalism and economic activity is supposed to do, to generate meaning and value in our lives. I draw upon the principles of world religions, theology, and humanist philosophy in thinking about implications for professional practice. I posit that the corporate responsibility and ethical investing movements, as well as Islamic finance, have much to contribute to this renewed consciousness of the moral purpose of capitalism, of values in public life, because they stem from a set of guiding concepts and vocabulary with civic moral meaning.

At a deeper level, these ideas and words are rooted in world religious, theological and humanist traditions regarding the civic moral obligations of wealth. Yet this dimension remains neglected by policymakers, financial professionals, the media, and even corporate social responsibility (CSR) and sustainability practitioners who often are preoccupied with "measuring what matters" and fighting climate change—itself a moral prerogative—rather than keeping in mind and engaging in dialogue about larger civic moral meaning and purpose. Islamic finance has much to offer in stimulating this dialogue and frame change about economic stewardship as it seeks to apply *shari'a* law to its transactions.

A suggested vehicle for getting started: establishment of a series of "communities of inquiry and practice," along with broader public dialogue, that take advantage of enabling technologies such as social media and other digital interactive tools, so that professionals and everyday citizens may deepen their understanding and improve performance regarding the practice of civic stewardship in modern economic life. We desperately need this kind of conversation, which should include citizens as well as practitioners. These

initiatives, coupled with others, might help revive a more ethically informed marketplace less impoverished along moral lines, and more suited to sustainable prosperity and justice, for all.

Our Current State

Within the United States, we are slowly emerging from the worst economic circumstance since the Great Depression, affecting not only major institutions and sectors—banks and other financial services, the housing and automotive sector, for example—but also individuals and families. Amidst public resentment toward bailouts and bonuses, Congress and the executive branch continue to grapple with legislation and rulemaking that alter regulatory system, affording greater consumer, investor, and taxpayer protection. These changes in financial regulations place new responsibilities on institutional investors, requiring new forms of engagement, education and behavior. Meanwhile, investigations into the causes and culprits behind the disaster continue apace, although whether anyone gets punished remains to be seen.[5]

On the regulatory side, in the summer of 2010 the U.S. Congress passed what has been called the most sweeping piece of financial legislation since the Great Depression. Named after its two key proponents, Rep. Barney Frank (D-MA) and then-Sen. Christopher Dodd (D-CT), the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010. [6] Among its provisions: an end to "too-big-to-fail" bank bailouts; an advance warning system on systemic risks; greater transparency and accountability on "exotic" investments (such as derivatives and credit default swaps); stronger regulatory oversight and more aggressive investigation into financial fraud, conflicts of interests and manipulation of the system; and greater consumer protection. Also included are corporate governance provisions for "say on pay" votes and majority voting in board elections, as well as authorization for the Securities and Exchange Commission to adopt a proxy access rule. Overall, Dodd-Frank requires regulators to create 243 new rules, many of which fall under the watch of the SEC.[7]

More than 1,400 pages long, Dodd-Frank remains controversial for a host of reasons, ranging from perceptions that it is too unwieldy and will thus undermine capital efficiency and competitiveness, to beliefs that it is deeply flawed and fails to eliminate the problems that caused the crisis.[8] The most glaring omission in the law is what to do about Fannie Mae and Freddie Mac, two quasi-public agencies responsible for generating massive losses in the housing market, and costing the U.S. Treasury taxpayers $153 billion, a bailout tab that continues to grow, with no one able to predict how much it will ultimately cost.[9]

Worldwide, calls for reform continue, leading to passage of similar policies and guidance on what it means to be a trustee.[10] One such reform is the United Kingdom's Stewardship Code, which the *Financial Times* called "the first of its type in the world" and noted is "designed to sit side by side with the UK's code on corporate governance."[11] The Stewardship Code comprises seven core principles—including public disclosure of stewardship policy and approach to voting proxies, active engagement with portfolio companies and collective action with other investors—to which institutional investors would voluntarily comply, or explain why they would not.

Despite these measures, public ferment concerning trust in capital markets will continue to boil until there is a broader belief that duty, honesty, integrity, fairness and transparency are given primacy of place. This is a mighty challenge, given the prominent role of financial services in the modern economy and the failure of reforms to address the moral dimension of economic decision making.[12] Unlike manufacturing or retail, the social, environmental, and governance imprints of the money business is hard to measure. It is an industry that creates value for a limited number of people—primarily its own employees—rather than creating vast numbers of good jobs, improving the quality of life or conducting scientific breakthroughs. Profits do not create true value that accrues to a community and can inflict tremendous damage. Massive income and wealth inequalities remain in the U.S.[13] and elsewhere,[14] which can lead to political instability, violence and even regime change, as events in the Arab states demonstrated throughout the late winter and spring of 2011.

The financial services sector now dominates the U.S. economy and continues to grow; Gretchen Morgenson, *New York Times* assistant business and financial editor, told a Kennedy School gathering in April 2011 that since the crisis began in 2008, the U.S. banking sector has grown seven times faster than the U.S. GDP. Making matters worse, she said: Dodd-Frank does nothing to eliminate the threat of institutions that are too big and politically connected to be allowed to fail, despite their direct responsibility for the financial panic and attendant woes. On top of that, no high-profile participants in the disaster have been prosecuted or punished.[15] Yet in January and April 2011, two major reports—one from a ten-member Financial Crisis Inquiry Commission, the other from the U.S. Senate Investigations Subcommittee—were released, presenting both causes of and culprits in the crisis, and finding systematic breaches in accountability and ethics at all levels. Both reports had the same message: the financial crisis was caused by human actions, inactions and misjudgments—warning signs that were ignored.[16] Only time will tell if justice prevails and trust is restored.

These values, and others, lie at the heart of the fiduciary ethic, rightly understood, which was eclipsed by the race to achieve profits at any cost, with whatever risk. Within a context where risk is diluted to virtually nothing—meaning one faces no fines, penalties or other punishment for the results of one's actions, only rewards that enrich at the expense of others, most of whom are innocent bystanders with little knowledge of what has happened—our economic system has failed to deliver on its promise: that the playing field is open to those who chose to engage, and that the game is not rigged in favor of a few.

While there are many good reasons to criticize those who have deceived to gain success, there also is a case to be made for our own failure to build a broader consensus for the change we seek to make. As we demand badly needed reform and condemn Wall Street buccaneers, I suggest that those of us who have called for the integration of social responsibility criteria into economic decision-making reflect among ourselves about another insidious possibility: that we are at risk of losing our moral vocabulary and direction, our quest for values beyond meaningless generalities or quantifiable metrics. As Robert Wuthnow, Princeton professor and director of its Center for the Study of Religion, writes in *Poor Richard's Principle*, "Much of the Problem our society faces today in trying to bring its economic commitments back into alignment is rooted in the way we *think*, that is, in the moral frameworks we use in ordering our priorities and deciding how to lead our lives."[17]

We have become complacent in our respective niches, as a seismic shift has occurred in business thinking. As more companies, investors, regulators and intermediaries incorporate social and environmental factors into their decision making, we scramble for clients and subscribers, rather than create outlets for discussing what the moral roots of these matters and how we can do better. We have commercialized our commitments, without cultivating or converting them into public policy, public awareness or public education. We have failed to develop a critical consciousness that examines the ways and means of doing business in a globalized world of limited resources, while reducing inequities and increasing opportunities for living a good life.

We have splintered into stakeholder groups and issue camps, our battles for legitimacy won but our battle for capitalism's soul lost—for now. We have polished our rhetoric and expertise in narrowly defined terms and communicate only with each other, rather than opening up the conversation to a more diverse group of participants, keeping our eyes on that larger prize: a vision of the public interest, the common good affecting all people, and our responsibilities for fulfilling it.

We have focused on tactics and strategies, on key performance indicators and other metrics, often to the exclusion of the larger ideals, hopes and aspirations—Iincluding justice, fairness, dignity and respect—that originally inspired so many of us to action. Rather than sequestered, they should coexist, perhaps in tension but enriching discourse and decision making. At stake is no less than the future of civilization and community well-being, rather than whether or not one group's metrics are better or worse than another's, or one company's reporting format and story is better than another's, or one group's investment fund is better than another's. Put another way, economic rationality and its many applications exist in service to civic moral aims, just as economic behavior needs to be restrained by moral considerations—an idea that got lost in recent history, which landed us this mess.

Nota bene: Within the CSR realm, this realization surfaced again in March 2010, with two separate announcements of the "best" ethical or CSR companies made by two entities, Corporate Responsibility Magazine, and a group called the Ethisphere Institute. In both instances, questionable methodologies were used to determine what firms made the list. In the case of *Corporate Responsibility Magazine*'s "100 Best Corporate Citizens," a number of highly regarded companies with long-term commitments to CSR were not included. After checking into why, longtime CSR journalist Marc Gunther wrote on his blog, "So what's wrong? Essentially, the list takes a mechanistic approach that rewards structure and transparency—enacting policies, reporting and measuring data and publishing all of that on a website—at the expense of substance."

As for the Ethisphere Institute, *Slate* magazine reporter Will Evans discovered that their list had validity and credibility problems. The Ethisphere Institute describes itself as "a leading international think-tank dedicated to the creation, advancement and sharing of best practices in business ethics, corporate social responsibility, anti-corruption, and sustainability." In reality, it is a for-profit company, with an "advisory panel" of ethicists. According to *Slate*, several former members say they have had little, if anything, to do with it. Finally, "the Institute and an affiliated company sell services to and collect fees from some of the same companies Ethisphere extols."[18]

A Call to Action: The Need to Reassert Meaning and Public Engagement

Rather than take advantage of this sea change in business thinking to articulate its significance and value to a wider public, we have remained within the rarefied air of our own institutions, talking to each other within our cohort circles, seemingly unable or unwilling to explain our actions, share

our beliefs, engage in public debate or mobilize support for building the kind of capitalism we want, and describing the vision it serves. We remain comfortable in our own moral rectitude, unwilling to form necessary alliances to combat suffering, injustice, inequality, ignorance and other forces that poison public life around us.

My sense is that we have moved from flesh-and-blood activism to dispassionate and depersonalized, even parochial, professionalism. As CSR, SRI and now the term "sustainability" has evolved, so too has its routinization and insularity. Where once you could gather in one room those leaders and practitioners who built a movement, now there are literally thousands of providers and products from which to choose. Rather than focus on a vision embracing purpose, they focus on atomistic building blocks: how to write a sustainability report, how to communicate with stakeholders, how to vote your proxies.

Now that more companies issue sustainability reports (at last count, roughly 1,000 use the Global Reporting Initiative framework,[19] yet thousands more do not see the value in it), there is a danger that the spotlight will fixate on company numbers and narratives, rather than on norms and values that affect the broader system of which companies are but one part. The paradox of this progress is that as sensitivities to the environmental, social and governance ("ESG") dimensions of capital and corporate management grow, there seems to be less awareness of the greater good, the larger vision of sustainable prosperity and justice to which all this effort presumably is aimed.

Despite its sprawling infrastructure,[20] as demand for ESG services has increased, so, too, has the consolidation of the fledgling "industry." Once there were a number of specialized firms, including one co-founded by Steve Lydenberg called Kinder, Lydenberg and Domini (this was later known as KLD Research & Analytics, and recently sold to RiskMetrics, which financial index and investment services firm MSCI bought for roughly $1.55 billion in 2010). These specialized firms offered services to clients in ways that promoted public understanding, but now there is a low-key oligarchy, where oftentimes publicly-available knowledge is hard to get.[21] This is especially ironic in an open-source era, with Internet search engines providing timely information on unlimited topics. Gaining access to ESG information and shareholder resolutions, and their implications for a wider public, remains problematic unless you are looking for a specific issue covered by many websites (e.g., climate change or bonus pay/executive compensation) or are willing to provide private information for potential business purposes.

Three Propositions

In this paper, I will advance three propositions, all aimed at reinvigorating critical thinking and deliberation over why we do what we do, and inviting colleagues from other rooms in God's mansion to join us as we move along.

First, I briefly shall review the history of the CSR/SRI movement and its evolution into what we now call "sustainability," not from the standpoint of what has happened—historians can do a far better job of that than I—but from the standpoint of some of the key normative values, and their source that informed it. I shall also touch upon the evolution of corporate governance and reporting, in the broader context of accountability, although not with the attention it deserves. This history is rich in insights, made more exciting by current movement toward integrating financial and non-financial information into one unified report, as argued by Bob Eccles and Mike Krzus in their new book, *One Report: Integrated Reporting for a Sustainable Society*.[22]

My sense is that current practitioners may have forgotten these civic moral values, or lack a language for talking about them. They may be unaware of the rich traditions that guided those who pioneered this field, and may not comprehend the social compact, the spiritual resonance, that elevated the desire for human and ecological well being beyond the limits of self-interest, politics and markets.

Second, I shall argue that now is a propitious time to collaborate with those working in the field of Islamic finance, because we all can benefit from a deeper understanding of those religious, theological and ethical ideas that animate our practice. I will provide a small sampler of what I have learned and taught here, with respect to a vocabulary of values, certain faith traditions and their teachings about the obligations of wealth. Indeed, I am reluctant to say much about Islam because I know so very little; I want to learn more about the values Islam brings to economic enterprise, and the implications for the work that we do. As for theological reflection—here, too, I am a novice, but know of rich repositories of related information—typically falling under the rubric "social ethics," from which we can draw, if we are willing. Indeed, our colleagues at ICCR are in a perfect position to help us with this, as well as participate.

Third, as a way of getting started, I shall propose the creation of a "community of inquiry and practice" that enables an ongoing process of dialogue and exchange. Relying upon virtual and face-to-face engagement, this community of inquiry and practice can help us achieve a broader and better appreciation for these values and their roots, as well as enable future possibilities for collaboration, education and innovation.

Laying the Foundation for Building the Bridge

Any current discussion of corporate social responsibility (CSR) and socially responsible investing (SRI)—as well as the related realms of social enterprise, venture philanthropy, sustainable business, the integration of environmental, social, and governance (ESG) concerns into economic decision making and accountability—must begin with a recognition that we are in a very different place than when the modern "money and morality" movement began, some 40 years ago, here in the United States. Before turning to a discussion of bridges between this movement and Islamic finance, let us recall the evolution of the CSR/SRI movement—later to be joined by calls for better corporate governance and more disclosure and reporting, and more recent regulatory developments—so that a sturdier foundation might be laid, upon which that bridge can be built.

The Civic Moral Context: Controversy, Confrontation + The Common Good
Within the United States, beginning in the mid-1960s, social turmoil, not economic turmoil, dominated the public policy landscape.

Back then, there was public concern about "equity," but of a very different kind. I shall refer later to the semantic roots of this term, and how it directly relates to the social justice meaning given here.

Back then, there were affirmative action pressures to open up boardrooms and civil rights pressures to open up ballot boxes. Blacks and women refused to be relegated to the sidelines, and made their voices heard in ways that were to affect all institutions and organizations, opening up pathways for others also harmed by discrimination, non-English speaking immigrants, the disabled, gays, lesbians and transgendered people, to follow.

Back then, there was public opposition to an unpopular war as well as weapons of mass destruction. Antiwar demonstrators calling for peace and justice put the military industrial complex on notice, demanding greater transparency and, as in the case of nuclear power plants, that they be shut down.

Back then, thanks in large measure to Rachel Carson's *Silent Spring*, there was recognition that unless we changed our ways, we might find ourselves living amidst environmental devastation.[23] In a bygone climate of civic engagement and bipartisanship, the belief that clean water and clean air are rights, not privileges; that endangered species and wilderness lands are to be protected, not bought and sold; and that certain pesticides and toxic waste were a menace to humankind, met with widespread support and the passage of new laws.

Back then, few worried that sometimes product malfunctions might injure people. Ralph Nader helped changed this way of thinking with the

publication of *Unsafe at Any Speed: The Designed-In Dangers of the American Automobile*, ever more appropriate these days in light of Toyota's problems.[24] From then on, consumer protection and product quality and safety were viewed as legitimate matters.

Finally, back then, these respective movements—affecting civil rights, peace and justice, women's liberation, environmental stewardship and consumer protection—were nourished by the religious and moral ideas, language and symbols that constitute the beating heart of the American civic tradition. They existed within an ethos that recognized diverse perspectives while providing common ground.

Nowadays, the appeal is more instrumental: that one can do the right thing, and profit, without having to concede any losses. Nowadays, even with the CSR overlay, the profit motive governs the direction of financial services and marketplace activity, rather than being in service to something larger, grander and far more enduring.

Since the birth of our Republic—a genealogical product of Enlightenment and religious traditions—these ideas, vocabularies and symbols have enriched the soil on which Americans found common ground, enabling personally held moral and religious convictions to find expression in how citizenship was defined. Even as there were carefully constructed divisions between "church" and "state," notions of a *"good society,"* a *"common good"* and a *"commonwealth"* were extensions of moral and religious beliefs, mediated by adherence to public reason, the rule of law and a commitment to mutual honor and respect.

Notions of *justice, liberty* and *fairness*; of *pluralism* and *diversity*; of *equity*, "standing" and *trust*; of *independence, vision* and *innovation*; of *freedom, self-governance* and *self-determination*; of political *stability, safety* and *security*, were embedded in our social, cultural and political life. These virtues helped define *integrity*—meaning, both literally and figuratively, their integration into the fabric of community, institutional and individual life. They served as building blocks for our constitutional system of representative governance, enlivened by participation and public accountability. They were predicates, too, for our economic arrangements, because business was essentially about *community*.

Beginning in the late 1960s and early 1970s with FIGHT Kodak,[25] Campaign GM,[26] Dow Chemical's production of Agent Orange[27] and the Episcopal Church,[28] there were enormous social pressures on companies and institutional investors to eliminate discriminatory practices and promote equal opportunity for all. In 1971, the Interfaith Center for Corporate Responsibility (ICCR) was formed, now comprising 275 faith-based institutional investors.[29] Borrowing from the civil rights movement, the public

actions taken during this period were accompanied by appeals to a civic moral consciousness that radiated Judeo-Christian religious themes, but were not restricted to them, including beliefs that:

- an all-knowing God, not mammon or the market, supersedes all authorities;
- we humans are called to an ethic of service, justice and responsibility, especially in our professional and public life—a covenant, if you will, with God and for each other;
- human rights, a belief that each of us is made in the image of God, are a fundamental part of this covenant, thus enabling us to fight against oppression and the diminution of human dignity;
- a pluralist, democratic society provides the free space—governed by the rule of just laws, subjected to ongoing critical assessment and revision—in which we respectfully work out our differences, in service to the common good;
- we are freely able to form associations—in addition to our membership in groups based on family ties, race, class or jurisdiction—and that these incorporated entities, or "corporations," would be overseen by trustees who were accountable to the public interest obligations;
- as individuals and in communities, the covenant includes stewardship over the earthly realm of nature and her resources, another form of trusteeship that takes the long view of history; and
- our role in history is a tiny part of a longer journey toward a future destination, a New Jerusalem where life is transformed, that "city on a hill" to which John Winthrop referred when speaking of the founding of Boston.[30]

We have, of course, a long journey ahead of us before truly fulfilling these ideals, and I would be the first to say that we have made many horrible mistakes along the way. Democracy is a messy, unfolding project, and we still have much to learn, both within our own tradition and through insights gained from others, about how to do a better job.

But however imperfect and limited our progress, the "money and morality" movement that began more than 40 years ago sprang from many of the same religious, theological and ethical convictions that our forbears brought to public life. The idea was to make the American dream a reality and the country a better nation, with prosperity, liberty and justice for all.

Sadly, this "rootedness" in historic civic moral traditions is lacking today, despite the advances that have been made in integrating social responsibility, environmental and governance concerns across the range of economic decision making. While we can celebrate these tangible achievements—again,

those of us of a certain age never dreamed we would come so far, in what feels like a short time—we should be alarmed by the fact that they appear untethered to a paradigm or ethos or set of big ideas that can help us internalize a vision to help guide and assess our actions. You could argue that we have become a victim of our success, and that "the movement" is in danger of losing its soul. We need to dust off our moral compass and keep it in plain sight.

In addition to this depleted spiritual vessel, we suffer from a vocabulary that is impoverished. It is difficult to stir people's souls with terms such as *"social enterprise," "sustainability," "ESG," "social venture,"* or even that workhorse of a word, *"responsibility."* While perfectly appropriate for business cards, websites or office doorways, there is no firepower in those words, no poetry, no spiritual resonance or call to action. This is in contrast to terms evoking image and emotion, such as *"justice," "truth," "trust," "equity,"* (there's that word again!), *"duty," "sacrifice," "liberty."*

I shall return to this linguistic part momentarily, to show that there are historic precedents blending moral and economic meaning into one, reminding us that economic activity, rightly understood, is socially situated because it affects the life and well-being of *people*, of *community*—as well as the environment.[31]

From Confrontation to Collaboration: Stakeholders, CSR, Governance + Reporting

During the late 20th century, the "money and morality" movement was led, appropriately, by institutions devoted to cultivating the mind and spirit. Churches, colleges and universities advanced the proposition that companies and institutional investors had ethical obligations, beyond the bottom line.[32] Today, these arguments are being advanced primarily by NGOs and private sector, niche market organizations that have a stake in changing the system for the better, but tend to concentrate on their immediate goals and objectives, rather than visibly and verbally connecting them to their larger vision.

Beginning with concerns about racial justice, urban unrest and equal opportunity, early on the CSR/SRI movement also addressed contentious issues of nuclear and military weapons, environmental degradation and consumer protection. The primary force, however, driving advocacy and reform throughout the late 1970s until the early 1990s was apartheid in South Africa, as questions about *divestiture* (e.g., the sale of equity holdings with South African ties) and *disinvestment* (e.g., a corporate decision to withdraw subsidiary operations from South Africa) reigned supreme.[33] In short order, this was followed by similar pressures directed to institutions with economic ties to Northern Ireland and Burma.[34]

After Nelson Mandela's release from prison in 1994, the CSR/SRI movement returned to the cause of environmentalism, now revitalized with the Exxon *Valdez* oil spill, which led to the creation of a coalition now known as Ceres.[35] Ceres borrowed from the South Africa playbook (which involved corporate agreements to abide by a set of fair labor standards called the Sullivan Principles, named after civil rights advocate Rev. Leon Sullivan, the first black board member of General Motors) and established a code for environmental stewardship. Shareholder resolutions became, as with the Sullivan Principles, the primary instrument for persuading companies to sign the Ceres Principles, along with corporate dialogue.

Stakeholder theory

By the 1980s, the idea of external parties advocating for corporate change continued to gain popularity, particularly among college students and faith-based groups. Meanwhile, other actors emerged, called "stakeholders." The term "stakeholder" was first used in an internal memo at the Stanford Research Institute (now SRI International) in 1963 to describe "those groups without whose support the organization would cease to exist." According to R. Edward Freeman and David R. Reed, they included "shareowners, employees, customers, suppliers, lenders, and society."[36] Eventually, this definition would be widely accepted, including other groups such as NGOs, advocacy groups and legislative and regulatory bodies.

The emergence of stakeholder theory represented the admirable realizations of a company's role that stretch its vision and values beyond immediate self-interest. The problem, however, with the stakeholder approach to corporate (and investor) civic responsibility is the same sort of problem that bedevils contemporary political life: it reduces the corporate role to a series of bargains and trade-offs negotiated with particular special interest groups, absent the connective tissue of a philosophy, ethic or mechanism that mobilizes moral and physical energy in pursuit of a broader public good. "Stakeholder responsibility" becomes "special interest group responsibility" and, *ipso facto*, atomistic and episodic. Often missing is an overriding vision of the greater good and the civic ideal, described in both financial and non-financial terms, which give life to corporate activity in the first place.

CSR and business strategy

With respect to CSR, activists eventually found that they could make inroads with companies by carefully designed strategies and arguments. Companies, too, would find that it was in their interest to listen to stakeholders, because doing so might well improve business operations. Over time, this "Path to Corporate Responsibility," as Simon Zadek, a long-time

leader on the corporate accountability front, puts it, would become less a matter of external pressure and confrontation and more a question of organizational adaptation and dialogue with various external stakeholders. In 2004, Zadek presented a five-stage typology of organizational growth toward greater accountability through stakeholder engagement.[37]

Table 1: Path to Corporate Accountability

Defensive	Deny practices, outcomes, or responsibilities ("It's not our job to fix that")
Compliant	Adopt a policy-based compliance approach as a cost of doing business ("We'll do just as much as we have to")
Managerial	Embed the societal issue in their core management processes ("It's the business, stupid")
Strategic	Integrate the societal issue in their core business strategies ("It gives us a competitive edge")
Civil	Promote broad industry participation in corporate responsibility ("We need to make sure everybody does it")

Source: Zadek 2004

As firms become less defensive and more strategic, they recognize the multiple benefits that can accrue by asserting leadership in "best practices," which Nike learned after being targeted by activists in the 1990s due to egregious worker conditions throughout its supply chains. Even though it remains a business accountable to its shareholders, Nike "has taken significant steps in evolving a strategy and practice that shifts it from being an object of civil activism to a key participant in civil society initiatives and processes," Zadek writes.[38]

Corporate governance reform

Up until the early 1990s, shareholder engagement was hampered because institutional shareholders were prohibited from communicating with each other, and therefore could not form alliances. A decision made by the Securities and Exchange Commission (SEC) in October 1992 changed this, making it easier for large shareholder groups to talk among themselves and take collective action.[39]

Another reform measure at that time pertained to corporate governance. Historically, the corporate governance and social responsibility movements were populated by different people, up until the late 1990s. Even nowadays, these realms—both of which pertain to corporate power and accountability—remain distinct, despite their shared underlying values and concerns. A common goal for both groups was a desire for greater corporate disclosure

and transparency. In the early 1990s, though, in a nod to mounting shareholder concerns about excess pay, the SEC required that corporations increase their disclosure of executive compensation packages. This facilitated greater shareholder scrutiny of pay schemes, a contentious topic in 2010.[40] Nowadays, bonus pay and executive compensation remain on the reform agenda as part of a broader policy commitment to greater transparency, accountability and shareholder engagement.

During the 2000s, as stakeholder activism continued on a number of social and environmental issues, perhaps the most prominent efforts were directed to corporate governance concerns and greater corporate disclosure and voluntary reporting. By 2010, a myriad of legislative and regulatory proposals characterize the current corporate governance reform movement—some involving sustainability factors—and include measures before Congress, the SEC, various states and the New York Stock Exchange, as well as proxy resolutions.[41] Most of them call for better transparency and shareholder engagement.

Since President Obama took office in 2009, the SEC has taken major steps to revive its role as shareholder advocate, including consideration of environmental, social and governance factors. In June 2009, the new SEC Chairman Mary L. Schapiro created an Investor Advisory Committee (IAC) to give investors a greater voice in the SEC's work, and appointed a diverse and prominent group of 18 experts to it.[42] By late summer, the IAC identified three areas of work on which subcommittees would concentrate, including *investor education*, *investor as purchaser* and *investor as shareholder*.[43]

On February 22, 2010, the IAC met to review these subcommittees' preliminary recommendations. With respect to proxy voting transparency, the Investor as Owner subcommittee recommended that the SEC staff, as part of its review of the U.S. proxy voting system, study the costs and benefits of mandating a standardized tag-data format for certain proxy and proxy voting filings to make public search and access easier.[44] The IAC also discussed the formulation of an ESG Disclosure work plan; financial reform legislation and its implications for the SEC; a national survey of financial capability; and other investor education initiatives.

More than at any point in its history, the SEC has taken steps to integrate environmental, social and governance (ESG) concerns into its corporate disclosure requirements. In December 2009 the SEC adopted a set of new proxy disclosure rules, which took effect February 28, 2010. These rules, primarily aimed at boards of directors, expanded ways in which material risk could be defined, including its application to executive compensation policies and practices; qualifications and experiences of board members and board nominees; interlocking board relationships; diversity in the board nomination

process; board leadership structure; board role in risk management; potential conflicts of interest; and more timely voting results.[45]

The biggest area of corporate governance reform, however, involves opening the board election process to make it more consistent with our American tradition of self-governance and representative democracy, which is called "proxy access."[46] In theory, shareholders elect corporate directors to represent their interests; in practice, shareholders elect board candidates who are nominated by companies, not shareholders. Shareholder nomination of board candidates is an issue that has been around for a long time (at least 80 years), but in the future, there likely will be more activity regarding the provisions of Rule 14a-11 of the Securities Exchange Act of 1934. Rule 14a-11 is the shareholder proposal rule, which the SEC viewed as an impediment to the exercise of shareholders' rights, particularly with respect to board elections and shareholder nomination of candidates to corporate boards of directors. Its proposed changes to Rule 14a-11 granted investor groups owning at least 3 percent of the voting power of a company's stock for at least three years the power to nominate candidates for a corporate board; it also would let these nominations be included in the company's proxy materials, mailed to shareholders at the company's expense. Generally referred to as "access to the proxy" or "proxy access," this issue remained stalled until July 22, 2011, when the Court of Appeals for the District of Columbia struck down the SEC's proposed change to Rule 14a-11.

Here's the background on the battle for proxy access, which in some ways resembles the battle for self-governance and the voting rights efforts of the civil rights movement in the mid-20th century, albeit without violence.[47] In December 2009, the SEC reopened the public comment period for about a month on its modifications to Rule 14a-11,[48] first proposed in June 2009.[49] On Aug. 25, 2010, the SEC made its decision on proxy access,[50] which was challenged by the U.S. Chamber of Commerce and the Business Roundtable, who filed suit[51] on Sept. 29, 2010, in the DC Circuit Court of Appeals, to block its enactment, on the grounds that it "empowers unions and special interests at the expense of shareholders."[52] On Oct. 4, 2010, the SEC granted a stay on the effectiveness of its proxy access rule.[53] Oral arguments were held on April 7, 2011, before three judges, who questioned the SEC's assessment of the costs and benefits of the proposed rule, and whether it would empower labor and public pension funds at the expense of other investors.[54]

The measure was slated for adoption in November 2011, and would give shareholders the authority nominate directors on corporate boards through a federal proxy access right and include shareholder proposals in company proxy materials. This means that, under certain circumstances, a company would have to include in the company's proxy materials a shareholder's, or

group of shareholders', nominees for director. Normally, this is a prohibitively expensive cost for shareholders to incur, so the change will help democratize the process; so, too, will the use of Web 2.0 technologies to conduct public communication on director campaigns.

But on July 22, 2011, the DC Circuit Court of Appeals overturned the SEC's proxy access rule (14a-11), claiming that the S.E.C. "acted arbitrarily and capriciously" in failing to adequately consider the rule's effect on "efficiency, competition and capital formation." [55]

"Here the commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters," the court said, in a unanimous decision written by Judge Douglas H. Ginsburg.[56] The court also expressed concern about the union and state pension funds might use the rule for their own purposes, at the expense of other shareholders.

Meanwhile, SEC proposed amendments to Rule 14a-8 remained intact, which lets shareholders owning at least $2,000 in stock for a year to submit proposals. This means that individual shareholders may continue to submit proposals asking companies to specify under what conditions they may nominate candidates for boards of directors, in fulfillment of Rule 14a-8, which took effect on September 20, 2011.[57] This is similar to conditions prior to the 1965 Voting Rights Act, when, absent a universal law protecting suffrage, civil rights attorneys had to go county by county to demonstrate that the constitutional rights of African Americans were being violated.[58]

By early 2012, a number of companies and grassroots groups such as the United States Proxy Exchange base their efforts on this, while seeking to open up corporate governance and accountability more broadly.[59] (Further information on the proxy access debate is available online at the Harvard Law School Forum on Corporate Governance and Financial Regulation, including its proceedings of the HLS Proxy Access Roundtable.[60])

On the environmental front, in January 2010, the SEC released what many consider to be a landmark guidance on disclosure related to climate change.[61] Taking effect in February 2010, the guidance clarifies existing rules requiring companies to disclose material risks related to climate change, such as projected impacts of new legislation and international treaties capping carbon emissions.

On social fronts, pressure continues to mount on Congress and companies to address the role of corporate money in political campaigns, in the wake of the recent Supreme Court decision in the *Citizens United v. Federal Election Commission* case, which considerably expanded corporate political

contribution rights.[62] At the end of March 2011, the SEC made an important decision to allow a shareholder resolution seeking a say on political spending at Home Depot, for consideration during the 2011 season.[63] Shareholders used a variety of approaches in their proposals to increase a firm's transparency and accountability of its political spending—including floor motions and votes at annual meetings questioning a firm's association with the Chamber of Commerce.

Meanwhile, in August 2010 the SEC proposed new rules for greater disclosure and engagement between boards and shareholders, as well as for board diversity.[64] And by June 2011, the United Nations will ratify Guiding Principles for the Implementation of the U.N. 'Protect, Respect and Remedy' Framework, affecting business and human rights. This concludes a global consultation process begun in 2005 by John Ruggie, Special Representative of the United Nations Secretary-General for business and human rights. [65]

Corporate disclosure + reporting

As with the notion of corporate social responsibility, within business circles the idea of corporate reporting covering both financial and non-financial areas is not new. Going back at least 80 years, academics, accountants, policymakers and practitioners in the United States, Canada and Great Britain have tackled the interrelated topics of "social auditing" and "social accounting" as a means of measuring and appraising corporate social responsibility in addition to economic performance. In doing so, they have wrestled with the scale and scope of definitions and with comparable forms of assessment.[66] Some of these efforts set the stage for normative accounting methods as a complement to financial metrics. In the meantime, many companies in the Netherlands, Sweden, Germany and India also reported on their social, environmental and economic performance, which supplemented their annual reports, but were not integrated into corporate decision making.[67]

The late Howard Bowen is credited with coining the term "corporate social responsibility" and "social audit" (which he argued should be conducted every five years by an independent agent) with the publication of *Social Responsibilities of the Businessman* in 1953.[68] Yet, as Eccles and Krzus point out in their book *One Report*, Bowen was not the only one thinking along these lines:

> Varying discussions on business's responsibility to and role in society had appeared even earlier, including Harvard Business School Dean Wallace B. Donham's *Harvard Business Review* article "The Social Significance of Business" in 1927. Donham claimed that "the development, strengthening, and multiplication of socially minded

> business men is the central problem of business' and expressed the concern that 'unless more of our business leaders learn to exercise their powers and responsibilities with a definitely increased sense of responsibility toward other groups in the community . . . our civilization may well head for one of its periods of decline." Although Donham did not use the term "stakeholder," which appeared much later, he was clearly referring to them in his reference to "other groups in the community."[69]

By the early 1970s, the Boston consulting firm of Abt Associates created a social accounting instrument that combined qualitative and quantitative criteria, based on Clark C. Abt's work described in *The Social Audit for Management*.[70] Because the book was published during the height of social unrest, particularly directed to issues of military contracting and racial justice, companies were reluctant to reveal potentially controversial information to outsiders, and thus become vulnerable to boycotting or other forms of sanctions.

During the 1980s, a different reporting approach emerged, which involved comparative rating schemes that addressed broad areas of concern, such as equality and labor standards, or environmental stewardship. As mentioned earlier, the success of the Sullivan Principles in the 1970s and 1980s, pertaining to labor conditions in South Africa, served as the prototype for subsequent ratings models, including the McBride Principles (regarding corporate activity in Northern Ireland), and the Valdez Principles (named after the 1989 Exxon tanker *Valdez* oil spill in Alaska's Prince William Sound, and directed to environmental responsibility).

By the early 1990s, as Steve Lydenberg and his co-author Karen Paul wrote about in 1992, four basic types of CSR rating systems were in place: single company, single issue; single company, multiple issue; multiple company, single issue; and multiple company, multiple issue.[71]

Since then, the notion of CSR rating has expanded greatly (as has the realm of corporate social responsibility reporting), driven by a combination of: wider acceptance of the legitimacy of integrating sustainability concerns into business practices; more sophisticated stakeholder strategies and tactics; and changes in the public policy environment that raise public expectations while placing business under greater scrutiny.

In addition, the proliferation of innovative digital tools for the production of accurate, verifiable information make it possible for real-time, location-specific, widely accessible distribution to virtually anyone who wants it, even though few companies currently avail themselves of such options. Finally, recent calls for the integration of financial and non-financial data

into one unified corporate report are taken more seriously, in recognition of both the materiality of environmental, social, and governance considerations to overall business success, and the urgency of a longer-term sustainability vision to overall planetary well being.[72]

Since 1997, the Global Reporting Initiative (GRI) has played a crucial role in driving acceptance of reporting on social, environmental and economic performance. In 1997, the GRI was created by Allen White and Robert Kinloch Massie, who believed there ought to be a publicly verifiable disclosure framework for corporate environmental, social and governance reporting. Following a period of global consultation involving hundreds of stakeholders, in 2000, the GRI's first Sustainability Guidelines were issued, with 50 organizations releasing reports based upon them.[73] By 2008, the global number of companies issuing CSR reports had reached an all-time high, with more than 1,000 relying upon the G3 Guidelines, the latest generation of guidelines, issued in 2006.[74]

The G3 Guidelines generally are perceived as the world's most authoritative framework for sustainability reporting, in part due to the highly participatory nature of their origins. In the *Commission Guidance Regarding Disclosure Related to Climate Change* issued in January 2010, the SEC cited GRI as a "widely used sustainability reporting framework."[75] At the February meeting of the SEC's new Investor Advisory committee (installed by Chairman Mary Schapiro in July 2009), the Investor as Owner subcommittee proposed a work plan to examine the value of environmental, social and governance (ESG) disclosure based on GRI and Carbon Disclosure Project frameworks.[76] Sweden already requires all state-owned companies to publish annual GRI-based sustainability reports, and other countries, including Denmark, Norway and China, are developing similar policies.

The GRI has added its voice to this call. In the March 2009 *Amsterdam Declaration on Transparency and Reporting*, the GRI urged all the world's governments "to extend and strengthen the global regime of sustainability reporting. In particular, assumptions about the adequacy of voluntary reporting must be reexamined."[77]

The Role of Religion and Ethics in Public Life

Earlier this month, the Kennedy School's John F. Kennedy Jr. Forum hosted a panel discussion on the role of faith in the marketplace, and ways in which organized religion can be an important force for financial reform. According to the scholars who took part in a panel entitled "From Wall Street to Main Street: The Search for a New Moral Compass for the New Economy," the current economic crisis is not only structural, but spiritual. "We have to address both," said panel member Jim Wallis, an evangelical minister as well

as president and CEO of Sojourners, an evangelical Christian organization. He described unwarranted high corporate salaries and bonuses "a symptom of societal erosion." According to a report on this discussion in the *Harvard Gazette*, Wallis called for a new national ethic, one that "focuses on helping one another and that considers the repercussions of current actions on future generations."[78] Echoing the impetus that led to the formation of ICCR, panelists claimed that church and social justice organizations have an important role to play in pressing for reform, and holding policy makers and organizations accountable.

The moral responsibility of institutions is an important part of this effort, said Fr. J. Bryan Hehir, a former colleague of mine at the Harvard Divinity School and Parker Gilbert Montgomery Professor of the Practice of Religion and Public Life at the Kennedy School. Fr. Hehir is a distinguished thought leader in the realm of religion, social policy, and international affairs, particularly with respect to the Catholic Church. At the faith and finance forum, Fr. Hehir pointed out that the Catholic Church is "fairly institutional," and therefore well suited to address "what institutions need to do." Using that type of institutional framework, people can "then open up into other aspects of civil society," he said,[79] a perspective very much akin to the animating mission of this 9th Forum.

Fr. Hehir and Rev. Wallis were acknowledging an essential truth: that *economic enterprise is not value-free.* Embedded within their structures and operations are assumptions about what is considered "good" and "right," "right" or "wrong," assumptions that become more coherent and fully developed as the institution or industry cultivates its specific culture and character. These assumptions, clouded as they may be by the language of financial accounting and quarterly reports, serve as the compass that guides institutional decision making and communication. Behind the numbers lie certain first-order principles or values—a company's moral sense, if you will—that need to be made more explicit, more transparent, as many thoughtful observers have recognized.[80]

A Values Vocabulary

Semantic similarity

Let us ponder: A striking example of the connection between economic activity and the moral realm is the semantic similarity of financial and religious vocabularies. Terms such as "*good,*" "*equity,*" "*value,*" "*trust,*" "*denomination,*" "*capital,*" "*vest*" and "*invest,*" "*redemption*" and "*redeem,*" "*debt,*" "*futures,*" and "*dispensation*" are examples of words with double meaning. In fact, the word "economy" comes from the Greek "*oikonomia,*" which means "management of the household," with the household connected to

the production, distribution and consumption of life's necessities. *Oikonomia* is a multifaceted word that sometimes is translated as "stewardship," itself a first cousin of "fiduciary," which means a designated agent occupying a special relation of trust, confidence or responsibility in obligation to others.

As theologian John Reumann, who began studying and writing about the concept more than 50 years ago, put it, the term *oikonomia* "has an amazing host of established meanings in many areas of life. It [is] a word capable of new applications, a 'word field' of expanding horizons."[81] Put another way, the *oikos* (household) is the root of economy, representing a community of interdependent persons possessing a shared purpose, the locus of shared survival, its members immersed in a set of moral and political beliefs and seeking "the good life" as they understand it. The household becomes, in McGill University political scientist William James Booth's words, "the institution in which we labor to provision ourselves in the things necessary for life; but it is also where we seek to emancipate ourselves, as far as we are able, from the drudgery that is our estate . . . [It] is the means by which we secure such freedom as is possible from the poverty of our condition and in which we avoid a freedom-robbing dependence on others."[82]

In the language of some Christian theologians, the metaphor of "economist" is applied to God's work, because He brings into being and seeks to maintain the household of Israel and the church, the household of all nations and, ultimately, the household of all creation; thus, whole economies can be referred to as households, constantly threatened by chaos, sin, evil and death.[83]

Fiduciary obligation

We hear the word "fiduciary" often, but do we know what it really means, and how it is interpreted? Once again, there are deep roots in virtue language and moral philosophy, even as the idea of fiduciary is subject to legal and regulatory interpretation.

Notions of "fiduciary responsibility" are not absolute; they are relativistic concepts that have evolved over time. The idea of a fiduciary relationship to a fund of money is rooted in English common law but the legal concept of the "prudent man" was expressed in a case involving Harvard College 180 years ago.[84] The scope of fiduciary responsibility as applied to institutional investors is subject to definition by federal and state agencies under existing laws. These agencies include the private pension system subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and the Department of Labor; investment companies subject to the 1940 Investment Act and the Securities and Exchange Commission; bank trusts subject to the Federal Reserve, the FDIC and the Comptroller of the Currency; and

public pension funds, charities and endowments subject to the Internal Revenue Service, as well as state laws and the offices of attorneys general.

Under the laws pertaining to the fiduciary role, board members have three duties to consider in maintaining a trustee's standard of care. The first is to *act as a prudent person* might act in similar circumstances. The second is to *avoid conflicts of interest*. The third is to assure that the *organization operates consistently*, in keeping with the rules and laws governing its formulation, and in accordance with its bylaws and mission. Generally speaking, these duties entail full exercise of the legal rights of ownership, which includes the purchase and sale of assets, voting proxies, conveying concerns to corporate boards and management, submitting proposals for shareholder action at annual meetings, convening shareholder meetings or joining forces with other investors and interested parties on issues of mutual interest, taking legal action, conducting equity research, hiring outside specialized agents and so on.

Thanks to the efforts of corporate governance activists, governance concerns are now considered a significant part of the fiduciary role, even though the focus is on companies rather than on an investor's own governance regime or that of stakeholders. This is where significant room remains for addressing fiduciary leadership and governance.

Similarly, there is room for addressing the "consistency" standard, meaning the extent to which an organization's investment policy and practices integrate the ideals, values, and principles embedded in its mission statement. The challenge of aligning investment decisions with institutional mission has yet fully to be met. Certain beneficial fiduciaries, including a handful of foundations, socially responsible investment funds, many religious investors and a number of prominent pension funds have broken important new ground in this territory and serve as models for others to emulate. One such organization is the Initiative for Responsible Investment, the brainchild of Steve Lydenberg, now based at Kennedy School's Hauser Center for Nonprofit Organizations.[85]

In addition to the meaning of "fiduciary," we also need to be clear about what "economy" is and what it is not. "Economics" is an array of analytic tools that apply to diverse situations. It is not a rigid set of universal principles, nor is it a roadmap for how we should live our lives. What *oikonomia* and economics both have in common is recognition, since the time of the ancient Greeks, that there was no sharp boundary between economic matters and those having to do with social status, politics, and ethics. The "natural" economy of the household and the world of the market, as Aristotle taught us, could either advance or undermine the good life, freedom, and community.[86]

We have come a long way from Aristotle, but the essential truths remain the same. Nowadays, although it may provide a glimpse, the marketplace is not a good gauge of the moral sense of society, or of its institutions. It cannot help us understand what kind of world we want to live in, what our aspirations are or how things might be better. In fact, the marketplace does little to help us maintain our civic moral bearing. It does little to preserve basic fairness, justice or truth telling. It does little to help us aspire to greatness, the stuff of which our democratic way of life is made. In fact, within the globalized consumer economy, these values and democratic ideals have become corroded, with civic virtue giving way to crass commercialism and a consumer ethic of unbridled consumption.

The financial crisis is a painful reminder that corporate profitability and stock price value provide only a distorted picture of society's well being, or of the extent to which human dignity or freedom are honored. After the meltdown, we are reminded that commercialism and consumerism are not enough, that some goods cannot be bought and sold, and that we have a long way to go before our dynamic global economy can produce a decent global life.

The call for a new breed of capitalism seeks to strengthen capital markets and corporate enterprise by promoting religious, theological and ethically situated civic moral principles, standards, procedures and trustee knowledge and competence. The goal is to help corporate directors and institutional investors fulfill their fiduciary obligation in a manner that balances long-term financial prosperity with the common good, a noble idea with ancient roots and enshrined within our democratic ideals.

Equity culture

Another word with multiple meaning that is used by so many of us every day is "*equity.*" Taken literally, equity means "standing," that one has a stake in an entity, whether it be a company (e.g., stock ownership), a society (e.g., fair treatment or social justice) or a relationship (e.g., an equitable right or claim). As British historian Anthony Everitt tells us in his superb biography of Cicero, in ancient Roman society the notion of *equites* referred to a class of citizens having commercial concerns. *Equites* were the landed gentry, businessmen and merchants who tended to avoid national politics. Originally a military class, *equites* meant "knights" whose wealth enabled them to buy a horse for military campaigns. Within the Roman social hierarchy, *equites* ranked below the aristocracy, yet were above the plebs (the urban masses, including shopkeepers, artisans and landless farm workers) as well as, at the very bottom, the slaves.[87]

Thus in many ways, "equity" denotes "citizenship." The late Harvard government professor Judith Shklar provided a contemporary notion of equity.

She referred to equity as social standing—meaning inclusion and respect—symbolized by the opportunity to vote and to earn a living, as well as participation, accountability and representation in the polity. One can only speculate as to how much we would have gained, had she lived to enlighten us, by hearing her tackle the question of citizenship as applied to corporate directors or shareholders, particularly institutional investors.[88]

With regard to human endeavors, "equity" takes on special importance because it suggests a capacity to be involved, to participate, to be in a position to chart one's course, to be engaged in a process of self-governance. As applied to social capital, "equity" is a cornerstone of democratic civil society. As applied to human capital, "equity" is a tenant of nondiscriminatory labor policies. As applied to financial capital, "equity" is a fundamental fixture of open markets and effective capitalism.

Whatever the capital domain, whether social, human or financial, "equity culture" relies on certain virtues or else it faces collapse. The most basic of these is trust, so that decisions can be made based upon truthful and reliable information, that these decisions are guided by principles of ethics and fairness and that "access to equity" is not just a right but a responsibility for strengthening equity culture for generations to come. Another requirement for equity culture is knowledge, so that one's stake in an entity can be managed in a way that promotes growth and development, prosperity and well being. A third is sustainability, so that this growth and development can continue, without inflicting injury or falling victim to the dangers of greed, ignorance or hubris.

As the past several years have shown, however, economic enterprise sometimes undermines the very virtues and values it is supposed to uphold. We should remember that not everything can be bought and sold, that intangible goods such as honor, trust, honesty and integrity are the connective tissue that holds together the body politic, capital markets, equity culture and civil society. Yet equity culture has been hijacked by those who have scorned these intangible goods, violated their fiduciary duties, made a mockery of our financial system and, in the process, inflicted damage on countless investors, pension beneficiaries, homeowners and innocent bystanders.

Theological Reflections and Religious Teachings on the Moral Obligations of Wealth

There is much to be learned from the world's faith traditions with respect to the moral obligations of wealth, and this forum provides one important outlet. Let us briefly review what the Christian, Jewish, Muslim and Buddhist traditions have to offer, a point of departure for a far deeper exchange, as we think about the implications for our professional practice.

Christian traditions

In the late 1980s and early 1990s, various Christian groups and individuals issued a number of publications that specifically address the integration of civic moral concerns into economic decision making; generally left out of these, however, is the manner in which this might become manifest in corporate governance and ownership responsibilities. In 1986 the National Council of Catholic Bishops produced a pastoral letter entitled *Economic Justice for All*, a comprehensive and sophisticated work drawing upon scripture and Catholic social teaching as well as extensive consultation with lay people and economic, political and social science experts.[89] The bishops firmly stated that "economic decisions have human consequences and moral content; they help or hurt people, strengthen or weaken family life, advance or diminish the quality of justice in our land."[90] Moreover, they elaborated on the idea of a "preferential option for the poor," particularly as applied to U.S. relations with developing nations. Here they stressed the importance of understanding the interplay among three main sets of actors: individual nations; multilateral institutions, which channel money, power, ideas and influence; and transnational corporations and banks, which have grown dramatically in number, size, scope and strength since World War II.[91]

Overall, the bishops suggested that the time has come for a "New American Experiment" involving the implementation of economic rights, the expansion of economic power sharing and economic decision making that is more accountable to the common good. Essential to this is "an imaginative vision of the future that can help shape economic arrangements in creative new ways" and "new forms of cooperation and partnership among those whose daily work is the source of the prosperity and justice of the nation."

> The United States prides itself on both its competitive sense of initiative and its spirit of teamwork. Today a greater spirit of partnership and teamwork is needed; competition alone will not do the job. It has too many negative consequences for family life, the economically vulnerable, and the environment. Only a renewed commitment by all to the common good can deal creatively with the realities of international interdependence and economic dislocations in the domestic economy. The virtues of good citizenship require a lively sense of participation in the commonwealth and of having obligations as well as rights within it. The nation's economic health depends on strengthening those virtues among all its people, and the development of institutional arrangements supportive of these virtues.[92]

Included in these new arrangements and partnerships were references to greater employee/labor participation in business, more local and regional

cooperation with special emphasis on community development corporations, public/private efforts aimed at the formation of national economic policies, and the formation of new international partnerships, particularly within developing countries, "based on mutual respect, cooperation, and a dedication to fundamental justice."[93] They lightly touched upon the topic of the corporate manager/shareholder relationship, claiming that "the parts played by managers and shareholders in U.S. corporations also need careful examination" and that this relationship be governed by broader criteria than simply return on investment. They said:

> Most shareholders today exercise relatively little power in corporate governance. Although shareholders can and should vote on the selection of corporate directors and on investment questions and other policy matters, it appears that return on investment is the governing criterion in the relation between them and management. We do not believe this is an adequate rationale for shareholder decisions. The question of how to relate the rights and responsibilities of shareholders to those of the other people and communities affected by corporate decisions is complex and insufficiently understood. We, therefore, urge serious, long-term research and experimentation in this area. More effective ways of dealing with these questions are essential to enable firms to serve the common good.[94]

In 1991, Pope John Paul II's encyclical *Centesimus Annus* ("The Hundredth Year") examined the economic and moral questions raised, among other things, by the upheaval in Eastern Europe in 1989; the 25,000-word document represented the most comprehensive treatment in any papal document of the role of the free market in the economy.[95] *Centesimus Annus* was issued to mark the 100th anniversary of *Rerum Novarum* ("Of New Things"), an encyclical by Pope Leo XII that marked the beginning of the modern era of Catholic social teaching. While *Rerum Novarum* dealt with the impoverished conditions of the industrial working class in the late 19th century, *Centesimus Annus* stated that "*the free market*" is the most efficient instrument for utilizing resources and responding to needs" but it exists within a moral framework limited by three realities: (1) "there are many human needs which find no place on the market"; (2) there are whole groups of people without the resources to gain access to the market; and (3) there are goods that "cannot and must not be sold." "It is a strict duty of justice and truth not to allow fundamental human needs to remain unsatisfied, and not to allow those burdened by such needs to perish. . . . Even prior to the logic of a fair exchange of goods and the forms of justice appropriate to it, there exists *something which is due to man because he is man,* by reason of his lofty dignity."[96]

John Paul acknowledged "the legitimate *role of profit* as an indication that a business is functioning well" but claimed that this is not the only criterion. He wrote, "*other human and moral factors* must also be considered which, in the long term, are at least equally important for the life of a business."[97] These are the elements to be found in what he called "*the new capitalism,*" a capitalism that exists in service to human freedom, the core of which is ethical and religious.[98] Within this core are to be found a number of important economic virtues, including "diligence, industriousness, prudence in understanding reasonable risks, reliability and fidelity in interpersonal relationships, as well as courage in carrying out decisions which are difficult and painful but necessary, both for the overall working of a business and in meeting possible set-backs."[99]

While insisting that economic development and the production of wealth are key to economic justice, the Pope also asserted the need to include labor and management in a "community of work" and "circle of exchange," thereby reinforcing the view that business is a "community of persons" or "society of persons" in which people participate in different ways and with specific responsibilities. He writes:

> It is not wrong to want to live better. [W]hat is wrong is a style of life which is presumed to be better when it is directed toward "having" rather than "being," and which wants to have more, not in order to be more but in order to spend life in enjoyment as an end in itself. It is therefore necessary to create life-styles in which the quest for truth, beauty, goodness, and communion with others for the sake of common growth are the factors which determine consumer choices, savings and investments. In this regard, it is not a matter of the duty of charity alone, that is, the duty to give from one's "abundance," and sometimes even out of one's needs, in order to provide what is essential for the life of a poor person. I am referring to the fact that even the decision to invest in one place rather than another, in one productive sector rather than another, is always *a moral and cultural choice.* Given the utter necessity of certain economic conditions and of political stability, the decision to invest, that is, to offer people an opportunity to make good use of their own labor, is also determined by an attitude of human sympathy and trust in Providence, which reveal the human quality of the person making such decisions.[100]

John Paul went on to argue for the inclusion of poor nations in the world economy's "community of persons" and for increased attention paid to ecological and environmental questions, which accompany the problems of production and consumerism. He also addresses the need to place the market

economy in the broader context of state and society, noting the interconnections between faith and religious life and major political, social and economic developments, particularly the internationalization of the economy. Admitting that the "Church has no models to present" because "models that are really and truly effective can only arise within the framework of different historical situations, through the efforts of all those who responsibly confront concrete problems in all their social, economic, political and cultural aspects as these interact with each other," he cites the Church's social teaching as providing "an *indispensable and ideal orientation* which recognizes the positive value of the market and of enterprise," but also points out that "these need to be oriented toward the common good."[101]

Insofar as ownership is concerned, the Pope did not specifically discuss the issues of corporate stock ownership or institutional investing yet his pronouncements could be applied to this indirect form of ownership. He continually reiterated the theme of *"the relationship between individual or private property and the universal destination of material wealth."*[102] In his view, ownership "morally justifies itself in the creation, at the proper time and in the proper way, of opportunities for work and human growth for all."[103] This "universal destination of material wealth" well could be interpreted as one call of the covenant, offering access to a better life to those traditionally excluded from economic enterprise.

In 1987, the United Church of Christ (UCC) issued its comprehensive *Christian Faith and Economic Life* to promote reflection and discussion of the relationship between faith and economic justice issues within the denomination. The paper was the product of the UCC's Economics and Theology Covenant Group and addressed a wide range of issues, including economic democracy, environmental hazards and militarization; it focused on both domestic and global aspects of what it terms a "public theology of economics" and calls upon the church for public advocacy and economic transformation.[104] In its section concerning the corporation, *Christian Faith and Economic Life* referred to the need to address the relationship between corporations and the political and social order. Without offering specifics, the document stated:

> . . . the Christian principles of economic justice offer the basis for beginning to consider corporate roles, ownership patterns, and modes of operation in relationship to the wider society. The goals of such a reformation would be to assure the preservation of pluralism and the productivity of the corporation while promoting greater responsibility and accountability to the community, broader participation in corporate decision-making, and greater justice in the impact of the corporation on the wider community.[105]

The application of ethical imperatives to economic enterprise is as old as civilization itself. Moreover, the contribution of organized religion to questions about the public moral responsibilities associated with the accumulation of wealth is not wholly restricted to Christianity but can be found in at least three other of the world's great religions. And, the origin of the term "covenant" is found in Biblical times but is not restricted to them.

Jewish tradition

Within the Torah, certain "laws of the household" are put forward as part of the covenantal relationship with the people of Israel (the Book of the Covenant, Exodus 20:22–23:33), with special emphasis on the needs of the poor. "The future is guaranteed not by I-thou contract but by the binding agreement of the community," writes M. Douglas Meeks, a theologian (and co-chair of the UCC Economics and Theology Covenant Group) who has written extensively about the relationship between Christian/Judaic doctrine and the political economy. "What is required for promise-keeping is that all put each other under obligation, [with] the multiple relationships of the community [serving as] the guarantor of all expectations within the community."[106] These guidelines for household management enabled the Israelites to live faithfully to God and responsibly to the community; the Torah places limits on cultivating, collecting, buying and selling and emphasizes the subordination of economic activity to fulfillment of the covenantal relationships. Those who have no standing in the community are to be included as full participants in the promise of the covenant, including the poor (Exodus 23:6, Deuteronomy 15:7–11), the stranger (Exodus 21:21–24), the sojourner (Deuteronomy 10:19) and the widow and the orphan (Deuteronomy 24:19–22). The Torah respects the integrity of all of creation; land is to be included in the covenant with the faith community and not merely at the disposal of human beings (Exodus 23:11; Leviticus 25:1–7).

Extending from the covenant, other Torah laws have implications for our time, such as the issue of interest on loans. "If you lend money to any of my people with you who is poor, you shall not be to him a creditor, and you shall not extract interest from him" (Exodus 22:25; cf. Deuteronomy 23:19–20). Israel condemned interest because it led to poverty and certain forms of slavery; even with the introduction of a market economy, the Torah provided strict laws on surety, such as prohibiting the taking of collateral if it were to destroy a person's access to livelihood (Exodus 22:26–27; cf. Deuteronomy 24:6, 10–13; 15:7–11). Another Torah law concerned the giving of tithes. The law of the tithe was intended to grant the poor access to a livelihood (Deuteronomy 14:22–29) and as a reminder that prior to the covenant the Israelites were slaves in Egypt (Deuteronomy 24:18, 22). Hospitality, too, is a form of inclusion for all those (the stranger and sojourner,

the widow, the orphan and servants) who were excluded from the benefits of the economic order; indeed, true hospitality was considered a form of worship, because it consisted of inviting in all those who were excluded or denied God's gifts for life.[107]

Finally, the Torah made provisions for special mechanisms that confronted squarely disparities in wealth and class. During the Sabbatical year, every seventh year, the land was to remain fallow (Exodus 23:11; Leviticus 25:1–7); so, too, were debts to be released (except those held by foreigners) every seventh year (Deuteronomy 15:1–11). The Jubilee Year was to occur every fifty years (the year following seven times seven), during which liberty was proclaimed throughout the land: property was to be restored to its original owners, slaves were to be freed, debts were to be canceled and the land was to lie fallow (Leviticus 25:8–17; 23–24). While there is disagreement as to whether or not the Jubilee Year was ever practiced, its images provide a powerful statement of the subordination of everything to the One Creator: that no one is given special status to take or withhold from others what they need to contribute to community, that there exists mutual respect among people and that the oppressed need to be released from bondage.[108] Put another way, this release from bondage occurs through the lifting of economic sanctions.

Islamic tradition

The idea of moral obligation as applied to economic life also can be found in Islam, with God speaking through the Quran. Believers were expected to have total obedience. The covenantal relationship between God and the followers consisted of obedience to divine rules in exchange for divine favors, the faithful being called the *umma*, or community of Muslim believers. The Prophet Muhammad communicated a moral basis for society, with compassion, goodness and piety as central virtues; extending from this is a specific way of life as determined through an elaborate system of rules for social behavior.

Insofar as wealth is concerned, one of the pillars of virtue in Islam is almsgiving; the Quran treats wealth (and children) as subordinate to deeds of lasting merit in service to the Lord. A sampler of these teachings:

- Let those who hoard the wealth which God has bestowed on them out of His bounty never think it good for them: it is nothing but evil.
- Believers, many are the clerics and the monks who defraud men of their possessions and debar them from the path of God. To those that hoard up gold and silver and do not spend it in God's cause, proclaim a woeful punishment. The day will surely come when their treasures shall be heated in the fire of Hell, and their foreheads, sides, and backs

branded with them. They will be told: "These are the riches which you hoarded. Taste then what you were hoarding."

- You shall not barter God's covenant for a trifling price. His reward is better than all your gain, if you but knew it. Your worldly riches are transitory, but God's reward is everlasting. We shall reward the steadfast according to their noblest deeds. Be they men or women, those that embrace the Faith and do what is right. We will surely grant a happy life. We shall reward them according to their noblest deeds.
- And what cause have you not to believe in God, when the Apostle calls on you to have faith in your Lord, who has made a covenant with you, if you are true believers? Those of you that gave their wealth before the victory, and took part in the fighting, shall receive greater honour than the others who gave and fought thereafter. Yet God has promised you all a good reward; God has knowledge of all your actions. Who will give a generous loan to God? He will pay him back twofold and he shall receive a rich reward.
- God does not love the haughty, the vainglorious; nor those who, being niggardly themselves, enjoin others to be niggardly also.[109]

There are many rich contributions that Muslims can make in bringing moral values to bear on economic institutions, particularly transnational ones, in this globalized, interdependent world. As this Harvard Islamic Finance Forum demonstrates, we have much to learn and share with respect to Islamic economic and financial principles and the moral obligations of wealth, not just in the Muslim world but our own. *Shari'a* perspectives, principles and rules are especially relevant, given the horrific impact of financial buchaneering on community and environmental well-being.

Buddhist tradition

The philosophical insights of Buddhism can be connected to the all-embracing nature of the covenant, particularly the foundational principle of *Paticcasamuppada*, or "dependent co-origination." *Paticcasamuppada* represents a radical form of interdependence and recognizes no independent causation of any circumstance: Everything is the result of everything else. According to Buddhist scripture:[110]

> That being thus this comes to be;
> from the coming to be of that, this arises;
> that being absent, this does not happen;
> from the cessation of that, this ceases.[111]

In contrast to the Judeo-Christian tradition of seeking divine guidance in moral decision making, Buddhism, which continues to evolve depending

upon the different contexts in which it is practiced, offers certain moral guidelines by which monks and lay people are to live. A basic tenet is that "all conditional things" share three features called the Three Characteristics of Existence, which can contribute to an understanding of the covenant and its implications for the accumulation of wealth. The first characteristic, or "mark" (*lakshana*), is *annica*, which means "all mental and physical phenomena are impermanent." The second mark is *duhkha*, which means "all mental and physical phenomena are painful." The third is *anattä*, meaning "all things are without self." The idea of impermanence contributes to a sense of non-attachment to material things; the idea of no self contributes to a sense of social engagement because the ego does not get in the way.

Taken together, the ideas of non-attachment and no self, along with the foundational principle of *Paticcasamuppada*, can enable the shareholder, for example, to look at the impact of investing beyond immediate shareholder value or rate of return. Because of the reigning Buddhist philosophy that nothing is independent or value-free, justification can be found for understanding the impact an owner can have on a company and the reciprocal relationship that the company has with both society at large and the greater good.

Because enlightenment is defined within an individual context, "traditional" forms of Buddhism are far less oriented to social action than are other world religions. In part because of this, Buddhism is popularly viewed as an ascetic religion, which is misleading. The Buddha, who was an Indian prince before he attained enlightenment, was not overly concerned with issues of wealth. In fact, he rejected the extremes of both wealth and poverty and settled on a middle path that accepted prosperity, a condition of the social era in which he lived. Even though Buddhist monks were not allowed to own property—in Burma, they are not even allowed to touch money—wealth was not considered intrinsically "bad." In some cases, it was seen as a manifestation of one's virtue in past lives.[112] The ultimate value of wealth was the way it was used and whether its use conformed with the Buddhist moral path.

Over the past few decades, a movement composed of Buddhist activists has evolved that combines a Judeo-Christian emphasis on social justice with Buddhist insights concerning the relationships among self, other and society. A prominent proponent of this socially engaged Buddhism is a Vietnamese monk, now living in France, named Thich Nhat Hanh, who founded the Tiep Hien Order in 1964 in direct response to the war in Vietnam. "Tiep Hien" means "to be in touch with," "to continue," "to realize" and "to make it here and now." Evolving from this order are the Tiep Hien Precepts, 14 maxims that are rooted in nonviolence and serve as guides to

social action; the fifth of the 14 states, "Do not accumulate wealth while millions are hungry. Do not take as the aim of your life fame, profit, wealth, or sensual pleasure. Live simply and share time, energy, and material resources with those who are in need."[113]

Another Buddhist seeking to connect Buddhist teachings to economic activity, particularly economic development, is Sulak Sivaraksa, a Thai thinker and writer. A co-founder of the International Network of Engaged Buddhists, Sivaraksa's work represents an attempt to develop a brand of Buddhist economic activism that incorporates the idea of service and certain moral teachings.[114]

Cultivating Communities of Inquiry and Practice

I began this paper with the observation, shared by most people, that the financial crisis provides an opportunity for those of us in the "money and morality" movement to reexamine what we do, why we do it and how we can improve our performance by deepening our understanding of the fundamental values and principles that, presumably, guide us. This is important because the growth of the overlapping fields of corporate social responsiblity, socially responsible investing, corporate governance and responsible ownership have created an industry that exceeds at the mechanics of accountability and transparency, without adequate attention to underlying values, purpose and substance. This is true of the related fields of organized philanthropy and program related investing, social entrepreneurialism and sustainable enterprise as well. Even the vocabulary that is used reflects this mechanistic modality, with terms like "sustainability," "social responsibility," "metrics," "KPIs," "ESG," and so on dominating our discourse. These are mundane words that belie their noble intent. Yet they reflect the reality that we are preoccupied with the trees, so to speak, and cannot see the forest, or the stars.

This is a disturbing development. I believe the time has come for those of us committed to integrating ethical and civic values in business practice to reappropriate the values that lie at the heart of our work, to develop a renewed and reinvigorated vocabulary for communicating why we do what we do. We can do this by engaging in an ongoing process of reflection, collaborative education, assessment and evaluation, so that we might deepen our understanding of these "first order principles" and how they apply in a globalized, interdependent world of rapid change.

How are we to do so? I think that this Forum is a good start. As stated in the materials we were given, the Harvard University Forum on Islamic Finance "provides a venue for the critical and objective examination of the purposes, theory, practice, structure, and institutions of the rapidly developing field of Islamic finance." The whole purpose of this 9th Forum is

"Building Bridges across Financial Communities." Islamic Finance Director Nazim Ali put it eloquently when he said:

> Dialogue among [faith-based, socially responsible, and corporate financial communities] will no doubt go far in determining the shape of the fields' future expansions, and the degree to which they become part of the financial mainstream. . . . Part of this global discussion on the need for greater or improved ethics, values, and social responsibility in modern finance includes a discussion on how religious principles and moral teachings can assist in defining this post crisis world.[115]

While this Forum has provided an excellent platform and structure for conducting such a discussion, it need not end here. Before turning to my thoughts on what we might consider, let us take a moment to think about who we are as professionals, engaged in this quest.

Implications for practice

What are the implications for recovering the ethical and civic moral paradigm for economic enterprise as we go about our professional practice? Many years ago, I asked Dr. Max L. Stackhouse this question. Stackhouse is an esteemed theologian, professor of Christian ethics *emeritus* at Princeton Theological Seminary and a member of the UCC Economics and Theology Covenant Group. He has spent his professional life studying the interplay between Christian ethics and the political economy. At the time we spoke, I was writing and teaching about the application of the idea of "covenant" to corporate equity ownership and investing.[116]

Professionals are people, he said, who not only have specialized knowledge but also "are supposed to be custodians of a resource for the whole commonwealth." *The professional has a sense of calling.* "We need that quality in the business world, where people are the responsible custodians, under first principles of right and wrong, for the creation and maintenance of wealth for the peoples of the world," he told me. "I think there's a higher calling in business than is often recognized, even by themselves." Connected to *calling* is *accountability* ("Professionals have got to call one another to account when they don't live up to the calling") and the idea of *stewardship:*

> [The investment manager is] a steward of these resources, not only for me but for the well-being of the larger community, in the whole covenantal sense of to whom we are responsible. A serious business ethic not only has to have first principles and a sense of responsibility to the context, but also a vision and ultimate sense of the future. That's a sense of carrying on the human enterprise into the long

> range. The practical people engaged in business are building an openness that doesn't close down the future . . .[117]

As we think about our work as a "calling," what are the sources of inspiration that keep us on track? How do we prevent ourselves from falling victim to the encumbrances of the day-to-day, to a false sense of superiority, to the comfort of our routines, to the company of our cohorts, rather than maintaining a holistic view and extending ourselves into the world as agents of change *and* exchange?

Communities of inquiry and practice

Generally speaking, members of communities of inquiry and practice are professionals, practitioners who "develop a shared repertoire of resources: experiences, stories, tools, ways of addressing recurring problems—in short a shared practice. This takes time and sustained interaction."[118] The idea is rooted in ancient guild relationships, where practitioners learn from those who have mastered their craft; it is modernized by interactive tools, which tend to flatten hierarchical relationships, sometimes enabling "amateurs" to be "experts," too.

For our purposes, there are multiple forms this might take, including communities of practice devoted to issues specific to institutional investors, companies, financial service providers, professional associations, professional roles or stakeholders. Communities of practice also could address certain ideas, issues or topics such as the role of religious, theological and ethical ideas in economic enterprise, human rights, regulatory reform, fiduciary obligation, climate change or corporate governance. There are endless possibilities.

In a handful of cases, smaller communities of practice are supported by existing platforms such as LinkedIn, Facebook and Twitter, through various member-initiated discussion groups. Meanwhile, communities of *inquiry* and practice emphasize mutual engagement in applied learning, and shared responsibility for knowledge *creation* as well as *presentation*. The formation of communities of inquiry and practice, populated by a select group of individuals who are seasoned in their respective fields, can deepen understanding, incubate knowledge creation, contribute to improved professional performance and help to set standards in areas that have yet to be recognized and formalized. Ably supported, designed and facilitated, and drawing upon decades of experience within the field of online education, communities of inquiry and practice hold the promise of truly "building value" in a globalized, networked world, and restore our sense of true professionalism in the process.

Blended engagement

If we were to form a community of inquiry and practice, we would want to use Web 2.0 technologies to enable what is called "blended engagement." Blended engagement involves a mix of face-to-face (f2f, or *synchronous*) and virtual (geographically distributed and atemporal, or *asynchronous*) communication and exchange.

- Blended engagement offers a means by which an ongoing immersion into this relatively uncharted area can happen, without introducing too much disruption in people's busy lives and schedules.
- Blended engagement is longitudinal and unfolds over a designated period.
- Blended engagement permits attention to *context*, which often is missing in one-off face-to-face meetings or online social media or blog postings related to complex issues.
- Blended engagement allows for a process of sorting, where participants can choose where they would like to "show up," and what they wish to know about based on what they consider important.
- Blended engagement also enables multiple entry points to a topic, so people can examine it from different perspectives and with different cognitive styles.
- Blended engagement creates a permanent record: videos and podcasts can be replayed, for example, or conversation threads read over several times, whereas a face-to-face meeting may not be as easily "remembered" or archived.
- Blended engagement promotes constructive use of "in between" times, say, between biannual conferences, quarterly meetings, or other regularly scheduled events, or, conversely, with face-to-face meet-ups, to supplement online interactions.
- Blended engagement affords the opportunity to combine informal, spontaneous, even unconventional, exchanges with more formal, disciplined, ritualized ones.
- Finally, blended engagement can provide participants with the opportunity for serious and sustained exploration of a complex problem or issue—generating new knowledge and insights as to how such problems could be addressed.

The Consultation on Sustainability and Transparency in the United States, known as COST US, is an example of a blended community of inquiry and practice, still in very primitive stages of development. COST US comprises 134 members, all of whom are leaders in the overlapping fields of corporate and investor responsibility, sustainability business report-

ing and development, corporate governance, public policy, pension fund management, financial services, academe and so forth. The group was founded by Bob Massie, with my assistance, in late summer 2008, right at the time the financial crisis broke into public view. Both Laura Berry and Steve Lydenberg, who are respondents on this panel, are charter members.

Since its founding in August 2008, COST US has convened two meetings—one at Tufts University, the other at Boston University School of Management—while maintaining a virtual presence through a Google Group. Members can communicate with each other as a group or individually, and draw upon each other's ideas and wisdom.

Although much more can be done to enhance the ability of COST US to create and share knowledge, the group does represent how Web 2.0 tools can help a geographically distributed community of experts work together in common cause. COST US also contains dimensions critical to what Chris Dede, educational technology leader and Timothy E. Wirth Professor in Learning Technologies at Harvard's Graduate School of Education, told me is a "community of wisdom."[119] They include:

1. A *cognitive* dimension involving rich understanding of a variety of intellectual disciplines and fields;
2. A *practical-experiential* dimension of sophisticated, pragmatic comprehension about how to act, given the unresolvable questions, philosophic issues and unavoidable problems (such as personal mortality) associated with everday life;
3. An *interpersonal* dimension of insightfully appreciating the interactions and contributions of diverse groups, cultures and societies in shaping civilization;
4. An *ethical* dimension encompassing what the ancient Greeks meant by "knowing and doing the good";
5. A *metacognitive* dimension of reflective judgments, awareness of the limitations of knowing and of how these limitations affect the resolution of ill-defined problems.

Conclusion

This essay is based on more than 30 years of experience with how institutions can be governed, organized and managed in ways that promote high performance while fulfilling public interest and civic moral obligations, whatever sector (private, nonprofit, public) they occupy. My premise is, and remains, that organizations did not spring from Adam's rib; they are made with human hands, and therefore socially situated and capable of being changed. In our American democratic tradition of representative self-governance, the corporate form was deliberately designed to enable

deliberation, participation and representation. In theory, this was because of a recognition that power, unwatched, can rapidly accrue to those whose interest are self-serving, at the expense of everyone else. The idea was that a free society required checks and balances to offset the darker side of human nature, thus enabling its citizens to cultivate a good and decent life.

As for ethics and values, before this most recent financial crisis began, critics often argued that morality had no legitimate role in economic decision making, particularly portfolio management, because it might weaken financial acumen or interfere with positive rates of return. Before the most recent financial crisis, they claimed that equity investments should be judged on the basis of financial performance alone because investors have only financial equity at risk, and that this equity—indeed, the corporation itself—is a *persona ficta*, lacking a soul. (One wonders how the *Citizens United* decision, in which a majority of the Supreme Court declared that the corporation should be accorded the rights of a person, would answer that one: Just what is a corporation's *soul?*)

Before this most recent financial crisis, critics argued that the best judge of corporate responsibility and character lie within either the marketplace or the legal-regulatory system, and that "do-gooders" should leave well enough alone. As we have seen, theirs was not a valid argument. As we have come to recognize painfully, there is a great deal of "free space" between society's laws and the behavior of the market, free space in which corporations and capital act, sometimes to the detriment of those very owners whose equity is at stake, not to mention innocent bystanders with little or no standing in the game. Moreover, neither the marketplace nor the law is adequate to the task of protecting society from the damages that can be inflicted by excessive speculation, potential monopolies or oligopolies created by mergers and acquisitions, or the widening gap between the haves and the have-nots.

Yet most of the time, financial criteria, rather than non-financial criteria, are the template that most corporate owners use to measure the value of their investments and the performance of corporate managers. They do not consider the moral location of the economy and therefore do not view corporate institutions as reflecting moral and political norms. They view the corporation and its performance as separate from politics and ethics rather than embedded in it. So, too, do they see themselves as separate from a political and ethical regime, even if their primary missions have distinct social or charitable or political qualities.

This is a misleading perspective because *corporations and industrial sectors are not value-free.* They are situated within a socio-political context, informed by history and experience. Those of us who have worked a long

time in this area of corporate social responsibility, investing and governance know this. We were "called" to this work, for a host of reasons—just as, I presume, many here at this 9th Forum are called to it, and others who have joined the vast numbers of people in this sprawling CSR/SRI/sustainability ecosystem.

But we need to renew our vows, so to speak, and rededicate ourselves to those truths we hold self-evident, those guiding lights by which we abide. We need to recommit ourselves, and in doing so, tell our stories, talk about what is important, make an effort to formulate new words and phrases and vocabulary and language with which we might inspire each other, and those who follow, to more public action.

Like the world of organized philanthropy, we are at risk of becoming a vast industry with many moving parts, holding tremendous moral and financial power but unable to leverage it in ways that go beyond the next customer, client or grantee. We have become too insular, too complacent, too preoccupied with justifying our role in reforming capital markets to those who have demonstrated their utter inability to live up to their own commitments—and should be ashamed of themselves.

As we look to the future, we will benefit from opening our minds and hearts to a broader conception of what we are trying to do, what purpose we are seeking to achieve. This is a profoundly theological question: To what aim are our efforts directed, and how shall we get there?

Our world needs definitions of civic virtue and the common good, or better yet, valid processes for arriving at such definitions, which can be used as the basis for coherent institutional and individual behavior, especially within the realm of economic enterprise. Our public discourse needs to include what is important to us, what values we hold dear, as defined within a pluralist context marked by different racial, cultural, ethnic, religious and economic traditions.

In many societies, the elders were responsible for helping to keep the values, commitments and traditions alive, through storytelling and interaction with strangers and newcomers. Those of us in the "money and morality" movement who can now be considered "elders" have this obligation, too. Our ability to include and learn from other practitioners, such as those represented here at this Forum, along with others with shared aspirations and goals, will go a long way toward bringing about the change we seek. In that way, we will have succeeded, beyond our wildest dreams.

Endnotes

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19. New figures . . . show that the number of companies and other organizations publicly disclosing their performance against a range of key sustainability indicators has risen markedly over the last year. The Global Reporting Initiative is now aware of over 1,000 organizations worldwide who issued sustainability reports based on the GRI G3 Guidelines in 2008—the highest number ever recorded. The figure represents an increase of 46 per cent on the 2007 figure of 685.

    The GRI G3 Guidelines set out the principles and indicators that organizations can use to measure and report their economic, environmental, and social performance. The guidance was developed, and continues to evolve, through a

process in which representatives from businesses, civil society, finance, labor, academia and others seek consensus on a common framework for reporting on issues of common concern, such as greenhouse gas emissions, labor standards and human rights.

Among the sustainability reports of which GRI is aware, more are produced in Spain than any other country, beating the United States into second place. Europe is home to 49% of the reporters known to GRI, followed by Asia on 15%, North America on 14%, Latin America on 12%, with 6% from Oceania and 4% from Africa. "Number of companies worldwide reporting on their sustainability performance reaches record high, yet still a minority," press release of the Global Reporting Initiative, July 15, 2009. http://www.globalreporting.org/NewsEventsPress/LatestPressReleases/2009/PressRelease_14_July_2006_1000GRIReports.htm.

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    Then in November 2009, information advisory group Thompson Reuters acquired Swiss-based Asset 4, a provider of ESG information and tools for professional investors and corporate executives. More recently on 22 January 2010, the news broke that the RiskMetrics Group—a risk advisory firm whose services include ESG research, analysis and advice—had announced that it had put itself up for sale. In March, the *Wall Street Journal* reported that financial-index and investment-services firm MSCI Inc. would buy RiskMetrics for $1.55 billion. See Aaron Lucchetti, "MSCI Seizes RiskMetrics in Union of Niche Firms," Wall Street Journal, March 2, 2010 at http://online.wsj.com/article/SB10001424052748704754604575095100547835756.html.

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Americans living in Rochester, NY. FIGHT used its status as a shareholder to confront management at its annual meeting, and persuaded church groups holding Kodak stock to protest the company's resistance to FIGHT's demands. Although the shareholder yes votes were low, Kodak soon recognized FIGHT as a bargaining agent and hired more black workers. Moreover, FIGHT's basic elements—identification of an area of social concern; meetings and negotiation with management to correct the situation; switch to proxy machinery if negotiations are unsuccessful or break down; launch of full-blown proxy campaign to cast public spotlight on cause—were to serve as the basis for future proxy campaigns.

26. In 1970, Campaign GM was organized by the Project on Corporate Responsibility, which initiated nine shareholder resolutions; two passed SEC scrutiny and were included in GM's proxy statement. One proposal called for the establishment of a shareholder's committee on corporate responsibility; the other proposed that three publicly elected directors be added to the Board. Neither proposal passed the then-SEC requirement that resolution must pass three percent threshold to enable resubmission, but Campaign GM did provoke intensive lobbying and the involvement of institutional investors, including universities, foundations (the Rockefeller Foundation and Carnegie Corporation supported Campaign GM), and pension funds. At this time, Philadelphia civil rights activist Dr. Leon H. Sullivan was appointed to GM's Board of Directors, becoming the first African-American to occupy a board seat of a major American corporation. Rev. Sullivan soon would become a figurehead in the American-based South Africa antiapartheid movement, organizing the Sullivan Principles as a measure of corporate commitment to victims of apartheid to rectify their circumstances.

    In 1971, Campaign GM (Round II) produces three shareholder resolutions on shareholder democracy (a shareholder list of director candidates would be included with the slate proposed by GM management), constituent democracy (three directors would be nominated by constituent groups comprising employees, consumers, and dealers), and disclosure (requiring GM to report information with respect to air-pollution control, auto safety, minority hiring, and franchising practices. The proposals were defeated, but the disclosure proposal received strong institutional support from the New York City Pension Funds, TIAA-CREF, and managers representing employee pensions; the social proposals were strongly supported by the Rockefeller Foundation, Carnegie Corporation, and the New York City Bar Association.
27. Robert K. Massie, *Loosing the Bonds: The United States and South Africa in the Apartheid Years* (New York: Nan A. Talese, an imprint of Doubleday, 1997).
28. In 1971, the Episcopal Church initiates social policy shareholder proposals to three large corporations, including one with General Motors prohibiting manufacturing operations in South Africa.
29. For nearly 40 years the Interfaith Center on Corporate Responsibility (ICCR) has been a leader of the corporate social responsibility movement. ICCR's membership is an association of 275 faith-based institutional investors, including national denominations, religious communities, pension funds, foundations,

hospital corporations, economic development funds, asset management companies, colleges, and unions. ICCR and its members press companies to be socially and environmentally responsible. Each year ICCR-member religious institutional investors sponsor over 200 shareholder resolutions on major social and environmental issues. For more information, go to http://www.iccr.org/.

To celebrate the 40th anniversary of its 1971 founding, ICCR is telling its story through a year-long series of monthly podcasts. They feature the voices of those ICCR members who made history by pioneering the practice of shareholder activism. To listen to these historic recordings, go to http://podcast.iccr.org/.

30. John Winthrop, "A Model of Christian Charity," in Brian O'Connell, ed., *America's Voluntary Spirit: A Book of Readings* (New York: The Foundation Center, 1983), 29–33.
31. Terms like "civic virtue" and "the common good" have a dark underbelly and are sometimes used as a justification for cultural oppression or military valor and victory. Even worse is the temptation to dichotomize civic virtue and the common good into "we-they" terms, often through mobilized opposition to other nations or peoples, something we see throughout the world as well in our nation's cities. Perhaps a better way of thinking about "civic virtue" and the "common good" is to think of them as an assemblage of goods and virtues, oftentimes overlapping and sometimes contradictory, with each having a place within the different spheres of human existence but none representing some casuistic, absolute standard of goodness—because the absolute version of the full human good is transcendent, beyond human hands.
32. John G. Simon, Charles W. Powers, and Jon P. Gunnemann, *The Ethical Investor: Universities and Corporate Responsibility* (New Haven and London: Yale University Press, 1972).
33. Massie, *Loosing the Bonds*.
34. Marcy Murninghan, *Corporate Civic Responsibility and the Ownership Agenda: Investing in the Public Good*, Occasional Paper (Boston: UMass Boston John W. McCormack Graduate School of Policy Studies, 1994); Murninghan, "Corporations and Social Responsibility: An Historical Perspective," in *The Social Investment Almanac*, ed. Peter D. Kinder, Steven D. Lydenberg and Amy L. Domini (New York: Henry Holt and Company, 1992), 86–94; Murninghan, *Discovering Union Voices: Corporate Disinvestment and Black South African Trade Unions*, A Report to The Ford Foundation (Boston: The Lighthouse Investment Group, 1988); Murninghan, *Survey of U.S. Corporations' Employment Policies and Practices in Northern Ireland*, Report to the Comptroller, Office of the Comptroller (Albany: New York State Common Retirement Fund, 1987).
35. Ceres (pronounced "series") is a national network of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change. Its mission is "integrating sustainability into capital markets for the health of the planet and its people." For more information, see http://www.ceres.org.

36. R. Edward Freeman and David L. Reed, "Stockholders and Stakeholders: A New Perspective on Corporate Governance," *California Management Review*, 25:3 (Spring 1983). For a comprehensive treatment of this interpretation of corporate social responsibility, see also R. Edward Freeman and Daniel R. Gilbert, Jr., *Corporate Strategy and the Search for Ethics* (Englewood Cliffs, N.J.: Prentice Hall, 1988).
37. Simon Zadek, "The Path to Corporate Responsibility," *Harvard Business Review* (December 2004). Zadek's article can be viewed on SlideShare by visiting http://www.slideshare.net/soniabess/the-path-to-corporate-responsability-by-simon-zadek.
38. Zadek, "The Path to Corporate Responsibility."
39. The SEC voted unanimously on October 15, 1992 to adopt new rules concerning shareholder communication. The new rules end the requirement that no more than ten shareholders can discuss upcoming meetings or other corporate matters without making extensive filings with the SEC. Moreover, no filings will be required for "published or broadcast announcements" about how a shareholder intends to vote and reasons for its vote. Only those shareholders owning more than $5 million of a company's stock will have to notify the SEC and the exchange on which the company is listed if they send "unpublished" written materials to solicit other shareholders.
40. This rule requires the disclosure of four compensation tables and the provision, by a company's compensation committee, of a signed report on a detailed discussion of and rationale for a CEO pay package and a more general discussion of pay policies affecting other top executive officers.
41. U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Restoring American Financial Stability Act of 2010*, Submitted by Sen. Christopher Dodd, March 15, 2010. 111th Cong., 2d sess. 2010; http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf.; Dodd Statement: Financial Reform Markup, March 23, 2010, http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=8b7db637-c53b-9c9f-50e9-2ea13a1d9c40&Region_id=&Issue_id=; Robert A.G. Monks, "Corporate Governance: Past, Present & Future," Manuscript, 2010, http://blogs.law.harvard.edu/corpgov/2010/03/04/corporate-governance-past-present-future/; The Corporate Library, *The Corporate Library Blog*, 2010, http://thecorporatelibrary.typepad.com/blog/; HLS Forum on Corporate Governance and Financial Regulation, *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 2010, http://blogs.law.harvard.edu/corpgov?s=board+elections&submit=Go.
42. Securities and Exchange Commission, *SEC Announces Creation of Investor Advisory Committee*, June 3, 2009, available at http://www.sec.gov/news/press/2009/2009-126.htm.
43. ———. *SEC Investor Advisory Committee*. 2009–2010. http://www.sec.gov/spotlight/investoradvisorycommittee.shtml.
44. ———. *SEC Investor Advisory Committee Meeting*, February 22, 2010. http://www.sec.gov/spotlight/invadvcomm/iacmeeting022210-agenda.pdf.

45. ———. *Proxy Disclosure Enhancements,* December 16, 2009. http://www.sec.gov/rules/final/2009/33-9089.pdf.
46. James McRitchie, a longtime advocate for corporate democracy and accountability and publisher of CorpGov.net, provides a good overview of proxy access in "The Case for Proxy Access," NACD *Directorship*, December 16, 2011, available at http://www.directorship.com/the-case-for-proxy-access/.
47. Gordon A. Martin, Jr., *Count Them One By One: Black Missippians Fighting for the Right to Vote* (Jackson, MS: University Press of Mississippi, 2010).
48. Securities and Exchange Commission. *SEC Re-Opens Public Comment Period for Shareholder Director Nomination Proposal,* December 14, 2009. http://www.sec.gov/news/press/2009/2009-265.htm.
49. ———. *Facilitating Shareholder Director Nominations,* June 10, 2009. http://www.sec.gov/rules/proposed/2009/33-9046.pdf.
50. ———. *SEC Adopts New Measures to Facilitate Director Nominations by Shareholders,* August 25, 2010. http://www.sec.gov/news/press/2010/2010-155.htm.
51. The D.C. Circuit Court of Appeals Petition for Review, *Business Roundtable and Chamber of Commerce of the United States* v. *United States Securities and Exchange Commission*, can be viewed at https://docs.google.com/viewer?url=http%3A%2F%2Fwww.uschamber.com%2Fsites%2Fdefault%2Ffiles%2Ffiles%2F1009uscc_sec.pdf.
52. U.S. Chamber of Commerce Press Release, "U.S. Chamber Joins Business Roundtable in Lawsuit Challenging Securities and Exchange Commission," Washington, D.C., September 29, 2010.
53. Amy L. Goodman, "Proxy Access Litigation and Next Steps," Harvard Law School Forum on Corporate Governance and Financial Regulation, October 28, 2010 at http://blogs.law.harvard.edu/corpgov/2010/10/28/proxy-access-litigation-and-next-steps/.
54. Jenna Greene, "SEC Defends Proxy Access Rule Before D.C. Circuit," *LegalTimes*, April 7, 2011 at http://legaltimes.typepad.com/blt/2011/04/sec-defends-proxy-access-rule-before-dc-circuit.html.
55. The U.S. Court of Appeals for the District of Columbia Circuit decision can be viewed at http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf.
56. Edward Wyatt, "Appeals Court Rejects S.E.C.'s Rule on Access to Proxy Materials," *The New York Times*, July 22, 2011, at http://www.nytimes.com/2011/07/23/business/appeals-court-rules-against-sec-on-proxy-materials.html.
57. Securities and Exchange Commission, *Facilitating Shareholder Director Nominations – Corrected*, Sept. 15, 2011, at http://www.sec.gov/rules/final/2011/33-9259.pdf.
58. Martin, *Count Them One By One*.
59. The United States Proxy Exchange is a nonprofit organization "dedicated to facilitating shareowner rights and confronting Wall Street abuse," according to its website http://proxyexchange.org/about/.
60. The Harvard Law School Forum on Corporate Governance and Financial Regulation is a rich source of information, and blogs on proxy access can be viewed

at http://blogs.law.harvard.edu/corpgov/. See also Lucian A. Bebchuk and Scott Hirst, *The Harvard Law School Proxy Access Roundtable* (January 1, 2010) *Harvard Law and Economics Discussion Paper No. 661*, available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1539027.

61. Securities and Exchange Commission. *Commission Guidance Regarding Disclosure Related to Climate Change,* January 27, 2010, at http://www.sec.gov/rules/interp/2010/33-9106.pdf.
62. See, for example, fixcongressfirst,org, a nonprofit advocacy organization cofounded by Harvard Law School professor and director of Harvard's Edmond J. Safra Center for Ethics Lawrence Lessig, and Joe Trippi, founder of Trippi Associates with deep experience managing state and national political campaigns, http://fixcongressfirst.org/about/. See also SCOTUS Wiki, *Citizens United v. Federal Elections Commission,* January 2010. http://www.scotuswiki.com/index.php?title=Citizens_United_v._Federal_Election_Commission.
63. Sanford Lewis, "Important New SEC Ruling Offers Diversified Shareholder Responses to Corporate Elections," *Corporate Disclosure Alert,* March 31, 2011, at http://corporatedisclosurealert.blogspot.com/; Nell Minow, "Shareholders United: SEC Rules That Political-Spending Proposal Must Go To a Vote," *BNet*, April 6, 2011, at http://www.bnet.com/blog/corporate-governance/shareholders-united-sec-rules-that-political-spending-proposal-must-go-to-a-vote/366. For more on tracking corporate money in U.S. politics, and particularly the role of shareholders, visit the portal OpenSecrets.org, maintained by the Center for Responsive Politics, at http://www.opensecrets.org/, and the Center for Political Accountability at http://www.politicalaccountability.net/. Consistently comprehensive and excellent analysis of shareholder activism comes from the Sustainable Investments Institute at http://www.siinstitute.org/index.html and the IIRC Institute at http://irrcinstitute.org/. For thoughts on the limitations of the current proxy resolution process, see also "Proxy Resolutions, Shareholder Engagement, and Buggy Whips," Parts One and Two, *The Murninghan Post*, February 28 and March 2, 2011, at http://murninghanpost.com/2011/02/28/proxy-resolutions-shareholder-engagement-and-buggy-whips/ and http://murninghanpost.com/2011/03/02/proxy-resolutions-shareholder-engagement-and-buggy-whips-2/.
64. Mary Schapiro, *Speech by SEC Chairman: Remarks at the NACD Annual Corporate Governance Conference*, October 19, 2010; Luis A. Aguilar, SEC, *Speech by SEC Commissioner: Board Diversity—Why It Matters and How to Improve It,* at http://www.sec.gov/news/speech/2010/spch110410laa.htm. See also David Lee, Donna Hamlin, Anthony Jordan, and Cheryl Wade, *SEC Disclosure Rules and Board of Director Diversity*, a presentation to the American Bar Association Spring Meeting, April 14, 2011, at http://goo.gl/HNo1u; Eleanor Bloxham, "Gender diversity on U.S. boards coming anytime soon?" *CNN Money – Fortune*, January 25, 2011 at http://management.fortune.cnn.com/2011/01/25/gender-diversity-on-u-s-boards-coming-anytime-soon/; and Marcy Murninghan, "Gender Rising," *AccountAbility Insights*, March 18, 2011, at http://www.accountability.org/about-us/news/accountability-1/accountability-7.html.

65. Information on the work of the Special Representative can be viewed at the web portal hosted by the Business and Human Rights Resource Center at http://www.business-humanrights.org/SpecialRepPortal/Home. See also Marcy Murninghan, "The Business Impact on Human Rights," *The Murninghan Post*, November 8, 2010, at http://murninghanpost.com/2010/11/08/the-business-impact-on-human-rights/.
66. American Accounting Association – Part of the Committee on Non-Financial Measures of Effectiveness, *The Accounting Review* Supplement to 46 (American Accounting Association, 1971): 165–212; See also Raymond A. Bauer and Daniel H. Fenn, Jr., *The Corporate Social Audit* (New York: Russell Sage Foundation, 1972); Robert W. Ackerman, *The Social Challenge to Business* (Cambridge: Harvard University Press, 1975); Archie Carroll and George W. Beiler, "Landmarks in the Evolution of the Social Audit," *The Academy of Management Journal* 18:3 (September 1975): 589–599; Ralph W. Estes, *Corporate Social Reporting* (New York: Wiley InterScience, 1976); M. Dierkes and L. E. Preston, "Corporate and social accounting for the physical environmentt—a critical review and implementation proposal," *Accounting, Organizations, and Society* (1977); James E. Post and Marc J. Epstein, "Information systems for social reporting," *Academy of Management Review* 2:1 (January 1977): 81–87; Leonard J. Brooks, Jr., *Canadian Corporate Social Performance* (Hamilton, Ontario: Society of Management Accountants of Canada, 1986); Robert Gray, "Thirty years of social accounting, reporting and auditing: What (if anything) have we learnt?," *Business Ethics: A European Review* 10 (2001): 9–15; Marc J. Epstein, "The Identification, Measurement, and Reporting of Corporate Social Impacts," *Advances in Environmental Accounting and Management* 2 (2004): 1–29.
67. J. E. Gröjer and A. Stark, "Social accounting: A Swedish attempt," *Accounting, Organizations and Society* 2 (1977): 349–386; Ronnie Lessem, "Corporate social reporting in action—an evaluation of British, European and American practice," *Accounting, Organizations and Society* 2 (1977): 279–294.
68. Howard Bowen, *The Social Responsibilities of the Businessman* (New York: Harper, 1953).
69. Wallace Donham, "The Social Significance of Business," *Harvard Business Review* 5:4 (1927): 406–419; Eccles and Krzus, *One Report*, 123–124.
70. Clark C. Abt, *The Social Audit for Management* (New York: AMACOM, 1976).
71. Karen Paul and Steven D. Lydenberg, "Corporate Social Monitoring: Types, Methods, Goals," in *The Social Investment Almanac: A Comprehensive Guide to Socially Responsible Investing*, edited by Peter D. Kinder, Steven D. Lydenberg and Amy L. Domini (New York: Henry Holt and Company, 1992), 185–202.
72. Eccles and Krzus, *One Report*.
73. Global Reporting Initiative, *GRI's History*. http://www.globalreporting.org/AboutGRI/WhatIsGRI/History/OurHistory.htm.
74. This represents a 46 percent increase from 2007, when 685 firms published sustainability reports. Global Reporting Initiative, "Number of companies worldwide reporting on their sustainability performance reaches record high, yet still

a minority," Global Reporting Initiative web site, July 15, 2009, http://www.globalreporting.org/NewsEventsPress/LatestPressReleases/2009/PressRelease_14_July_2006_1000GRIReports.htm
75. SEC, *Commission Guidance Regarding Disclosure Related to Climate Change.*
76. ———. *SEC Investor Advisory Committee Meeting*, February 22, 2010.
77. GRI, "The Amsterdam Declaration," Global Reporting Initiative web site, March 2009, http://www.globalreporting.org/currentpriorities/amsterdamdeclaration.
78. Colleen Walsh, "Faith and the marketplace: religion should play a role in economic, moral reform, panelists say," *Harvard Gazette*, March 4, 2010, http://news.harvard.edu/gazette/story/2010/03/faith-and-the-marketplace/.
79. Ibid.
80. Throughout the 1980s and 1990s, a number of commentators, academics, theologians, and social scientists wrote about the moral dimension of economic enterprise, including Robert A. Dahl, *A Preface to Economic Democracy* (Berkeley: University of California Press, 1985); the National Council of Catholic Bishops, *Economic Justice for All: Pastoral Letter on Catholic Social Teaching and the U.S. Economy* (Washington, D.C.: National Conference of Catholic Bishops, 1986); Max Stackhouse, *Public Theology and Political Economy: Christian Stewardship in Modern Society* (Grand Rapids: Wm. B. Eerdmans Publishing Co., 1987); Amartya Sen, *On Ethics and Economics* (Oxford: Basil Blackwell, 1987); Amitai Etzioni, *The Moral Dimension: Toward a New Economics* (New York: The Free Press, 1988); M. Douglas Meeks, *God the Economist: The Doctrine of God and Political Economy* (Minneapolis: Fortress Press, 1989); Robert A. Dahl, *Democracy and Its Critics* (New Haven: Yale University Press, 1989); Thomas Donaldson, *The Ethics of International Business* (New York: Oxford University Press, 1989); Pope John Paul II, *On the Hundredth Anniversary of Rerum Novarum - Centesimus Annus,* May 1, 1991 (Washington, D.C.: United States Catholic Conference, 1991); Richard John Neuhaus, *Doing Well and Doing Good: The Challenge to the Christian Capitalist* (New York: Doubleday, 1992); John Reumann, *Stewardship and the Economy of God* (Grand Rapids: Wm. B. Eerdmans Publishing Co., 1992); Michael Novak, *The Catholic Ethic and the Spirit of Capitalism* (New York: The Free Press, 1993); and William James Booth, *Households: On the Moral Architecture of the Economy* (Ithaca: Cornell University Press, 1993).
81. John Reumann, *Stewardship and the Economy of God, supra* note 51 at 7.
82. William James Booth, *Households, supra* note 51 at 8.
83. Douglas Meeks, in *God the Economist*, *supra* note 51, also provides a well-written and compelling theological analysis of political economy. See, too, Stackhouse, *Public Theology and Political Economy*, *supra* note 51. In 1987, the United Church of Christ published a study paper edited by Audrey Chapman Smock entitled *Christian Faith and Economic Life*, prepared by the Economics and Theology Covenant Group, co-chaired by Douglas Meeks and with Max Stackhouse as a member, to promote reflection and discussion within the denomination of the relationship between faith and economics (New York: United Church

Board for World Ministries, 1987). Churches were actively thinking about these questions during this period: drafts of the U.S. Catholic Bishops' economic pastoral on Catholic social teaching and the U.S. economy were being circulated, and the Presbyterian Church (USA) published its "Christian Faith and Economic Justice."

84. See *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830). In this case, which involved the duty of a trustee with respect to the investment of trust funds, the Massachusetts Supreme Judicial Court determined that trustees have two basic duties: (1) to invest prudently, thus assuring maximum return on and safety of the trust assets, and (2) undivided loyalty to the beneficiaries of the trust. These articulated duties of prudence and loyalty represented a relaxation of the standards set out in earlier English law, which obligated a trustee to return to a beneficiary only property identical to that entrusted and prohibited trustees from making risky investments. Writing for the majority, Justice Putnam stated what has come to be known as the prudent man rule:

    > All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

    The prudent man standard represented in the *Harvard College* case, which provided for flexibility and ongoing modification, did not receive widespread acceptance outside of Massachusetts until the 1940s. Meanwhile, in 1869, the New York Court of Appeals provided its now classic formulation of the "prudent man" rule in *King v. Talbot*, 4 N.Y. 76 (1869), which was widely followed throughout the 19th century and well into the 20th century. In essence, the court stated that common stock investments were too risky and therefore imprudent, and that a stricter standard that preserves capital, rather than permitting undue risk to achieve capital appreciation, should be applied. The *King* case stated that "the trustee is bound to employ such diligence and such prudence in the care and management [of the trust], as in general, prudent men of discretion and intelligence in such matters, employ in their own affairs." 40 N.Y. 76 (1869), 85.

85. Directed by David Wood, among the programs supported by the Initiative for Responsible Investment is one called "More for Mission." More for Mission (M4M) is dedicated to broadly promoting mission investing and challenging foundations to take up mission investing practices. Mission investing is defined as the alignment of a portion of a foundation's endowment investments with their mission, while maintaining long-term targeted financial returns. More for Mission aims to help foundations acquire the tools and information needed to engage in mission investing and helps connect like-minded mission-driven

investors. The goal of M4M is to increase mission investment commitments by $10 billion over the next five years. See more at http://www.hks.harvard.edu/hauser/iri/.

86. Aristotle, Politics, Book 1 provides an introduction to his analysis of the *polis* and primarily is devoted to a discussion of *oikonomia*, the art of household management or home economics. Consult Aristotle, "The Theory of the Household," in *The Politics of Aristotle*, bk. 1 trans. and ed. Ernest Barker (New York: Oxford University Press, 1946). See also William James Booth for a superb exposition of the Aristotelian conception of the household (in addition to the classic liberal and Marxist interpretation), the most fundamental economic unit, and its significance to our times in *Households, supra* note 51.
87. Anthony Everitt, *Cicero: The Life and Times of Rome's Greatest Politician* (New York: Random House, 2001): 24–25.
88. Before her death in 1992, Judith Shklar invigorated our understanding of American politics and government with her trenchant insights into the contradictions between official claims of equal citizenship and the reality experienced by most who were denied it. In *American Citizenship: The Quest for Inclusion*, she moves beyond three other distinct meanings of citizenship (including active participation or "good" citizenship, ideal republican citizenship, and "citizenship as nationality," a legal recognition accompanied by various social exclusions and inclusions, "in which xenophobia, racism, religious bigotry, and fear of alien conspiracies have played their part") and introduces the concept of "citizenship as public standing," manifest by its two "great emblems": the vote and the opportunity to earn a living. The American Constitution does not mention citizenship at all until the Fourteenth Amendment, but Americans had quite clear ideas about what the social meaning of citizenship was, and when they were denied it, they protested . . . What has been continuous is a series of conflicts arising from enduring anti-liberal dispositions that have regularly asserted themselves, often very successfully, against the promise of equal political rights contained in the Declaration of Independence and its successors, the three Civil War amendments. It is because slavery, racism, nativism and sexism, often institutionalized in exclusionary and discriminatory laws and practices, have been and still are arrayed against the officially accepted claims of equal citizenship that there is a real pattern to be discerned in the tortuous development of American ideas of citizenship. If there is permanence here, it is one of lasting conflicting claims." See Judith Shklar, *American Citizenship: The Quest for Inclusion,* The Tanner Lectures on Human Values (Cambridge and London: Harvard University Press, 1991): 2, 13–15.
89. National Council of Catholic Bishops, *Economic Justice for All.*
90. Ibid, v.
91. Ibid, 123.
92. Ibid, 145–146.
93. Ibid, 160.
94. Ibid, 52.

95. Pope John Paul II, *Rerum Novarum.*
96. Ibid, 66–67. Italics are as they appear in the papal text.
97. Ibid, 68–69.
98. Ibid, 82.
99. Ibid, 63.
100. Ibid., 72–73.
101. Ibid., 83.
102. Ibid., 84.
103. Ibid., 85.
104. See UCC, *Christian Faith and Economic Life.*
105. Ibid, 17–18.
106. Meeks, *God the Economist,* 83–84.
107. Ibid., 87–88.
108. For more on the teachings of the Torah, as well as the Bible and various teachings of the Catholic Church with respect to economic life, see "A People of the Covenant" published in 1986 by the National Council of Catholic Bishops, *Economic Justice for All.*
109. See *The Koran*, translated with notes by N.J. Dawood (London: Penguin Books, 1990), 2:1; 3:178 ("Let those who hoard the wealth which God has bestowed on them out of His bounty never think it good for them: it is nothing but evil."); 9:31 ("Believers, many are the clerics and the monks who defraud men of their possessions and debar them from the path of God. To those that hoard up gold and silver and do not spend it in God's cause, proclaim a woeful punishment. The day will surely come when their treasures shall be heated in the fire of Hell, and their foreheads, sides, and backs branded with them. They will be told: 'These are the riches which you hoarded. Taste then what you were hoarding.'"); 9:82–9:99; 16:95 ("You shall not barter God's covenant for a trifling price. His reward is better than all your gain, if you but knew it. Your worldly riches are transitory, but God's reward is everlasting. We shall reward the steadfast according to their noblest deeds. Be they men or women, those that embrace the Faith and do what is right We will surely grant a happy life; We shall reward them according to their noblest deeds."); 17:24–17:31; 18:27–18:46; 19:76; 25:67; 34:33–34:39; 43:20; 57:7–57:12 ("And what cause have you not to believe in God, when the Apostle calls on you to have faith in your Lord, who has made a covenant with you, if you are true believers? Those of you that gave their wealth before the victory, and took part in the fighting, shall receive greater honour than the others who gave and fought thereafter. Yet God has promised you all a good reward; God has knowledge of all your actions. Who will give a generous loan to God? He will pay him back twofold and he shall receive a rich reward."); 57:21–57:25 ("God does not love the haughty, the vainglorious; nor those who, being niggardly themselves, enjoin others to be niggardly also."); 61:19; 64:12; 70:1–70:36; and 71:7.
110. There were two main systems of Buddhism, known as "Mahâyâna" (meaning "great vehicle") and "Hînayâna" (meaning "small vehicle") Buddhism, or basic

tradition Buddhism. The term Hînayâna was coined by followers of the Mahâyâna, hence its somewhat pejorative meaning. From Hînayâna Buddhism came the Eighteen Schools; only one, the Theravada, survives today. Mahâyânism tends to be more liberal, altruistic, and metaphysical; its supporters tend to be found in India, Nepal, Tibet, China, Korea, and Japan. Hînayânism/Theravadism is somewhat conservative and viewed as more rational; its adherents tend to come from Sri Lanka, Thailand, and Burma. For more on Mahâyâna and Hînayâna Buddhism, see the classic Daisetz Teitaro Suzuki, *Outlines of Mahayana Buddhism* (New York: Schocken Books, 1963). See also Edward Conze, *A Short History of Buddhism* (London: Allen & Unwin, 1980) and John Snelling, *The Buddhist Handbook* (Rochester, Vt.: Inner Traditions, 1991).

111. *Majjhimanikaya*, Volume II at 32, cited in Hammalawa Saddhatissa, *Buddhist Ethics: The Path to Nirvana* (London: Wisdom Publications, 1987).
112. See Phra Rajavaramuni, "Foundations of Buddhist Social Ethics," in *Ethics, Wealth and Salvation: A Study in Buddhist Social Ethics*, Russell F. Sizemore and Donald Swearer, eds., (Columbia, S.C.: University of South Carolina Press, 1990). Information about Buddhism in Burma was provided by Dr. Tyn Myint-U in a conversation held on August 28, 1993 at Harvard University's Center for International Affairs where he was a Senior Fellow.
113. Thich Nhat Hanh, *Interbeing: Commentaries on the Tiep Hien Precepts* (Berkeley: Parallax Press, 1987).
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Part IV:
Faith and Finance

Is Faith a Luxury for the Rich? Examining the Influence of Religious Beliefs on Individual Financial Choices

Ayesha Khalid Khan

Introduction

The influence of religion on economic behavior has generated a steady stream of scholarly discourse over the past decade. However, the academic roots of this discussion extend even further back to Adam Smith's discussion of the market structure of religious institutions in *The Wealth of Nations* and Max Weber's work on the existence of a "protestant ethic" as the source of modern capitalism. More recently, as religion has continued to exert a significant impact on economic outcomes, there has been a resurgence of interest in the economic analysis of religious beliefs, preferences and institutions.[1] This chapter aims to add to this growing body of literature by providing some unique evidence for the influence of religious beliefs on individual financial choices within the context of the rapidly growing Islamic banking industry.

We look at the individual decision to select a basic savings account and examine various reasons for the substantially higher demand for these accounts at a small, newly established Islamic bank in comparison to a larger, well-established conventional bank located in the same area and offering similar returns with lower risk. We test various reasons for the popularity of the Islamic bank in our sample including a lack of awareness of alternative options, lower financial literacy, private information on management and the expectation of better services. None of these factors seems to explain why the religious accounts are chosen twice as often as conventional bank accounts over the same time period and why Islamic religious account holders tend to maintain significantly higher balances in those

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accounts than individuals holding similar accounts at comparable conventional banks.

Our proposed explanation of the existence of a nonmonetary "faith premium," where more religious people derive greater benefits from opening religious bank accounts, provides one way to understand the selection of religiously prescribed bank accounts. The existence of this faith premium, along with the existence of decreasing absolute risk aversion with wealth, may explain the growing popularity of religious accounts and the Islamic banking industry.

The chapter is organized in five sections. *Section 1* provides some background on the economics impact of religion and describes the core prohibitions that underpin the Islamic banking industry. *Section 2* presents a simple portfolio choice model with private religious benefits that can be used to examine the risk-return tradeoffs involved in the selection of an Islamic bank account. *Section 3* describes the dataset and methodology. *Section 4* presents the results from various tests of the data and *Section 5* concludes with a discussion of the findings and their limitations.

Background

Religion does not seem to be fading away anytime soon. Rather, in contrast to the predictions of a secularization thesis that viewed religious beliefs as primitive, irrational quirks that were doomed to disappear in a modern era of science, technology and enlightenment,[2] religiosity has experienced a strong revival in many parts of the world.[3] Evangelical Christianity has been resurgent in the United States, Protestantism has expanded through Latin America and Africa, religious affiliation has rapidly escalated in the former Eastern Bloc and more fundamentalist strains of Islam have gained popularity throughout the Muslim world.[4]

In recent years, a growing body of literature has emerged to examine the relationship between religion and economics at various levels. At the macroeconomic level various economists have examined the connection between religion, institutional forms and economic development. Using data from the World Values Survey—a cross national survey based analysis of various countries—Guiso et al find that average religious beliefs are associated with attitudes that are conducive to higher per capita income and growth, and Christianity is more positively associated with these positive attitudes than other religions.[5] Barro and McCleary look at church attendance and religious beliefs in the U.S. to find that economic development is positively correlated with belief—not church attendance.[6] This leads them to conclude that growth depends on believing rather than belonging.

At the social and institutional level, various papers have explored the role of religion in shaping institutional forms and group values. Certain

types of social behavior—such as criminal activity, drug/alcohol consumption, marriage, fertility and divorce—are often influenced by religious beliefs and have economic significance. Freeman finds that African Americans attending church are less likely to smoke, drink or engage in drug usage.[7] Gruber finds that increased religious participation leads to higher education and income, less reliance on social insurance programs and higher rates of marriage in the U.S.[8] However, it is important to note that while it is possible that there is a causal link between religious beliefs and socio-economic behaviors, it is also possible that a different set of underlying characteristics shapes both religious and individual behaviors such that "good" people may be more likely to go to church and stay away from drugs, crime and alcohol.[9]

At the household level, neoclassical models of utility optimizing choice behavior have traditionally remained silent on the role of religion in determining individual preferences. Formal research in this area began with Azzi and Ehrenberg, who used Becker's model of household consumption[10] to develop a model of church attendance that included the concept of afterlife utility associated with religious activities. Greeley et al extended this model by defining faith as a type of human capital and religious choice as the result of expected utility maximization. In all these models, individuals allocate their resources so as to maximize the overall utility derived from religious and secular commodities.

While religious activities can be incorporated into a household utility function in terms of preferences, it is interesting to consider the case where adherence to a set of religious beliefs requires behaviors that constrain individual utility maximization and lead to a deviation from first best choices.[11] Iannaccone and others have used the model of club goods[12] and agency theory to explain such religious restrictions and costly rituals as optimal responses to the inherent free rider problem faced by religious institutions providing a public service. According to this model, since religious affiliation provides certain material and social benefits, religious groups impose costly behavioral restrictions on members to signal group commitments, enhance intra-group trust and facilitate collective action. For example, Berman finds that Israeli Ultra-Orthodox men continue to study full time in yeshiva—a religious seminary that provides virtually no practical training—until their forties because yeshiva attendance signals commitment to the community, which in turn provides mutual insurance to its members.

Similarly, Carr explains religiously mandated dietary restrictions such as those prohibiting Roman Catholics from eating meat on Fridays, Muslims from eating pork and drinking alcohol and Jews from deviating from an entire set of strict dietary laws known as the kashrut as a way to build group trust and identify outsiders. While viewing religious organizations

as clubs can explain certain religious actions from a maximization perspective, it fails to explain cases where religiously motivated actions—such as donating to churches or investing in religious funds—are performed in private and do not accrue social and material benefits via signaling group commitment. This chapter focuses on the latter case and uses a unique dataset of customer level data to understand the demand for Islamic banking products through the existence of a private, utility-augmenting faith premium associated with the selection of these products.

The Islamic Banking Industry

> *Those who charge usury are in the same position as those controlled by the devil's influence . . . those who persist in usury, they incur Hell, wherein they abide forever.*
>
> (The Quran, Al-Baqarah 2:275)

Since the 1970s, increasing religiosity across the Muslim world fueled by increasing oil revenues has transformed the world of Islamic banking from a handful of local banks to an increasingly sophisticated, global industry with an estimated market size of over $1 trillion.[13] While this is still relatively small in comparison to other sectors of the financial industry (about half the size of Citibank in 2010), the substantial growth rates in this sector—as much as 20 percent a year since 2003—make it a significant force in global finance. Furthermore, the industry taps into a large and increasingly captive market of 1.6 billion Muslims around the world. Currently, over 56 percent of the Islamic Finance market is located in the Middle East, 20 percent in Asia and about 14 percent in Europe.[14]

At its core, Islamic banking is a prohibition-based industry emerging from *shari'a* (Islamic law) restrictions on *riba* (interest), *gharar* (transactions involving uncertainty or speculation such as derivative trading and insurance) and businesses associated with particular immoral sectors such as alcohol, pornography or gambling.[15] The core prohibitions on interest are an outcome of the general belief that it is unjust to earn income without assuming risk.[16] So, according to *shari'a* rules, unless a depositor assumes some of the risk inherent in investing her funds, she is not entitled to a return on her money. Given that the payment of a fixed rate of interest is strictly prohibited in this model, all financing is based on the principle of buying and selling tangible assets.

In order to make sure that Islamic banks conform to strict Islamic principles of banking, a "*shari'a* board" composed of various religious scholars is used to supervise the development and creation of all financing products and services offered by the bank. This board usually ranks above the Board

of Directors within the organizational structure of an Islamic bank and is empowered to issue fatwas (legal pronouncements) on any matter proposed to it by different business units of the bank.

According to the *shari'a* model of finance, Islamic bank deposits are based on the principles of profit and loss sharing (PLS) where the depositor enters into an equity type relationship with the bank. Instead of receiving a pre specified rate of interest on their accounts (as they would at a conventional bank) depositors at an Islamic bank receive profit shares that tend to fluctuate over time. In practice, these fluctuations usually follow the movements of ordinary interest rates since Islamic banks in turn often invest their deposits into bonds and other interest bearing instruments. As Kuran points out, "employees of the Islamic banks often unofficially promise potential depositors returns no lower than the prevailing interest rate. . .in countries where Islamic banks compete with conventional banks, the ostensibly interest-free returns of the former essentially match the explicitly interest-based returns of the latter."[17]

However, despite being closely matched to conventional bank returns in practice, the profit rate based Islamic bank returns are *not* guaranteed in advance and are supposed to be entirely dependent on bank performance. Depositors are required to specifically acknowledge the risk that if the bank makes a loss, they will earn no returns and may even lose their principal. So at least as far as the specific financial contracts are concerned, the PLS *shari'a*-compliant deposits are inherently riskier than conventional bank deposits that guarantee a fixed rate of return. Mainstream banks guarantee a specific return to their account holders even if the bank is making a loss. In the worst-case scenario of a bank failure in the absence of FDIC type depositor insurance, account holders at conventional banks are preferred residual claimants and have some legal rights to recovering their deposits. On the other hand, if an Islamic bank suffers a loss, depositors suffer. Depending on the magnitude of the loss, depositors may not only lose their returns but they may also lose their principal. And in case the bank fails, since Islamic account holders are considered risk-sharing investors in the bank, they have the same rights as bank shareholders and are obliged to share the losses.

Furthermore, given that depositors do not have the ability to control or monitor bank investment activities, there is an additional risk of moral hazard since banks can pass on any losses to their account holders. In fact, this information asymmetry led to the spectacular failure of Islamic Money Management Companies (IMMCs) in Egypt during the late 1980s. Millions of Egyptians lost their savings to these Islamic institutions that functioned as giant pyramid schemes under the cloak of religious investment houses.

Their collapse damaged the reputation of Islamic banks in Egypt to such an extent that today, despite being one of the most populous Muslim nations, Egypt only has a few Islamic banks that operate on the margins of the state dominated conventional banking system. More recently in 2001, the Ihlas Finance House (IFH)—the largest of the six Islamic banks in Turkey with over 40 percent of the sector deposits—collapsed after illegally appropriating almost its entire $1 billion deposit base. When the IFH was liquidated, the misappropriation of funds was so large that the bank was unable to pay back its depositors.[18] As seen in these cases, the risk associated with investing in an Islamic financial institution is certainly not reduced if it happens to be located in a Muslim country.

A Portfolio Choice Model of Religious Asset Consumption

We propose a simple model of portfolio choice based on the mean variance analysis of Markovitz (1952) and as described by Campbell and Viciera to describe the decision to allocate wealth (savings) towards Islamic banking products.[19]

We assume that the individual at time t faces a wealth allocation decision between two different types of accounts. One is a riskless, conventional bank account offering entirely deterministic returns, r_{t+1} from time t to time $t+1$, while the other is a risky Islamic bank account offering a return of ρ_{t+1} from time t to time $t+1$ with a conditional mean $E_t\rho_{t+1}$ and conditional variance σ_t^2. The individual allocates a proportion α_t of her initial wealth, W_t to the Islamic asset. At time, $t + 1$ her accumulated wealth is:

$$W_{t+1} = \alpha_t W_t(1+E_t\rho_{t+1}) + (1 - \alpha_t)W_t(1 + r_{t+1}) \qquad (1)$$

(1) can also be written in terms of the total returns on her portfolio as:

$$W_{t+1} = (1 + R_\alpha)W_t \qquad (2.1)$$

where $E_1R_\alpha = r_{t+1} + (E_t\rho_{t+1} - r_{t+1})\alpha_t$ and $\mathrm{Var}(R_\alpha) = \sigma_t^2\alpha_t^2$ (2.2)

The individual chooses α_t to maximize her total utility and solve for:

$$\underset{\alpha_t}{Max}\ U(E_tW_{t+1}(\alpha_t), \eta_t(\alpha_t)) \qquad (3)$$

where $E_tW_{t+1}(\alpha_t)$ is the utility she derives from maximizing expected wealth at the end of the period and $\eta_t(\alpha_t)$ is the non-monetary utility or faith premium she derives from allocating α_t toward a religious asset. η_t is the indicator of individual religiosity such that $\partial U/\partial\eta_t = 0$ for non-religious people who derive no additional non-monetary benefits from the allocation of α_t toward a religious asset.

Assuming additive and separable utility, (3) can be rewritten as:

$$\underset{\alpha_t}{Max}\ U(E_t W_{t+1}) + U(\eta_t(\alpha_t)) \quad (4)$$

In order to solve (4), we further assume a power utility function with respect to wealth such γ that is the coefficient of relative risk aversion and—the returns on the Islamic banking asset ρ—are lognormally distributed.[20]

$$U(E_t W_{t+1}) = E_t\left(\frac{W_{t+1}^{1-\gamma}}{1-\gamma}\right) \quad (5)$$

For all $\gamma < 1$ we can ignore the scale factor since it is positive and does not affect the solution of the maximization problem. Converting (5) to log form we get:

$$E_t\left(\frac{W_{t+1}^{1-\gamma}}{1-\gamma}\right) = (1-\gamma)\log E_t W_{t+1} \quad (6)$$

Using the general result for any lognormal random variable X:

$$\log E_t X_{t+1} = E_t \log X_{t+1} + ½ Var_t \log X_{t+1} \quad (7)$$

We can write (6) as:

$$(1-\gamma)\log E_t W_{t+1} = (1-\gamma)E_t \log W_{t+1} + ½(1-\gamma)^2 Var_t \log W_{t+1} \quad (8)$$

dividing by $(1-\gamma)$ we get

$$E_t \log W_{t+1} + ½(1-\gamma) Var_t \log W_{t+1} \quad (9)$$

We can rewrite the budget constraint (2.1) in log form as:

$$\log W_{t+1} = \log(1 + R_\alpha) + \log W_t \quad (10)$$

Replacing (10) into (9) and simplifying, we get the first part of the objective function as:

$$E_t \log(1 + R_\alpha) + ½(1-\gamma)\sigma_t^2 \alpha_t^2 \quad (11)$$

To convert (11) from portfolio returns to the individual underlying asset returns, we can use apply the Taylor approximation of the nonlinear function relating log individual asset returns to log portfolio returns:[21]

$$\log(1 + R_\alpha) - \log r_{t+1} \simeq \alpha_t(E_t \log \rho_{t+1} - \log r_{t+1}) + ½\alpha_t(1-\alpha_t)\sigma_t^2 \quad (12)$$

Which allows us to write (11) as:

$$U(E_t W_{t+1}) = \alpha_t(E_t \log r_{t+1} - \log r_{t+1}) + ½\alpha_t(1-\alpha_t)\sigma_t^2 + ½(1-\gamma)\sigma_t^2\alpha_t^2 \quad (13)$$

And assuming $U\eta_t(\alpha_t)) = \eta_t\alpha_t$ (14)

We can rewrite the utility maximization problem (4) as:

$$\underset{\alpha_t}{Max}\ \alpha_t(E_t\log\rho_{t+1} - \log r_{t+1}) + ½\alpha_t(1-\alpha_t)\sigma_t^2 + ½(1-\gamma)\sigma_t^2\alpha_t^2 + \eta_t\alpha_t \quad (15)$$

Such that:

$$\alpha_t^{\bullet} = \frac{E_t\log\rho_{t+1} - \log r_{t+1} + \sigma_t^2/_2 + \eta_t}{\gamma\sigma_t^2} \quad (16)$$

As expected, $\alpha_t^{\bullet}$ —the optimal allocation to the religious bank account increases if the expected returns on the religious account increase relative to the returns offered by the conventional bank. $\alpha_t^{\bullet}$ also increases if η_t which is the faith premium associated with the allocation α_t increases. This makes intuitive sense since more religious people realize higher faith premiums and therefore hold higher $\alpha_t^{\bullet}$ as an optimal allocation.

$\alpha_t^{\bullet}$ decreases if the coefficient of relative risk aversion goes up. This implies that the more risk averse an individual is, the less likely she is to invest her savings in an Islamic bank account. By extension, since γ is a constant which implies decreasing absolute levels of risk aversion, if our model is correctly specified then by assumption as the level of wealth goes up, the optimal amount of savings invested in an Islamic asset, $\alpha_t^{\bullet}W_t$ will also go up. When individuals are wealthier, they have lower levels of absolute risk aversion and are more likely to consume the riskier Islamic banking assets. The assumption of decreasing absolute risk aversion (DARA) is consistent with most experimental and empirical evidence and makes intuitive sense since a billionaire is far less likely to worry about a $100 loss than a graduate student on a stipend.

In the following section we use the empirical results from our survey to test some of the implications of our empirical model of portfolio choice with private faith premium benefits.

Data, Context and Methodology

The Banking Industry in Pakistan

Pakistan, with a population of close to 180 million and a per capita GDP of $2,600 (2008, PPP) has recently been singled out as one of the most turbulent regions in the world. However, it is also the fifth largest emerging market by population and faces many of the same challenges of development and growth being confronted by other developing countries around the world. Like various emerging markets, the level of financial exclusion in Pakistan is very high. Only about 17 percent of the population (30 million) has a bank account while less than 4 percent (5.5 million) has access to formal credit.

Pakistan's total financial assets are primarily determined by the banking industry, which holds about 95 percent of the total $175 billion (110 percent of GDP) in the system. Bank shares also constitute 40 percent of total stock market capitalization. The banking sector consists of three main groups (see Table 1 in Appendix). The first group is made up of the five largest banks in the country that cumulatively account for 53 percent of total banking assets.[22] These banks were nationalized in 1974 in an effort to expand credit distribution. Subsequently, under the more recent process of financial restructuring, all but one of them was privatized between 1991 and 2002. The second group consists of smaller, local banks that were allowed to operate in the private sector from 1991 onwards and are primarily based in the most densely populated, urban areas. This group includes the recently popular Islamic banks. The third group is made up of various foreign, multinational banks that until very recently were only allowed to operate through a limited number of branches. Although some of these restrictions have now been removed, the central bank must approve of all new branch openings.

Until 1991, the five nationalized banks made up the entire banking sector. Since that time they have continued to enjoy significant market power. The real rate of return on deposits has invariably been negative and banking spreads have remained very high. This reflects the generally inelastic deposit supply, interest insensitivity and long-term structural excess liquidity in the banking system that has allowed large banks to keep their funding costs down and generate substantial profits that have made Pakistan's banking sector the second most profitable in the world after Colombia.[23]

In an effort to reduce the banking spreads, the Central Bank (SBP) introduced a minimum deposit rate of 5 percent on all savings deposits in June 2008 (which was a significant change from the average rate of 2 percent paid by banks up until that time). The survey component of our research was conducted shortly after this change, over a period of three months between December 2008 and February 2009. However, the vast majority of our respondents—over 95 percent—were entirely unaware of the returns on their savings account.

Islamic Banking in Pakistan

Given that Islam was the raison d'être for the creation of Pakistan in 1947 as a separate and independent country within the British-ruled Indian subcontinent, it is not surprising to find Islamic banking in Pakistan. However, it was not until General Zia-ul-Haq seized control of the country after a military coup in 1977 that efforts to "Islamize" the economy and convert the financial sector to a *shari'a* compliant mode took off in earnest. While it was not entirely clear if Zia's religious motivations emerged from personal conviction or political strategy, but in accordance with his mission to propagate

religious values in the public space, he mandated a conversion of the existing conventional banking system to an Islamic model over a period of three years. Unsurprisingly, given the abrupt and ad-hoc nature of the intended switch, the exercise was a complete failure and conventional banks simply continued doing business as usual after making a few cosmetic changes—such as renaming savings accounts as profit and loss sharing (PLS) accounts without changing any of the underlying structures.

Around 2002, the State Bank of Pakistan (SBP) adopted a more nuanced approach to Islamic banking. Instead of mandating a conversion of the entire system, the SBP issued licenses for new Islamic banks. These new, religious banks would co-exist with existing conventional banks and form what is now known as a dual financial system where customers had the option to select a *shari'a* compliant Islamic bank or a standard, conventional bank. The existence of a dual financial system is very typical of the Islamic finance industry in general where almost every country that has an Islamic banking presence also has a substantially larger and better-established conventional banking sector. The market share of Islamic banking varies from a high of around 15 percent of total deposits in Malaysia and the UAE, 11 percent in Bahrain, about 2 percent in Indonesia and an insignificant amount in other places like Singapore and the UK.

The first stand-alone Islamic bank in Pakistan was set up in 2003. By 2010, six out of the thirty-two banks in Pakistan were fully Islamic while twelve additional conventional banks had licenses to operate dedicated Islamic banking branches. At present the Islamic banking industry accounts for a market share of 4.5 percent of total banking industry assets.[24] Islamic banks had over 330 branches in 2009 and were present in all the major urban cities as well as some other smaller towns (see Table 2, Appendix).

The specific case of Pakistan—a country that has been rocked by successive periods of intense political and sectarian violence since its inception—also provides an interesting context for exploring the impact of environmental uncertainty on individual religiosity. On the one hand, if violence, uncertainty and political instability lead to increased religiosity, we should expect more people to gravitate towards Islamic assets. Alternatively, if uncertainty leads individuals to move toward better-established, lower-risk financial alternatives then we should expect them to place their assets in a conventional banking system.

We leave a more detailed discussion of this theme for subsequent work but it should be noted that Islamic banking did not emerge during a particularly violent phase in Pakistan's history. Instead, these banks grew most rapidly over a five-year period during the relatively stable and economically prosperous era of military dictatorship under General Pervez Musharraf.

Dataset—Description and Survey Methodology

Data on Islamic banking customers and their conventional banking counterparts were collected over a period of six months from the leading Islamic Bank in Pakistan and a comparable leading conventional bank. Meezan Bank, the Islamic bank in our study (henceforth referred to as IB), was established in 2003 with a single branch and currently has over 150 branches located in major cities and urban centers. The bank has assets of PKR 20 billion ($0.28 billion) accounting for about 42 percent of the total Islamic banking industry. In contrast, Habib Bank Limited, the conventional bank in our study (henceforth referred to as CB) was founded in 1941. The CB is one of the largest banks in Pakistan and has maintained a dominant market position through almost three decades of nationalization induced monopoly power during which time it expanded across the entire country via a network of over 1500 branches.[25] As a result, the CB enjoys particularly strong local brand recognition and was recently ranked as the most recognizable banking brand in Pakistan.[26] The CB has an asset base of PKR 488 billion ($6.8 billion).

In contrast to foreign, multinational banks that cater to a wealthier, upper middle class set of customers, the CB and the IB attract a similar, middle-income class demographic and are generally regarded as comparable banks in terms of customer profiles and brand positioning. Both banks regard each other as competitors, though given the substantial differences in size and market penetration, the CB is more likely to identify larger banks as more direct competitors. In recent years, despite the size, market power and brand recognition advantages enjoyed by the CB, its moderate 10–15 percent per year deposit growth has been eclipsed by the IB's significantly higher 40–100 percent per year rate of deposit expansion. This chapter attempts to explore reasons behind this substantial difference in popularity between the two banks.

Data on customers was collected from the IB and the CB based on a number of exclusionary criteria. We examined basic, customer-level data on the IB in October 2008. Given that the IB has most of its branches (35) located in Karachi, the survey responses were limited to retail banking customers in that city.[27] Fifteen IB branches located in different sectors of the city were selected. The sector stratification was based on residential income levels and specific branches were selected on the basis of age—with preference given to IB branches that had been opened earlier and were better established.[28] The 15 IB branches were matched with 15 CB branches located in the same locality to create 15 bank clusters with matched pairs of IB and CB branches (see Table 3 in the Appendix for a map of the branch cluster locations and associated residential income levels).

The branch matching process itself was fairly straightforward. After the selection of the initial 15 IB branches based on stratification by location and branch age, the CB staff was approached to identify the closest CB branch to each of the 15 IB branches that had been selected. Since the CB had over 150 branches in the city and the smaller IB had branches that were located in the most densely populated areas, it was easy to find a matched pair. In the case that more than one CB branch matched up with an IB branch, the IB branch managers were contacted for their opinion on the CB branch that they considered the closest competitor to their branch. To make sure that we had the comparison right, we consulted branch managers at both banks to confirm that each co-located pair of IB and CB was matched appropriately. At the end of the matching process, in nine of the clusters the IB and the CB were located within a mile of each other, in two cases they were located right next to each other or in the same building while in the remaining four cases, they were located within a two mile radius.

At each of the 30 branches within the 15 clusters, customer level data was collected for new accounts opened at the bank between January 2007 and May 2008. We looked at simple savings accounts offering low, non-zero rate of returns on deposits. These accounts are particularly relevant for a country like Pakistan, where capital markets are inadequately developed and there are very few alternative investment opportunities. Depositors placing their money in these accounts are typically small account holders who cannot predict their future liquidity needs and need a bank account for safety and transactionary purposes. These basic savings accounts represent the bulk of all interest-bearing consumer banking accounts in Pakistan and are easy to compare between banks because they offer similar returns and provide very few services in addition to the basic ability to withdraw money without penalties.[29]

We also limit our focus to basic interest (or profit) bearing savings accounts because checking accounts do not pay any interest to their customers and as such are permissible according to *shari'a* rules regardless of whether they are based at the CB or the IB. More sophisticated savings products and time deposits were also excluded because the rates and services associated with these products were difficult to compare across the banks.

The time frame was selected in order to find customers who were making a banking choice between the religious and non-religious options. As such, we exclude long-term CB customers who had been with the bank before the IB option (most of their branches were opened after 2005) was available in their preferred location. These customers may well have (weakly) preferred the IB to the CB but may not have switched due to inertia and/or above zero switching costs.

The initial data collection from 30 branches in 15 location clusters yielded a set of 9,078 customers out of which 2,802 had opened accounts at the CB and 6,276 had opened accounts at the IB. Given that we were looking at all new customers opening a basic savings account at either bank within a specific timeframe of January 2007–May 2008, the substantially greater number of IB customers in our sample supports the general trend of higher growth rate being experienced by Islamic banks in comparison to conventional banks.

As discussed earlier, in comparison to conventional bank accounts, religious savings accounts are inherently riskier since neither the actual returns nor the principal is guaranteed. The IB in our sample has a significantly smaller branch networks and offers a narrower product portfolio than the CB. It is also very new, and as such may be considered less stable than the CB, particularly in the context of a turbulent country like Pakistan where in the absence of any FDIC type depositor guarantee borrowers are forced to rely on the stability of a particular banking institution as the ultimate guarantee of the safety of their funds. Yet, despite the higher risk of investing in a new bank that offers uncertain returns in a turbulent environment, as seen in Table 1, more accounts were opened at the IB in every location and the average balances in these accounts were higher than those being held at the CB.

One possible explanation for the popularity of saving deposits at the IB may be because these banks offer a limited set of products in comparison to the CB. It is possible that the IB customers selected the basic savings account because they did not have many product choices at their preferred religious bank, while the CB customers were able to choose from a more diverse portfolio and selected other, more sophisticated accounts. However, while differences in product range may explain why the IB accounts held higher average balances than the comparable CB accounts, but they do not explain why the IB was chosen in the first place.

Alternatively, given that there are relatively few options for someone who wants to open a religious bank account aside from the IB, it is possible that the CB was unable to attract customers because the market for conventional bank accounts is more competitive. A wealthy person who is not motivated by religious sentiments can choose his bank from a wide array of options that includes, but is not limited to the CB. On the other hand, a religiously motivated person cannot really do much better than the IB. This explanation can explain why more customers are demanding religious banks but does not address why their average balances are higher at the IB.

Table 1: Summary Statistics for Accounts Opened and Average Balances

The sample includes all new, basic savings accounts opened at the IB and the CB between January 2007 and May 2008. C-1 to C-15 identify the paired, co-located branch clusters. Mean and median average balances are reported for each bank type within each cluster as well as for the entire sample and by cluster. The p-value for the difference between the mean average balances between the IB and the CB at each cluster is also reported.

	Total Sample				IB				CB				IB-CB	
	# Accts	Mean Balance	Median Balance	Std. Dev	# Accts	Mean Balance	Median Balance	Std. Dev	# Accts	Mean Balance	Median Balance	Std. Dev	Difference	p-value
Total	9078	138181.1	20709.5	576757.6	6276	162924.1	25385.6	667252.5	2802	82760.8	14481.0	275901.5	80163.3	0.000
C-1	388	249933.1	26507.7	1284773.0	269	288,339.2	30360.23	1486033	119	163116.1	21550.03	622203.5	125,223.1	0.377
C-2	970	94123.8	15841.3	426275.1	608	112,188.7	18926.67	520013.5	362	63782.6	12282.53	177738.9	48,406.1	0.087
C-3	103	171384.6	24207.4	564227.7	85	200,438.8	29732.4	617267.4	18	34183.9	15460.07	57301.32	166,254.9	0.258
C-4	750	104749.6	20774.8	266235.2	492	120958	25241.1	260011.3	258	73840.9	18519.13	275594.9	47,117.0	0.021
C-5	507	212882.3	33793.8	670005.2	369	243241	37427.9	747844.3	138	131705.1	23150.62	382897.7	111,536.1	0.095
C-6	493	124256.9	17093.2	440210.0	317	159886	22237.6	532943.1	176	60083.6	10928.44	159677.9	99,802.6	0.016
C-7	683	87891.7	13105.2	325132.0	483	87705	12057.2	298706.9	200	88341.5	16081.94	382322.2	−636.1	0.981
C-8	225	191423.3	16026.3	881169.2	203	198207	15315.5	920229.9	22	128826.5	23536.69	363385.1	69,380.7	0.727
C-9	543	138693.7	12759.6	979051.8	294	236436	22915.9	1321495	249	23286.9	7030.63	83393.63	213,149.3	0.011
C-10	660	173140.2	30109.1	428696.9	543	180065	32448.0	452599.9	117	141001.6	19366.56	292696.9	39,063.6	0.372
C-11	550	126024.6	19210.0	598713.7	331	171154	21321.5	762790.4	219	57815.0	15994.59	119060.2	113,339.2	0.030
C-12	817	169922.1	33954.6	553207.1	699	176247	37011.3	584036	118	132455.2	13161.29	312790.6	43,791.7	0.427
C-13	1198	95848.4	21148.4	294200.7	719	100713	25866.6	310544	479	88545.8	18235.33	267955.5	12,167.6	0.483
C-14	812	118816.2	22532.5	372168.1	546	130243	27330.0	419655.8	266	95361.4	16770.01	246735.5	34,881.5	0.210
C-15	379	233773.9	23171.3	774622.2	318	271981	30233.0	840194.4	61	34598.7	11296.89	50347.37	237,381.8	0.028

It is possible that Islamic banking customers are simply unaware of the conventional banking option available to them. However, this explanation is also difficult to support because until 2003 the only type of banks operating in Pakistan were mainstream, conventional banks. Even now 95 percent of the total banking sector operates on a conventional basis so it is difficult to imagine that IB customers would be unaware of conventional banks. Also, given that our sample was drawn from an urban population in the most cosmopolitan city in the country with the highest financial penetration rates, it is even more unlikely that people were not aware of the dual banking system. Furthermore, we based our analysis on clusters of co-located banks where the CB was physically close to the IB making it even more difficult to argue that IB customers were simply unaware of the CB option.

Given the predictions of our theoretical model and the higher risk associated with IB accounts, it is possible that the IB customers were less educated and financially savvy than those who selected the conventional bank. So even if they were aware of the existence of a CB alternative, we may believe that they were not able to comprehend the risk-return calculation unlike customers who selected the CB. On the other hand, despite the fact that the IB was new and less established, perhaps IB customers knew something about the management of the Islamic bank that others did not know and were able to trust it more than the CB. Also, perhaps despite the uncertainty associated with IB returns, $E(\rho) > i$, the IB customers actually expected higher net returns on their accounts than those being offered by the conventional banks. Finally, it is also possible, as predicted by our model, that customers were willing to pay a "faith premium" for Islamic banking assets, $\eta_t > 0$ and even if there was no significant difference between expected profits on the IB accounts and the interest rate paid on the CB accounts, IB account holders derived a positive faith premium from selecting these assets. We use the results from our survey to test the validity of each of these predictions.

Sample Selection and Survey Design

From the initial list of 9,078 customers in our sample, a target of 50 customers from each of the 30 branches in our sample was set up. These customers were to be randomly picked from the larger sample of all customers who had opened a new bank account between Jan 2007 and May 2008 at a particular branch and were asked to respond to a survey questionnaire designed to examine individual religiosity and criteria for bank selection (see Table 4 in the Appendix for a summary of the survey).

In developing the questionnaire, a set of various factors that are considered relevant for bank selection was derived from existing literature on the

subject.[30] For example, Kaufman and others looked at bank selection decisions in the U.S. and found that the most influential factor reported by households was convenient location.[31] Various subsequent studies conducted in different countries have further corroborated the importance of branch location on bank selection. Ross finds that the influence of friends and low service charges matter.[32] Laroche et al surveyed households in Canada and found that the friendliness of staff plays a major role in the bank selection decision process, followed by hours of operations, size of waiting lines and convenience of location.[33] Kaynak surveyed bank customers in Finland and found that the main determinants of bank selection were reception at the bank, efficient services and lower service charge while Mylonakis et al. studied bank selection decisions in Greece and found that the most important selection factors were location and the quality of service.[34] All of these potentially relevant bank selection factors were used to develop the initial questionnaire used in the survey. Local banking officials were also consulted to make sure that we had identified a relevant list.

Indicators to test individual religiosity were determined through detailed discussion with religious experts in the region and verified through more informal discussions with members of the local population. In order to make sure that the survey was generating the right responses, we pilot tested it with 100 randomly chosen respondents who held bank accounts outside our sample space and adjusted the initial questionnaire for relevance and clarity. In its final form, after pilot testing adjustments, the survey was conducted over the phone in Urdu and had a final response rate of approximately 30 percent. Out of every 10 people called from the banks' list of customers, in approximately 3 cases the account holder was available on the phone and in almost every case agreed to participate in the survey. The reason for the common willingness to talk was possibly due to the fact that phone based surveys are very uncommon in Pakistan and the recipients were not paying for the call.[35] Almost all of the non-responses in our sample were due to an inability to contact the customers because their phone numbers had changed or because they did not respond to the call.[36]

Surveys were administered through five research assistants who had been trained to follow a specific survey script and methodology. In order to make sure that there was no "interviewer effect" in the results, the branches were randomly assigned across clusters between the research assistants and no single research assistant was interviewing customers from both the IB and the CB branch in one cluster.

Sampling Robustness Checks

Out of the total sample of 9,078 we called 5,133 (3,629 from the IB and 1,504 from the CB) customers by alphabetically arranging customer lists by

branch and selecting every second customer on the list.[37] In comparison to the total sample where average balances for all customers was PKR 138,181 (PKR 162,924 for IB and of PKR 82,761 for CB), those who were called had an average balance of PKR 98,606 (PKR 127,498 for IB and PKR 72,184 for CB) since it was difficult to reach high balance customers on the phone. Finally, the survey respondents in the sample had average balances of PKR 92,974 (PKR 102,045 for the IB and PKR 83,338 for CB).[38]

While the sampling population is generally comparable to the total population of new customer at the 30 IB and CB branches, it is important to note that our sample is biased away from customers that were holding the highest account balances and response rates were lower in higher income areas. This is due to the fact that it was more difficult to reach high income/high balance customers on the phone and they were less likely to respond to survey questions than the general population. Given that we have the same bias for both the IB and the CB customers, this should not change the general validity of our conclusions. If average balances are correlated with education it is possible that our sample does not include the most educated and financially savvy end of the spectrum. However, we don't see this correlation in our data where average balances are not a significant predictor of education.

Given population limitations at some of the clusters, the final sample of survey responses was also weighed more heavily towards the IB. Table 2 describes summary statistics from the survey sample. The total sample of 1,480 survey responses was used to test various predictions from the model described earlier. The results from this analysis are described in the next section.

Results from Survey Analysis

The results from the survey enable a more nuanced description of individuals who are choosing Islamic banking products. Contrary to the hypothesis that the IB customers may be less financially savvy than their CB counterparts, our results show that IB customers are actually *more* educated than their CB customers. They are also older and have traveled more than CB customers. As such, if there is any difference between the two groups, the IB customers may be expected to know more about alternative financial options available to them than the CB customers.[39]

Furthermore, in selecting the Islamic bank, more customers seem to have switched from another bank than to have newly entered the formal banking sector from the previously unbanked population. This further contradicts the possibility that Islamic banking customers may not be aware of other options. It also negates the view that customers selecting an Islamic bank

were the previously unbanked and had remained outside the conventional banking sector because it was not in accordance with their religious beliefs.

We also find that the desire to open Islamic bank accounts is not explained by a lack of trust or satisfaction with the CB relative to the IB because levels of reported trust and satisfaction are similar at both banks. In fact, relative to the IB, the level of trust in a CB is more skewed towards higher levels, which is not surprising given the fact that the CB is an old, well-established bank and the IB is very new and relatively unfamiliar. It does not, however, explain why more customers in our sample select an IB versus a CB.

Interestingly, given the higher risk associated with holding IB products, we find that IB account holders are almost twice as likely as CB account holders to maintain additional accounts in other banks. Moreover, in almost every case, these bank accounts are not being opened at multinational banks or specialized banking institutions offering specific products that are not available at the IB. Rather, these additional bank accounts are opened at comparable conventional banks that provide very similar products to those being offered at the IB. Both the expected profit on an IB account $E_t\rho_{t+1}$ and the returns on the CB, r_{t+1} seem to be very weak motivators for selecting a bank account. Over 94 percent of the customers being surveyed did not know the profit /interest rate they were earning on their savings accounts. While this is not entirely surprising since our sample is constrained to look at basic savings accounts and these accounts may not be the most profit sensitive portion of an individual financial portfolio, it also reduces the relevance of the profit motive in choosing an IB.

Furthermore, it is interesting to note that in comparison to CB customers, relatively more Islamic bank account holders claimed to know the profit rates on their accounts and that on average, they expected lower expected profit/returns than CB customers (Table 2). While this finding needs to be interpreted with caution since only 5 percent of the respondents reported knowing the returns they earned, it further refutes the profit motive $E_t\rho_{t+1} > r_{t+1}$ for selecting an Islamic bank account.[40]

Given these results, if we go back to our portfolio selection model and assume that $E_t\rho_{t+1} = r_{t+1}$, which in effect eliminates the profit motive, we find that:

$$\alpha_t^{*} W_t = \left({}^{1}\!/_{2\gamma} + {}^{\eta_t}\!/_{\gamma\sigma_t^2} \right) W_t \tag{5}$$

According to (5), the optimal investment in the IB depends on (i) the degree of risk aversion, (ii) the level of individual religiosity and (iii) wealth.

While it is difficult to find empirical evidence of risk aversion, we can use the various dimensions of individual religious practices measured in

Table 2: Summary Statistics for Survey Sample

The table provides summary statistics for a randomly chosen sample of savings account holders at the IB and the CB. Mean, median and standard deviation statistics for each variable are reported by bank type and for the entire cluster. The p-value for the difference between the mean averages between the IB and the CB is also reported. BALANCE is the average balance held in each savings account. AGE is the age of account holders. GENDER is an indicator variable that is equal to one if the respondent is a female. HHDSIZE shows the size of the respondent's household. EDUCATION categorizes education levels on an increasing five-point scale where no schooling = 0, some school = 1, junior high = 2, high school = 3, bachelors = 4, masters and higher = 5. INTLTRAVEL shows the number of countries the respondent has visited outside Pakistan. SWITCHER is an indicator variable that is equal to 1 if the respondent switched into the current bank (the CB or the IB) from another bank. SWITCHER is equal to 0 if the respondent did not have another bank account before. MULTIPLE is an indicator variable that is equal to 1 if the respondent currently has more than one bank account. CREDIT is an indicator variable that is equal to one if the respondent has accessed credit from a bank. EXPPROFIT is the reported annual profit rate that respondents think they are getting on their bank accounts. TRUST shows the level of trust that the respondent has in his bank where no trust = 0, a little trust = 1, somewhat/average trust = 2, above average trust = 3, exceptional trust = 4.

	Total Sample				IB				CB				IB-CB	
	Obs	**Mean**	**Median**	**Std. Dev**	**Obs**	**Mean**	**Median**	**Std. Dev**	**Obs**	**Mean**	**Median**	**Std. Dev**	**Difference**	**p-value**
BALANCE	1293	92974.0	15421.63	338664.5	666	102045.2	17560.9	377489.1	627	83338.5	14893.92	291821.4	18706.7	0.321
AGE	1372	41.9	39	15.3	772	44.0	42.0	15.8	600	39.1	37	14.1	4.89	0.000
GENDER	1480	0.41	0.0	0.49	853	0.40	0.0	0.49	627	0.42	0.0	0.49	−0.02	0.553
HHDSIZE	1397	5.94	5.00	3.02	779	5.71	5.00	2.79	618	6.22	6.00	3.27	−0.52	0.002
EDUCATION	1440	3.41	4.00	1.28	818	3.56	4.00	1.20	622	3.22	4.00	1.36	0.33	0.000
INTLTRAVEL	1464	0.992	0	1.264	838	1.260	1	1.33	626	0.633	0	1.067	0.628	0.000
SWITCHER	1463	0.426	0	0.495	839	0.517	1	0.500	624	0.303	0	0.460	0.214	0.000
MULTIPLE	1461	0.334	0	0.472	838	0.412	0	0.492	623	0.230	0	0.421	0.182	0.000
CREDIT	1467	0.070	0	0.254	846	0.054	0	0.227	621	0.090	0	0.287	−0.036	0.008
EXPPROFIT	85	5.887	5	4.583	67	5.802	5	4.597	18	6.203	5	4.646	−0.402	0.744
TRUST	1458	2.665	3	0.892	837	2.601	3	0.894	621	2.750	3	0.882	−0.149	0.002

our survey to generate an indicator for individual religiosity and examine if this indicator is correlated with a preference for the IB. Similarly, while we do not have access to data on individual wealth, we can use the information we have from our survey responses to find some reasonable indicators for household income and see if they are correlated with the selection of the IB.

The Impact of Religiosity and Wealth on IB selection

When survey respondents were asked about bank selection criteria, the vast majority (62 percent) of the IB customers said that they chose the IB because it offered *shari'a* compliant, Islamic products. This was followed in a distant second by salary accounts,[41] where 13 percent of the respondents were using the IB because their employer directly deposited funds into their accounts at that bank while 10 percent of the IB customers chose their bank primarily due to its location and 8 percent came to the bank on someone's recommendation. In contrast, branch location seemed to be the most important selection criteria for 44 percent of the CB customers. This was followed by 16 percent who maintained salary accounts at the CB, 12 percent were attracted by the banks service and image, another 12 percent picked the CB because another member of their family already banked there and 9 percent came to the CB on someone's recommendation. Table 3 summarizes general religiosity trends for customers at the CB and the IB.

We also find that IB customers are more religious than CB customers—even in a context where most people appear to be fairly religious. The variables that are most strongly related to individual religiosity—memorizing the Quran, growing a beard, praying five times (or more) every day, attending religious classes and going to Saudi Arabia on a religious pilgrimage—are all higher for IB customers and the differences are statistically significant.

We used a weighted average of different religiosity indicators to construct a composite religiosity variable that is used to test for the impact of religiosity on the likelihood of selecting the IB. The religiosity indicator was constructed from sections of the survey described in Table 3 indicating whether the respondent had performed a Hajj pilgrimage, if they had memorized the Quran, if anyone else in their family had memorized the Quran, if they prayed five times a day, went to religious classes, if the men in their family had a beard, if the women in the household covered their head when they went out or if they watched religious TV regularly.

Given the different levels of individual religiosity associated with these indicators and their distribution within our sample, we weighed the performance of Hajj, self memorizing the Quran, praying five times a day and attending religious classes twice as much as the other indicators that were

Table 3: Summary Religiosity Based Statistics for Survey Sample

The table provides summary religiosity based statistics for a randomly chosen sample of savings account holders at the IB and the CB. Mean, median and standard deviation statistics for each variable are reported by bank type and for the entire cluster. The p-value for the difference between the mean averages between the IB and the CB is also reported. HAJJ is an indicator variable that is equal to 1 if the respondent has gone to Saudi Arabia for a religious pilgrimage. HAFIZ is an indicator variable for memorizing the Quran, FAMILYHAFIZ is an indicator variable for someone in the respondents immediate family having memorized the Quran. PRAYER is an indicator variable that is equal to 1 if the respondent prays five times or more every day. RELIGCLASS is an indicator variable to show if the respondent has attended formal religious classes discussing the Quran or the *Hadith* (the sayings of the Prophet Muhammad). PURDAH is an indicator variable that is equal to 1 if the women in the respondent's house veil themselves when they go outside the house. BEARDS is an indicator variable that is equal to 1 if the men in the respondent's house have beards. Beards and to a lesser extent purdah are both indicators of religiosity. RELIGTV is an indicator variable that is equal to 1 if the respondent watched specifically religious TV channels.

	Total Sample				**IB**				**CB**				**IB-CB**	
	Obs	**Mean**	**Median**	**Std. Dev**	**Obs**	**Mean**	**Median**	**Std. Dev**	**Obs**	**Mean**	**Median**	**Std. Dev**	**Difference**	**p-value**
HAJJ	1475	0.368	0	0.482	848	0.496	0	0.500	627	0.195	0	0.396	0.302	0.000
HAFIZ	1476	0.045	0	0.207	849	0.059	0	0.236	627	0.026	0	0.158	0.033	0.002
FAMILYHAFIZ	1473	0.237	0	0.425	846	0.257	0	0.437	627	0.211	0	0.408	0.046	0.040
PRAYER	1468	0.560	1	0.497	845	0.628	1	0.484	623	0.467	0	0.499	0.161	0.000
RELIGCLASS	1468	0.469	0	0.499	843	0.544	1	0.498	625	0.366	0	0.482	0.178	0.000
PURDAH	1462	0.815	1	0.388	842	0.825	1	0.380	620	0.802	1	0.399	0.024	0.247
BEARDS	1455	0.619	1	0.486	833	0.667	1	0.471	622	0.553	1	0.498	0.114	0.000
RELIGTV	1475	0.642	1	0.480	849	0.651	1	0.477	626	0.629	1	0.483	0.022	0.385

somewhat weaker indicators of personal religiosity and may have been more vulnerable to a positive response bias. For example, over 80 percent of the respondents in our sample reported that the women in their households covered their heads when they went out, a majority of the men had beards and over 64 percent watched religious TV on a regular basis. As such, these indicators were weighed less than other indicators that were more strongly correlated with individual religiosity, such as self memorizing the Quran—something that was only done by less than 5 percent of our respondents. The composite religiosity indicator had an average inter-item covariance of 0.072 and a Cronbach's alpha of 0.48. Table 4 shows the results from various logit models for the selection of an Islamic bank using the composite religiosity indicator.

In terms of our portfolio choice model, the results shown in Table 4 show that IB customers extract a positive faith premium from allocating their savings to Islamic assets and $\eta_t > 0$. These results are robust to adding other explanatory factors for the choice of an IB and religiosity remains a significant predictor of IB selection even after controlling for various demographic factors. IB customers are more educated than CB customers. They have also traveled more (and as such are likely to have had more financial exposure) than the CB group.

Table 4 also describes the results of various robustness checks using alternative specifications. We find that religiosity remains significant as a predictor of IB selection, even when we constrain the sample to only look at individuals who have switched from conventional banks to the IB (3) and individuals who have additional, conventional banking accounts in addition to their account at the IB (4). We do find, however, that individuals who maintain dual bank accounts are more educated than those that only bank at the IB or the CB and that these individuals tend to have traveled more internationally. We also restrict our model to cases where the IB is located very close to the CB (less than a mile apart) (5) and find that religiosity matters even more when the IB is chosen over a proximate CB. Finally in (6) we also look at the effect of environmental uncertainty and constrain the sample to banks located in areas with a higher than average level of violence. And while we find that in more violent areas, religiosity matters more than it does in the full sample, we also find that education levels of these customers are somewhat lower. However, since violent areas are also negatively related to residential income levels and the survey was conducted during a period of relatively low local violence, the results of this model should be interpreted with caution.

As predicted by our theoretical model, religiosity appears to be the most significant predictor of selecting an IB. However, if we examine the propensity

Table 4: Logit Models for the Selection of an Islamic Bank

Coefficients in all specifications are estimated by using maximum likelihood and are reported in exponential terms as odds-ratios. All regressions include a constant. Standard errors are in brackets and have been adjusted for clustering by the fifteen branch location groups. Coefficients that are significant at the 1 percent, 5 percent and 10 percent levels are indicated by ***, **, and *, respectively. (1) and (2) test the entire sample of customers in the survey who have selected an IB. (3) is restricted to customers who switched into the IB from a conventional bank (i.e., customers who have had prior [conventional] banking experience and were not part of the unbanked population). (4) is restricted to IB customers who also have another conventional bank account. (5) only looks at clusters where the IB and the CB are located within a one mile radius of each other while (6) is restricted to customers at IB and CB branches that are located in areas with high levels of violence. RELIGIOSITY is a composite indicator of individual religiosity. LOGBALANCE is the natural log of average balances, GENDER is an indicator variable that is equal to 1 if the respondent if female. HHDSIZE shows the household size, EDUCATION categorizes education levels on an increasing five point scale where no schooling = 0, some school = 1, junior high = 2, high school = 3, bachelors = 4, masters and higher = 5. CREDIT is an indicator variable that is equal to one if the respondent has accessed credit from a bank. AGE is age. INTLTRAVEL shows the number of countries the respondent has visited outside Pakistan. INCOMEGROUP shows the residential income levels of the location where the respondent opened his bank and ranges from 1 = low income to 4 = high income.

	(1)	(2)	(3)	(4)	(5)	(6)
	IB	IB	SWITCHERS	IBANDCB	IB *Adj Branch*	IB *Violent*
RELIGIOSITY	5.488***	5.542***	5.571***	5.052***	6.524***	6.475***
	(1.722)	(1.288)	(1.220)	(1.548)	(1.743)	(1.391)
LOGBALANCE		0.972	1.035	1.018	0.963	0.924
		(0.061)	(0.073)	(0.089)	(0.071)	(0.075)
GENDER		0.891	0.695	0.665	1.112	0.911
		(0.274)	(0.202)	(0.214)	(0.357)	(0.350)
HHDSIZE		0.933*	0.909**	0.919**	0.946	0.960
		(0.035)	(0.035)	(0.036)	(0.043)	(0.046)
EDUCATION		1.334***	1.466***	1.589***	1.366***	1.245***
		(0.107)	(0.138)	(0.132)	(0.136)	(0.096)
CREDIT		0.554	0.752	0.598*	0.418**	0.483**
		(0.200)	(0.276)	(0.186)	(0.146)	(0.142)
AGE		1.020***	1.028***	1.029***	1.023***	1.018***
		(0.006)	(0.007)	(0.008)	(0.006)	(0.006)
INTLTRAVEL		1.557**	1.795***	1.602**	1.221	1.245
		(0.351)	(0.406)	(0.350)	(0.254)	(0.275)
INCOMEGROUP		0.692*	0.681**	0.784	0.716	0.857
		(0.135)	(0.123)	(0.167)	(0.311)	(0.167)
OBSERVATIONS	1435	1131	882	826	861	839
PSEUDO R^2	0.07	0.1453	0.194	0.186	0.155	0.123

to choose Islamic banks in terms of specific types of religious behavior and characteristics, we find that the single most important predictor of the likelihood to invest in Islamic bank account is the performance of Hajj—a religious pilgrimage to Mecca that is obligatory only on Muslims who can afford the journey. Table 5 shows the results of various logit models for the selection of an Islamic bank using disaggregated religiosity indicators.

The most stable predictor of selecting an Islamic bank appears to be the performance of the Hajj. Our results are robust to alternative specifications in (3) and where we restrict the model to only look at customers who had switched from a conventional bank to the IB and (4) where we look at IB customers who also maintain additional bank accounts at conventional banks. In every case, and particularly in the case where IB account holders also have conventional bank accounts, the performance of Hajj is a significant predictor of the selection of the IB.

However, it is important to note that with an average cost of over $2,000 in 2006—roughly two and half times Pakistan's per capita GDP for the same period according to Clingingsmith—the Hajj is a significant expenditure for most households in the country. It is not just an indicator of religiosity but it is also an indicator of wealth. In fact, unlike the other "pillars" (*arkan*) or fundamental duties of Islam, such as regular prayers, fasting, charity, etc., the Hajj pilgrimage is not mandatory unless individuals have enough resources to finance the pilgrimage after they have adequately fulfilled all other basic financial needs. As such, it is not surprising that the performance of Hajj in our sample is also correlated with higher average bank balances.[42] Furthermore, as seen in Table 2, IB customers are more educated and have traveled to more countries and are more likely to hold multiple bank accounts than CB customers—all of which point toward the possibility of higher income levels.

The fact that wealthier individuals are more likely to choose an IB account and hold higher average balances in those accounts also fits the predictions of our model where if W_t increases, then given γ as a constant level of relative risk aversion, $\alpha_t^* W_t$ also increases and the individual is more likely to allocate funds to an Islamic bank account.

Discussion

Our results point toward the existence of a positive and significant nonmonetary benefit associated with the consumption of religious goods. This benefit, which we term a faith premium, is the primary determinant of consumer demand for an asset that may otherwise have very limited value in a competitive financial market. Contrary to any expectations of individuals choosing religious assets due to a lack of information or knowledge, we find

that customers choosing to hold their savings in Islamic banks are more educated and better informed than their counterparts at conventional banks. However, we also find that religious account holders are also far more likely to diversify their savings across different bank types and the wealthier they are, the more willing they are to accept the higher risk associated with holding an Islamic bank account.

We find that religiosity is far more complex than a simple indicator variable that makes the more religious people choose religious options while less religious ones do not. Rather, in this case, it appears that investing in Islamic banking products is a luxury where those who can afford to indulge their religious preferences do so, and they do so within a context that often does not exclude the simultaneous consumption of "non-religious" conventional alternatives to balance and support the consumption of their preferred religious good.

As with all studies conducted within a particular environment, there are several reasons to generalize these results with caution. First of all, there are some concerns about external validity. We conducted our surveys in the context of a deeply religious country that has sustained frequent bouts of political and economic crises that may have further entrenched religious sentiments within the population. Even in the context of a globally resurgent Islam, it is not clear that we will find similar religious attitudes outside Pakistan. However, as Islamic banking continues to gain popularity in various parts of the world, including in the U.S. where smaller community banks like the Devon Bank in Chicago are offering Islamic financial products to their customers, it is clear that even outside Pakistan, individual religiosity influences economic decisions.

So while our conclusions may be sensitive to specific context, they are likely to remain broadly applicable in a more general framework. In addition to restricting our investigation to a particular country, we also restricted our analysis to basic savings accounts that are easiest to compare across bank types. It is possible that the profit motive we find irrelevant in our survey could actually be increasingly relevant as we move toward more sophisticated financial products where individuals who are more interested in optimizing the return on their savings are likely to place their money. Since the substantial growth experienced by Islamic banks is not limited to basic savings accounts, a natural extension of our work would examine the determinants of demand for various types of religiously motivated financial products to see if our conclusions hold for less liquid assets with higher expected returns.

Our work has various practical implications for managers of financial institutions. Given the presence of a positive faith premium associated with

Table 5: Logit Models for the Selection of an Islamic Bank Using Disaggregated Religiosity Indicators

Coefficients in all specifications are estimated by using maximum likelihood and are reported in exponential terms as odds-ratios. All regressions include a constant. Standard errors are in brackets and have been adjusted for clustering by the fifteen branch location groups. Coefficients that are significant at the 1 percent, 5 percent and 10 percent levels are indicated by ***, **, and *, respectively. (1) and (2) test the entire sample of customers in the survey who have selected an IB. (3) is restricted to customers who switched into the IB from a conventional bank (i.e., customers who have had prior [conventional] banking experience and were not part of the unbanked population). (4) is restricted to IB customers who also have another conventional bank account.

	(1)	(2)	(3)	(4)
	IB	IB	SWITCHERS	IBANDCB
HAJJ	3.799***	3.112***	3.042***	3.278***
	(0.913)	(0.489)	(0.569)	(0.845)
HAFIZ	2.299*	2.519*	1.305	1.853
	(1.112)	(1.247)	(0.827)	(1.200)
RELIGIONCLASS	1.825***	2.117***	2.311***	2.134***
	(0.383)	(0.388)	(0.395)	(0.412)
BEARDS	1.243	1.408*	1.387*	1.446*
	(0.225)	(0.251)	(0.267)	(0.305)
LOGBALANCE		0.965	1.040	1.018
		(0.059)	(0.071)	(0.088)
GENDER		0.918	0.707	0.669
		(0.271)	(0.199)	(0.201)
HHDSIZE		0.937*	0.912***	0.926**
		(0.032)	(0.032)	(0.035)
EDUCATION		1.302***	1.433***	1.565***
		(0.103)	(0.135)	(0.122)
CREDIT		0.564*	0.770	0.654
		(0.193)	(0.277)	(0.180)
AGE		1.017***	1.026***	1.026***
		(0.006)	(0.008)	(0.007)
INTLTRAVEL		1.286	1.433*	1.221
		(0.291)	(0.283)	(0.243)
INCOMEGROUP		0.642**	0.635**	0.716
		(0.129)	(0.113)	(0.160)
OBSERVATIONS	1449	1139	888	832
PSEUDO R^2	0.095	0.160	0.209	0.210

Islamic accounts, managers of conventional banks operating in countries with a significant, religiously motivated Muslim population should pay close attention to the growth of their Islamic banking counterparts and consider offering *shari'a*-compliant banking products that can leverage their existing expertise in offering financial products and enable the bank to earn higher returns and diversify risk without incurring any significant startup

costs. In fact, this is already happening as most conventional banks, including Citibank, Standard Chartered, HSBC and almost every local bank in a Muslim majority country, have jumped on the Islamic banking bandwagon by opening up special Islamic banking "windows" and branches. For the managers of existing Islamic banks, it is important to note that the most significant source of demand for their products comes from the faith premium that is generated by the individual belief that Islamic banking products are religiously appropriate and necessary. As such, as Islamic banks continue to grow, they should take extreme care to remain within the boundaries of strict *shari'a* interpretations. In fact, Islamic banks should actively signal their religious commitments to their customers by employing the most credible religious scholars on their boards and adopting the most stringent, voluntarily transparent product structuring and operating processes. Furthermore, given that Islamic banking customers are more than twice as likely to have additional bank accounts, managers at Islamic banks should focus on expanding their product range and finding ways to signal bank stability to their customers.

Beyond the direct application of our findings to the financial industry, our framework and empirical results may have more general implications for future research on the economics of individual choices where there are positive non-monetary benefits associated with the consumption of specific preferred goods and services. Outside the field of religiously motivated economic choices and the faith premium associated with these choices, our findings connect to a growing body of work that has examined the nature of private non-monetary surpluses associated with socially responsible and ethical investments. For example, Hiscox and Smyth find that in the context of an upscale home furnishing store in New York, sales of particular items increased if they were labeled as being made under good labor standards—even when their prices increased by 10–20 percent.[43] In another context, Stern looks at the relationship between wages and the scientific orientation of R&D organizations that allowed researchers to publish and pursue individual research agendas.[44] He finds that conditional on scientific ability, scientists pay to the tune of a 25 percent wage discount for the privilege of being associated with a science friendly organization. In these and many others cases, we see that individuals generate private benefits from the consumption of particular goods that impact utility optimizing choices even though they do not have a monetary impact.

Our findings on the demand for Islamic banking confirm that as long as individuals derive positive benefits from behaving in accordance with their religious, ethical or social beliefs, they may be willing to compromise on the profit motive. Religion matters and in the context of Islamic banking

it matters a lot. Moreover, within the religiously motivated population, we find that income also matters and wealthier, more educated individuals are more likely to consume Islamic banking assets than those who are not as well off. At least in the context of opening an Islamic bank account, it appears that faith is a luxury that is easier to afford for the wealthy.

Appendix

Table 1: Ownership of Banks, 1997–2008
(P = Public sector banks, LP = Local private banks, F = Foreign banks)

End of Year	1997				2000				2007				Jun 2008			
Banks	**P**	**LP**	**F**	**All**	**P**	**LP**	**F**	**All**	**P**	**LP**	**F**	**All**	**P**	**LP**	**F**	**All**
Commercial Banks	6	16	20	42	6	14	21	41	4	26	6	36	4	25	6	35
Largest 10	3	3	4	10	3	3	4	10	2	8	–	10	2	8	–	10
All Others	3	13	16	32	3	11	17	31	2	18	6	26	2	17	6	25
o/w Islamic	–	–	1	1	–	–	1	1	–	5	1	6	–	5	1	6
o/w MFBs	–	–	–	–	–	–	–	–	–	–	–	–	–	6	–	6
o/w other	3	13	15	31	3	11	16	30	2	13	5	20	2	6	5	13
Specialized Banks	4	–	–	4	4	–	–	4	4	–	–	4	4	–	–	4
All Banks	10	16	20	46	10	14	21	45	8	26	6	40	8	25	6	39

Source: SBP

Table 2: Islamic Banks in Pakistan

Description	Dec. 03	Dec. 04	Dec. 05	Dec. 06	Dec. 07
Total Assets	13	44	71	119	206
% of Banking Industry	0.5%	1.5%	2.0%	2.8%	4.0%
Deposits	8	30	50	84	147
% of Banking Industry	0.4%	1.3%	1.8%	2.6%	3.8%
Financing & Investment	10	30	48	73	138
% of Banking Industry	0.5%	1.3%	1.7%	2.3%	3.5%
Full Fledged Islamic Banks (IBs)	1	2	2	4	6
Branches of IBs	10	23	37	93	186
Conventional Banks with IBBs	3	9	9	12	12
Branches of CBs	7	25	33	57	103
Total Islamic Banking Institutions	4	11	11	16	18
Total No. of Branches	17	48	70	150	289

Table 3: Income Levels and Location of Bank Clusters Used for Sampling

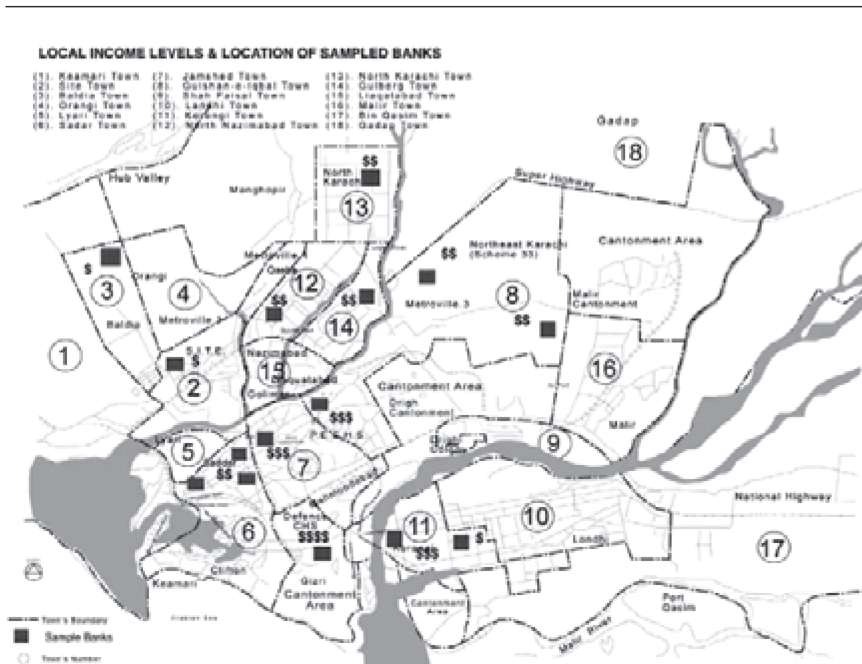

Table 4: Survey Questionnaire

Gender	0 = Male, 1 = Female
Name/Branch Name/Month of Birth	
Type of work?	1 = salary, 2 = own business, 3 = other, 4 = salary and business
Household size	
Education	Some school = 1, Junior high school = 2, High school = 3, Bachelors equivalent = 4, Masters plus = 5
Educational Institute where the last degree was obtained	
Account opening year	
Criteria for bank selection (ask for a reason without prompting but if asked, suggest options from the list)	1 = location, 2 = recommendation, 3 = family relationship, 4 = good service/image, 5 = better rates/profit, 6 = lower fee, 7 = product range, 8 = Islamic products, 9 = incentive/gift, 10 = salary account, 11 = other
Do you know the profit /return being offered by the bank on your savings account?	0 = No, 1 = Yes
If yes, how is this profit on an annual basis?	
Did you switch to this bank from another bank?	0 = No, 1 = Yes
If yes, what was the name of the Bank you switched from?	
Do you maintain accounts at other banks?	0 = No, 1 = Yes
If yes, what are the names of the bank(s) at which you hold additional accounts?	
Have you ever taken out a bank loan?	0 = No, 1 = Yes
If so, what type of loan did you take out?	1 = Car, 2 = Home, 3 = Personal, 4 = Business
Which bank did you take this loan from?	
Have you performed Hajj?	0 = No, 1 = Yes
Other countries visited?	0 = zero, 1 = one other country, 2 = between one and three, 3 = three or more
Do you watch QTV or Peace TV (dedicated religious TV channels)?	0 = Not at all, 1 = Sometimes, 2 = A lot
Have you memorized the Quran?	0 = No, 1 = Yes
Has someone in your immediate family memorized the Quran?	0 = No, 1 = Yes
What is the frequency of your daily prayers?	0 = Less than five times, 1 = Five times (or more)
So you participate in religious classes?	0 = No, 1 = Yes
Do the women in your household wear a wear a veil/purdah outside?	0 = No, 1 = Yes
Do the men in your household have beards?	0 = No, 1 = Yes
How much trust do you have in your bank?	0 = None at all, 1 = A little, 2 = somewhat/average, 3 = Above average, 4 = A lot/exceptional
Are you satisfied with bank service?	0 = No, 1 = Yes

Endnotes

1. For an overview of the economics of religion, see Laurence R. Iannaccone, "Introduction to the Economics of Religion," *Journal of Economic Literature* 36:3 (1998): 1465–1495.
2. Gerhard Lenski, *The religious factor; a sociological study of religion's impact on politics, economics, and family life* (Garden City, N.Y.: Doubleday, 1963); Peter Berger, *The Sacred Canopy: Elements of a Sociological Theory of Religion* (Garden City, N.Y.: Doubleday, 1967); and Bryan Wilson, *Religion in Secular Society: A Sociological Comment* (London: Watts, 1966).
3. Many of the most ardent proponents of the secularization thesis have recently distanced themselves from the theory that modernization necessarily means an end of religiosity. As Peter Berger stated in his 1999 book, *The Desecularization of the World: Resurgent Religion*, "the world today is as furiously religious as it ever was, and in some places more so than ever. This means that a whole body of literature by historians and social scientists loosely labeled 'secularization theory' is essentially mistaken."
4. John L. Esposito, Voices of Resurgent Islam (Oxford: Oxford University Press, 1983).
5. Guiso et al, "People's Opium? Religion and Economic Attitudes," *Journal of Monetary Economics* 50:1 (2003), 225–282.
6. Barro and McCleary, "Religion and Economic Growth across Countries," *American Sociological Review* 68:5 (2003), 760–781.
7. Richard Freeman, "Who Escapes? The Relation of Churchgoing and Other Background Factors to the Socioeconomic Performance of Black Male Youths from Inner-City Tracts," in *The Black Youth Employment Crisis*, edited by Richard Freeman and Harry Holzer (Chicago: University of Chicago Press, 1986).
8. Jonathan H Gruber, "Religious Market Structure, Religious Participation, and Outcomes: Is Religion Good for You?," *Advances in Economic Analysis & Policy* 5:1 (2005).
9. Iannaccone, "Introduction to the Economics of Religion."
10. Corry Azzi and Ronald Ehrenberg, "Household Allocation of Time and Church Attendance," *The Journal of Political Economy* 83:1 (1975), 27–56.
11. From mainstream Jews, Muslims and Christians to groups as diverse as the Nuer of Sudan and the Iatmul of New Guinea, religious beliefs impose a set of constraints on individual actions and prescribe particular models of behavior that impose a substantial cost on practicing believers. In fact, more successful religious groups that provide public goods often weed out potential defectors by requiring sacrifices as signals of commitment. For further discussion, see E. Berman, "Sect, Subsidy, And Sacrifice: An Economist's View of Ultra-Orthodox Jews," *Quarterly Journal of Economics* 115:3 (August 2000): 905–953.
12. Laurence R. Iannaccone, "Sacrifice and Stigma: Reducing Free-riding in Cults, Communes, and Other Collectives," *Journal of Political Economy* 100:2 (1992): 271–291; see also James M. Buchanan, "An Economic Theory of Clubs," *Economica* New Series 32:125 (1965): 1–14.

13. The breakdown has been estimated as: Islamic banks with $320 billion, Islamic windows with $320 billion, and funds under management with $380 billion.
14. Key countries include Saudi Arabia, Bahrain, the U.A.E. and Kuwait in the Middle East, Malaysia in Asia and the UK in Europe.
15. Islam does not allow a separation between mosque and state. *Shari'a* law prescribes a complete code of life and determines every aspect of a Muslim's religious practices, everyday life, and economic activities.
16. M. Umer Chapra, *Islam and the Economic Challenge* (Leicester, UK: Islamic Foundation, 1992).
17. Timur Kuran, "Islamic Economics and the Islamic Subeconomy," *The Journal of Economic Perspectives* 9:4 (1995): 155–173.
18. Wafik Grais and Matteo Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," World Bank Working Paper, WPS 4052. 2006. Available at http://go.worldbank.org/WX8PQZQ570.
19. Harry Markowitz, "Portfolio Selection," *Journal of Finance* 7 (1952): 77–91; John Campbell and Luis Viceira, *Strategic Asset Allocation: Portfolio Choice for Long-Term Investors* (Oxford: Oxford University Press, 2002).

    The pioneering rational choice model of religious consumption described by Azzi and Ehrenberg in their model of household participation in church related activities provides some very useful conclusions with respect to the voluntary selection of religious activities over leisure and other income generating activities. However, in this case, since we are looking at a choice between holding two financial assets that vary in terms of religious benefits and risk, a portfolio choice model generates more relevant and testable conclusions.
20. The assumption of CRRA utility in a power utility function also implies DARA (decreasing absolute risk aversion) with respect to wealth and makes intuitive sense since a billionaire is likely to be less worried about the same gamble that a very poor person would refuse. The assumption of lognormal returns (unlike the assumption of normal returns) holds at every time horizon since the products of lognormal random variables are also lognormal. See Campbell and Viciera for details.
21. Refer to Campbell and Viciera for a more detailed discussion of the Taylor approximation, which is valid under short time intervals. As seen in (12), the difference between the log portfolio returns and a linear combination of the individual asset returns is zero if . The expansion also rules out bankruptcy () and leverage ().
22. The five banks were the National Commercial Bank (NCB), Habib Bank Limited (HBL), Muslim Commercial Bank (MCB), United Bank Limited (UBL) and Allied Bank.
23. Banking spread in Pakistan has oscillated between 5.95 and 9.58 percent during 1990–2008 and was around 8 percent in January 2009. For comparison purposes, the average interest rate spread in Canada was 1.3 percent, in the UK 2.3 percent, in Spain 2.4 percent, in the U.S. 2.8 percent, in Australia 3 percent and in France 3.1 percent. Generally acceptable levels of bank spreads are 3.5 percent.

24. The market share of deposits is at 4.2 percent.
25. The CB also has 55 international branches located in Afghanistan, Australia, Bahrain, Bangladesh, Belgium, Canada, China, France, Hong Kong, Iran, Kenya, Lebanon, Maldives, Nepal, Netherlands, Nigeria, Oman, Singapore, Sri Lanka, Turkey, the U.A.E., the U.K. and the U.S.A.
26. "Top 500 Banking Brands," *The Banker*, February 2009, http://www.thebanker.com/news/fullstory.php/aid/6416/Top_500_banking_brands.html.
27. Karachi is amongst the most densely populated cities in the world. In 2005, its population was estimated at 15.1 million and is expected to reach 27.5 million by 2020. The population is diversified in terms of ethnicity and economic conditions. About 75 percent of the households fall in the category of poor and low-income groups, while 25 percent constitute the middle and high-income groups. Education levels are higher than the national averages.
28. We excluded all IB branches that had opened after January 2007 since we were looking at the data in late 2008 and most of these branches had only been functional for a few months. As such, it was not possible to find a significant sample of customers from these newly established branches. Also it was possible that customers at these new branches had not had enough time to evaluate the performance of their bank.
29. The IB was not able to offer a return ex-ante. Instead, it showed all new customers a table of "historical" monthly returns over a 6-month period as a signal to approximate future returns. These returns were very closely matched those being offered by the CB.
30. D. Ross, "Your banks and how to choose them," *Accountancy* 104 (1989): 130.
31. G. G. Kaufman, "Business firms and households view commercial banks: a survey of Appleton, Wisconsin," 1967 Report to the Federal Research Bank of Chicago.
32. D. Ross, 1989.
33. Laroche, Rosenblatt, and T. Manaing, "Services used and factors considered important in selecting a bank: an investigation across diverse demographic segments," *International Journal of Bank Marketing* 4:1 (1986): 35–55.
34. Erdener Kaynak, "Retail banking in Nordic countries: the case of Finland," *International Journal of Bank Marketing* 13:8 (1995): 10–20; Mylonakis, Malliaris, and Siomkos, "Marketing-driven factors influencing savers in the Hellenic Bank Market," *Journal of Applied Business Research* 14:2 (1998): 109–116.
35. Also, all the research assistants conducting the survey were female and culturally people were more likely to cooperate with them.
36. Initially, survey respondents were going to be offered the chance to enter a gift lottery for their participation. However, since the IB pointed out that this could be construed as breaking the Islamic injunctions against gambling, the gift lottery option was removed. None of the survey participants were in any way compensated for their participation.
37. An exception to this rule was made in the case of branches that had less than 100 customers opening new accounts in the 17-month period. In this case, every single customer was called.

38. All amounts are in terms of Pakistani rupees. The conversion rate at time of writing fluctuated between Rs 70 and Rs 80 to the U.S. dollar.
39. 54.2 percent of Islamic banking customers have travelled internationally to countries other than those visited for religious purposes compared to 36.7 percent for conventional banking customers.
40. Four outliers were removed, all of them were from the IB and reported profit rates ranging from 25 percent to 210 percent.
41. These are accounts that are set up by corporations to hold the salaries for all individual employees.
42. Respondents who had performed the Hajj had an average balance of 119,186 compared to those who had not performed the Hajj and held and average balance of 78,142 in their accounts. These differences were statistically significant at the 5 percent level.
43. Michael J. Hiscox and Nicholas Smyth, "Is there Consumer Demand for Improved Labor Standards? Evidence from Field Experiments in Social Product," 2008 working paper available online at http://www.people.fas.harvard.edu/~hiscox/papers.html.
44. Scott Stern, "Do Scientists Pay to be Scientists?," *Management Science* 50:6 (2004): 835–853.

Faith and Finance: A Catholic Consideration

Séamus P. Finn

Introduction

Faith traditions are grounded on their respective understandings of God that have been informed and nourished through a number of revelatory events. These revelations take place in and through the historical experience of communities and individuals and have been recorded in sacred books; through the grandeur and order of creation itself, and through the deepening and ongoing understanding that emerges from the lived experience of communities and believers across the world. The specific wisdom, teachings and truths that are constitutive of each tradition have as a horizon of reference the human-divine, the human-human and the human-earth relationships.

It is also important to acknowledge, from the outset, that the historical and scientific developments and perspectives on how the earth life systems upon which all activities depend have evolved—the big picture—do inform any reflection on faith and finance. The understanding that has emerged from scientific exploration about the origins and destiny of the earth as a living organism has important implications for both religion and ethics and can serve to interrogate any understanding of the principles that emerge from the sacred teaching and tradition of religion.[1] This approach, of course, may seem more obvious within religious traditions that see creation as God's first language and a primary source of revelation and a place where we can encounter the truth that God wants to reveal to us.[2]

The process whereby goods and services are exchanged, the workings of the financial system and the economic activities that constitute the system take place within the context of a particular world vision and the role of human agency in these relationships. The vision and teachings of a faith tradition provide both the principles and the moral compass to evaluate the value and virtuousness of the system and the morality of the specific decisions and instruments that constitute specific economic models. One often will find a significant level of agreement among the faith traditions

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about the vision and the set of universal principles that might be employed to evaluate the political, financial and commercial systems that are found in different parts of the world. Honesty, trust, truth, justice, mercy, sincerity, accountability, responsibility, transparency and do unto others as you would have them do unto you, immediately come to mind.

With these introductory remarks as background, let me turn to the wisdom and teaching of the Roman Catholic tradition and review both the vision and the principles that it provides to organize and evaluate our financial systems and order the activities of our economic life. This review will hopefully also identify some of the challenges that the contemporary financial reality brings to that tradition.

The Foundation of Catholic Social Teaching

Catholic Social Teaching is rooted in the dynamic interplay between the teaching of the scriptures, the lived tradition of the church that includes a positive evaluation of the contribution of human reason, and the active presence of the Holy Spirit in the leadership of the church and the lives of the faithful. We will in turn review each of these diverse sources and briefly review the teaching that emerges.

Hebrew Scriptures

In the early books of the scriptures we read that God created human beings in his image and likeness, that God created the whole world (Genesis 14:19–22; Isaiah 40:28; 45:18) and that God looked on everything that he had created and saw that it was "very good" (Genesis 1:31). One theme that flows from this theology of creation is the belief that no aspect of human life is outside of God's care and concern. God remains always present to creation, and creative engagement with what God has made is itself reverence for God.

Human beings are called to share in the creative activity of God and, according to the Book of Wisdom, they are "to govern the world in holiness and justice, and to render judgment in integrity of heart" (Wisdom 9:3). They are therefore considered to be co-creators, cooperating in the work of the creator. They did, however, turn away from God and gave to creation the obedience due to God alone. The Bible castigates both the worship of idols and the manifestations of idolatry, such as the search for unrestrained power and the desire for great wealth (Isaiah 40:12–20, 44:1–20; Wisdom 13:1–14:31; Colossians 3:5, "the greed that is idolatry").

Throughout the history of the people of Israel, the Covenant that God makes with his people is captured in the different commandments and laws that are found throughout the biblical tradition (Exodus 20:1–17; Exodus 20:22–23:33). It includes God's steadfast promise of love (hesed) and fidelity

(‘emeth) and the promise by the people to fulfill their side of the covenant by worshipping God and directing their lives according to His will.

Laws such as that for the Sabbath year when the land was left fallow (Exodus 23:11; Leviticus 25:1–7) and for the year of release of debts (Deuteronomy 15:1–11) summoned people to respect the land as God’s gift and reminded Israel that as a people liberated by God from bondage in Egypt, they were to be concerned for one another, especially the poor and oppressed in their midst. Every fiftieth year a jubilee was to be proclaimed as a year of “liberty throughout the land” and property was to be restored to its original owners (Leviticus 25:8–17, cf. Isaiah 61:1–2; Luke 4:18–19). The norms of the covenant: reciprocal responsibility, mercy and truthfulness were reflected in the codes of Israel.

The core of the prophetic tradition is proclaimed by the prophet Micah: “to do justice, and to love kindness, and to walk humbly with your God” (Micah 6:8, RSV). Biblical faith in general and prophetic faith especially, insists that fidelity to the covenant joins obedience to God with reverence and concern for the neighbor. The biblical terms that best summarize this double dimension of Israel’s faith are *sedaqah* (justice also translated as righteousness) and *mishpat* (right judgment or justice embodied in a concrete act or deed). The biblical understanding of justice gives a fundamental perspective to our reflections on social and economic justice.

God demands justice from the whole people (Deuteronomy, 16:20) and executes justice for the needy (Psalms 140:13). A key focus of the biblical understanding of justice is that the justice of a community is evaluated by its treatment of the powerless in society, the non-Israelites in the land. The Law, the Prophets and the Wisdom literature of the Old Testament all show deep concern for the proper treatment of such people. What these groups of people have in common is their vulnerability and lack of power. They are often neglected and without a protector or advocate. Therefore, it is God who hears their cries (Psalms 109:21, 113:7), and the king who is God’s anointed is commanded to have special concern for them.

Christian Scriptures

Jesus enters human history to announce the reign of God and its initiation in his life and teaching. He calls his followers to seek out ways in which God’s revelation of the dignity and destiny of all of creation might become incarnate in history. He warns against attempts to “lay up treasures on earth” (Matthew 6:19) and exhorts his followers not to be anxious about material goods but rather to seek first God’s reign and God’s justice (Matthew 6:25–33) and all things will be given to them.

When asked what was the greatest commandment, Jesus quoted the age-old Jewish affirmation of faith that God alone is One and to be loved with

the whole heart, mind and soul (Deuteronomy 6:4–5) and immediately adds: "You shall love your neighbor as yourself" (Leviticus 19:18; Mark 12:28–34).

Jesus offered a very clear picture of the last judgment (Matthew 25:31–46) when the nations of the earth will be assembled and will be divided into those blessed and welcomed into God's kingdom or those cursed and condemned to eternal punishment. The blessed are those who fed the hungry, welcomed the stranger, visited the sick and imprisoned; the cursed are those who ignored the cries of the abandoned and neglected.

Jesus called his followers to a discipleship (Mark 1:14–15; Matthew 11:29) that involves a change of heart and imitating the pattern of Jesus' life by openness to the will of God through the service of others (Mark 10:42–45). It is a model for those who suffer persecution for the sake of justice (Matthew 5:10). Nor did the death of Jesus mark the end of the disciples' union with him. After the post-resurrection appearances and the gift of the Spirit (Acts 2:1–12), they became apostles of the good news to the entire world.

In the Gospel of Luke we are presented with a blueprint for Christian life that remains relevant today. Mary, the mother of Jesus, in the Magnificat prayer, rejoices in a God who scatters the proud in heart, brings down the mighty and raises up the lowly (Luke 1:51–53). The first public words of Jesus as he reads from the scroll of the prophet Isaiah are, "The Spirit of the Lord is upon me, because he has anointed me to preach the good news to the poor" (Luke 4:18; cf. Isaiah 61:1–2). Attached to this blessing of the poor, a warning is also issued: "Woe to you who are rich, for you have received your consolation" (Luke, 6:24). He warns his disciples about greed and the accumulation of abundant possessions and underlines this teaching by the parable of the man whose life is snatched away at the time he tries to secure his wealth (Luke 12:13–21).

This vision of creation, covenant and community, as well as the call to discipleship that demands a special concern for the poor and marginalized, which are articulated in the scripture, unfolds under the tension between the promise made by God and the ongoing work of creation. God's kingdom has already been inaugurated but not fully realized and awaits complete realization under God's providence.[3]

The Tradition

Early Christianity saw the poor as an object of God's special love, but it did not canonize material poverty or accepted deprivation as inevitable. Few early Christians possessed wealth or power (1 Corinthians 1:26–28; James 2:5), though some were well off (Acts 16:14, 18:8). The early community at Jerusalem continued the concern that Jesus demonstrated for the poor by

distributing its possessions so that "there was no needy person among them" and held "all things in common"—a phrase that suggests shared material possessions, in the context of friendship and mutual concern among all its members (Acts 4:32–34, 2:44). Christians were a small minority in a hostile society in the beginning and cared for one another through generous almsgiving and sharing. The church fathers consistently reminded the early church that the goods of the earth were created by God for the benefit of all without exception and that all have special duties toward those in need.[4]

As followers of Christ strove to fulfill his teaching, they did so in very different historical and cultural contexts. Each century presented different challenges but there is probably no older or sharper dispute than that of the ethics of *interest* in the tradition. It is clear that there was a prohibition on the charging of interest on loans to the poor and the amassing of great wealth in the scriptures, but with the passage of time new interpretations of that teaching emerged. The early scholastics, like Aristotle, condemned the practice of interest on money because of the "sterile nature of money." They nevertheless found that though it should be condemned intrinsically, it might be acceptable for extrinsic reasons. An example of the latter would be the loss sustained or the opportunity of profit foregone because of money that was out on loan.

Two key developments that spread rapidly across Europe in the late Middle Ages served to expand and intensify the already robust debate about debt and interest that had attracted great intellectual interest in the sixteenth and seventeenth centuries. The first was the growing acceptance of the idea that reasonable interest on a monetary loan under certain circumstances did not amount to illicit profit. This shift in mentality facilitated the growth and expansion of the banking system and therefore brought additional attention to the discussions about interest and usury. The second key development was the establishment and recognition of the limited liability corporation (LLC) as a separate "person," a creation that presented a new set of questions and challenges about the responsibility and obligation of individuals to repay their debts. When we consider that the practice of charging interest had been strictly circumscribed in most of its forms for hundreds of years, these developments brought additional complexity and urgency to the debate.

While the church through the centuries condemned various practices concerning interest, it does not make the practice under all conditions a violation of justice. In Benedict XIV's encyclical to the bishops of Italy, Vix Pervenit, in 1745, the practice of the later scholastics, which justified interest on intrinsic as well as extrinsic grounds, was deemed acceptable. The former notion, interest on intrinsic grounds, from their perspective, was

considered acceptable by distinguishing loans for production and those for consumption and seeing money loaned for production as productive or fertile. The encyclical "was extended to the universal Church by a decree of the Holy Office[5] of July 28th1835. . . . It is the last ex professo statement of usury by a pope. It is an espousal of the central scholastic position. It leaves a great deal unsaid."[6]

Finally, in a series of decisions between 1822 and 1836, the Holy Office "ends all doubts and practical difficulties by publicly decreeing that the interest allowed by law may be taken by everyone."[7] These pronouncements settled the practical problem, without defining what a moderate rate of interest might be, but clearly left the theoretical question unresolved. This development and others in both the organizational structuring of ecclesiastical institutions and the financial system have led over time to the common practice of church institutions and organizations placing their financial assets in interest bearing accounts in banks and other deposit-taking institutions. This has also evolved into their availing themselves of the many other dividend producing investment vehicles and products that correspond to their operational needs and match their appetite for risk and sound management.

Guided by the teaching of the tradition, the writing of philosophers, theologians and the evolving natural law process, the church has continuously wrestled with the management of the temporal affairs of her institutions and organizations within financial systems that is built on the practice of deposits, credit and interest. She is also charged with the responsibility to articulate the basic principles in this arena for the good practice for discipleship, personal virtue and justice in society. Over the last 120 years, beginning with encyclical letter of Leo XIII, *Rerum Novarum* (1891), down to the writings and speeches of Benedict XVI, the popes and conferences of bishops have addressed more systematically in a series of letters and social encyclicals the rapid changes occurring in modern societies as a result of the Industrial Revolution, including those precipitated by the financial systems and economic models that have been established. These writings and the documents of the Second Vatican Council, which was held in the 1960s, are therefore especially significant for any consideration of and reflection on financial systems, economic life and how the faithful should participate in them.

Principles that have Emerged in the Tradition

Any reflection on the financial system and economic life today, from the Roman Catholic perspective, is therefore rooted in the biblical vision that we have inherited and is shaped by the rich and complex tradition of

Catholic experience and thought. The teachings and the principles in the area of finance and economics that have emerged in the tradition are offered for both the benefit and guidance of individual Catholics, catholic institutions and organizations and other actors in society, especially governments and more recently private corporations. These general principles may be enumerated as follows.

The Human Person in Community

Every human person is created as an image of God and the denial of dignity to any person is a blot on this image. The same God who came to the aid of an oppressed people and formed them into a covenant community continues to hear the cries of the oppressed and calls them to community that is grounded in His word. The "common good," which means "the sum total of social conditions which allow people, either as groups or as individuals, to reach their fulfillment more fully and more easily,"[8] is the expression of this belief. How we organize our societies in every sector—in economics and politics, in commerce and law and policy—directly affects human dignity and the capacity of individuals to grow in community. Economic life should enhance not threaten our life together as a community.

The Human Person and the Earth

To stand before God as the Creator is to respect God's creation, both the world of nature and of human history. From the patristic period to the present, the Church has affirmed that misuse of the world's resources or appropriation of them by a minority of the world's population betrays the gift of creation, which is destined for and bestowed on all God's people. The Church's principle of the *universal destination of goods* is a clear and consistent reminder to all of the origin and purpose of the goods of the earth whose distribution is to be governed by the principles of fairness and solidarity.

Pope Benedict also reaffirms this principle when he writes:

> At the same time we must recognize our grave duty to hand the earth on to future generations in such a condition that they too can worthily inhabit it and continue to cultivate it. This means being committed to making joint decisions after pondering responsibly the road to be taken, decisions aimed at strengthening that covenant between human beings and the environment, which should mirror the creative love of God, from whom we come and towards whom we are journeying.[9]

How we acknowledge our inherent dependence on the natural world and how we account for the use and depletion of natural resources within the financial system is critical for any comprehensive long-term sustainability planning.

Subsidiarity
This is among the most constant and characteristic principles in Catholic Social Teaching and refers to the human network of relationships and associations to which people belong and where they are free to develop and act. All people have a right to freely participate in the economic life of society through private initiative, through collaborative efforts, with the right balance between the public and private spheres and without the dominance of a centralized top-down authority. There is therefore an inherent preference that the freedom to legislate and decide about issues is the prerogative of local communities and as elected intermediary institutions they are deserving of protection and respect.

Solidarity
All members of society have a special obligation to the poor and vulnerable. "The exercise of solidarity within each society is valid when its members recognize one another as persons. Those who are more influential, because they have a greater share of goods and common services, should feel responsible for the weak and be ready to share with them all they possess. Those who are weaker, for their part, in the same spirit of solidarity, should not adopt a purely passive attitude or one that is destructive of the social fabric, but, while claiming their legitimate rights, should do what they can for the good of all."[10]

The quality of the justice and goodness in a society is to be judged by the treatment of the poor, the widow and the orphan. This was also true of the justice that was constitutive of God's covenant with Israel. It was measured by how the poor and unprotected—the widow, the orphan and the stranger—were treated. The kingdom that Jesus inaugurated and preached in his word and ministry excludes no one. The poor, throughout Israel's history and in early Christianity, were the agents of God's transforming power.

The Tradition and Financial Systems

At the systemic level, the tradition therefore offers a number of principles and criteria to serve as a compass to evaluate whatever financial system or economic model is operative. The 1986 pastoral letter on the economy by the United States Conference of Catholic Bishops is a good example of how these principles could work. They proposed the following questions for consideration and guidance as they began their reflection on the U.S. economy: *"What does the economy do for people? What does it do to people? And how do people participate in it?"*[11] An additional question that follows along the same lines and might appropriately be added today would be about the impact of economic activities and business models on the environment and on both local and global ecologies.

The universal principles of the faith that are available to examine and evaluate financial systems and economic models are grounded in the belief that God is the source of all creation and the construction, operation and regulation of all systems within that creation must be consistent with the fulfillment of the divine will. A prominent principle in the Catholic tradition is the protection and promotion of human dignity by respecting and loving one another and giving expression to this belief. Care and reverence for the earth, for instance, is another and this would resonate with many traditions, especially those who see the earth as a living system that is created by God as a blessing for all and must therefore be respected and safeguarded in all activities.

In order to serve the needs of all, especially the people living in poverty and the marginalized, and be based on a process that takes into account the earth as a living organism, financial systems must function honestly and equitably, be stable, transparent, accountable and be subservient to lawful political authorities who have a special responsibility for the common good. This could, in some instances, for example, justify the adoption of capital controls, temporary suspension of lending by banks and the placement of limits on the use of commodity markets for a speculative reason.

The Current Crisis

The wisdom of the tradition, especially as it is summarized in "Caritas in Veritate," the recent encyclical from the Holy Father, is instructive and prescriptive in a number of different ways about the financial meltdown of 2008. These teachings can be divided according to the audience that is addressed and specific objectives but one must always keep in mind the coherency that exists between them. The encyclical takes for granted in its perspective the existing global financial system but also acknowledges that a number of unique tools, models of commerce and trading arrangements may exist on the periphery of the system or in communities or societies that are bound together by a common culture, set of values or beliefs.

It is important to reiterate from the outset both the dynamic conversation between faith and reason that exists in the tradition and the prominent place that reason and the intellect are given in the development and understanding of specific teachings and principles. There exists therefore openness to the various areas of learning and understanding that have been developed through the centuries and a commitment to allow those discoveries and principles to inform and enhance the understanding of the Holy Scriptures, the lived experience of the church and their application to modern life. An in-depth study, for instance, of the acceptance of interest and the prohibition against usury that has developed over time would be a clear

example of this approach. One could also look at the evolution of the Church's teaching on religious liberty or the acceptance of the concept of the democratic state as other examples of the evolution in the tradition over the past 200 years.

While there does not appear to be any reconsideration of the Church's position on the separation of church and state in response to the current financial crisis and the establishment of a financial system based only on the teachings of the tradition, there is a clear call for the engineers and regulators of the financial system to revisit some of the teaching and wisdom of the faith traditions as they work to reform and reduce the instability that emerged during the current crisis. The practice of excessive and highly speculative risk taking, especially in as much as they are of such a scale that they increase the level of systemic risk, must be examined and monitored in terms of their potential impacts on the common good. In the same way the impacts of the use of derivatives, credit default swaps and other activities such as short selling on the stability and soundness of the financial system and therefore the well being of communities across the world must be monitored and evaluated.

We have already reviewed a number of specific teachings and principles that are relevant to both the analysis and understanding of the current financial crisis but let me summarize them as we find them in the encyclical. I will examine consecutively the role and responsibility of government; the purpose and rules of financial activity; the responsibility of the institutions and investors who invest in the capital markets, the code of conduct for those who work in the financial services arena and the behavior of individuals.

Role of Government

The role and responsibility of the political community for the pursuit of the common good and therefore the governance of the financial system is articulated clearly by Pope Benedict when he writes, "Economic activity cannot solve all social problems through the simple application of *commercial logic*. This needs to be *directed towards the pursuit of the common good*, for which the political community in particular must also take responsibility."[12] The establishment of the rules and regulations whereby economic activity is directed to the achievement of a specific social purpose is a particular responsibility for the political community. The specific role of government is further elaborated in response to the "grave imbalances" that "are produced when economic action, conceived merely as an engine for wealth creation, is detached from political action, conceived as a means for pursuing justice through redistribution."[13] Regulation and appropriate penalties for reckless speculation, undisclosed liabilities and risk taking that

can lead to a system-wide meltdown must be enforced and monitored by government authorities if the common good is to be served and protected.

Another set of questions emerges when one considers the global financial system as it exists today and is utilized by many global corporations as an operating platform. This reality presents government with a unique set of challenges to act collectively in such bodies as the G8, the G20 and the G77 or at the United Nations to provide a framework for both the smooth and fair functioning of financial markets and the service of their respective citizenry and at the same time addressing the great inequities that exist between countries and regions across the world. Pope Benedict in his encyclical reiterates the call of Pope John XXIII nearly 50 years earlier of the need for "a true world political authority" to manage the global economy and "to seek to establish the common good, and to make a commitment to securing authentic integral human development."[14]

The encyclical goes on to recognize that the very existence of a global financial system with many global corporations operating from that platform presents some very unique challenges to this principle. It therefore goes on to point out the need for a global authority, not government, to regulate, monitor and revive local and regional economies.

Economic Activity

Among the operating elements, challenges and tools that constitute a functioning financial system are liquidity, stability, transparency, savings, capital adequacy, accountability, regulation, monitoring, taxation, systemic and credit risk management and innovation. The role of tools like credit default swaps that are mechanisms used to transfer risk and hedge exposure also come to mind. These and many other activities and tools are constitutive of the functioning of the system and the operation of economies at the country, regional and global levels. Overnight, they can have rapid significant positive or negative impacts on the lives of people in different corners of the world.

The church understands its role in monitoring and evaluating these activities and instruments not in themselves, but especially in how they are used by individuals, by public and private institutions and through the optic of their impact on the poor and marginalized. The encyclical clearly reminds us that, "Efforts are needed—and it is essential to say this—not only to create 'ethical' sectors or segments of the economy or the world of finance, but to ensure that the whole economy—the whole of finance—is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature."[15] In addition, the church teaches "that *justice must be applied to every phase of economic activity*, because this is always concerned with man

and his needs. Locating resources, financing, production, consumption and all the other phases in the economic cycle inevitably have moral implications. *Thus every economic decision has a moral consequence.*"[16]

It may therefore be asserted that economic decisions that fail to take into account the social and ecological consequences of the activities that they facilitate are not consistent with the teaching of the church. It is important also to recognize the level of congruence between this teaching and the direction of the socially responsible investment movement. The movement has now developed a body of research and analysis to measure some of the social and ecological impacts of economic activities and to also demonstrate that the impact of such considerations on expected return is negligible.

Responsibility of Investors

The teaching of the tradition is available to inform and guide the activities and decisions of all investors. It strives to promote a sense of stewardship over ownership, a reasonable balance between risk and return and between fiduciary responsibility and the promotion of the common good. The teaching of the Ten Commandments, as found in the scripture, is the source for the customary prohibitions on greed, cheating, fraud, robbery and deceit. Many of these are already enshrined in the laws of different societies even those that are made up of citizens who follow different religious beliefs and traditions. Many other faith traditions share these commandments and they may be identified in most countries as the virtues and customs that most societies rely on to function.

In addition to the commandments, the virtues of prudence, justice, solidarity and mercy are also a part of the framework that is provided for those responsible for investment decisions. The tradition also recommends the use of many of the tools that have been developed more recently to both avoid investments that are inconsistent with the teachings of the faith and to seek out positive social impact investments that contribute to the promotion of the common good. In many situations these approaches will be pushing against the standard practices of the financial sector that operates primarily from the maximization of profit principle and has resisted efforts to introduce social and ecological consideration into the investment process.

The same response is expected from catholic institutions and organizations as they navigate their presence in different societies around the world. They are expected to follow the laws and regulations that are enacted for the good of society as a whole, but in addition, to integrate into their activities and practices the additional standards and principles that are consistent with the teaching and practice of the faith tradition. For example, to sustain their extensive operations, religious organizations and institutions have

become active participants in the financial system and financial markets; they are expected to do this within the parameters and guidance of principles that are consistent with the faith tradition. This includes evaluating and monitoring the institutions with whom they do business and having a more active ownership of the positions they hold in corporations and financial institutions.

The use of specific tools, instruments and practices that are part of the financial markets and the market economy today are expected to be evaluated according to the same criteria. Hedge fund practices and private equity operations need to be evaluated not only according to their objectives and business models but also in terms of the amount of risk that they may be introducing into the system as a whole that can negatively impact the broader community. Securitization practices, excessive leveraging, short selling and any highly speculative activities, especially purely speculating on commodity prices, also deserve special scrutiny. Investing in life-sustaining commodities for purely speculative reasons should be avoided because of the disastrous impact such activities can have on the price of staple food prices, wages and safety for workers and the future of local communities, all of which are integral to the support of the common good.

Responsibility of Financial Managers and Businesses

While referring specifically to the responsibility of those in the financial sector and taking into account their roles in the financial meltdown, Pope Benedict writes that "Financiers must rediscover the genuinely ethical foundation of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interests of savers." The demands that are intrinsic to an ethical framework are not inconsistent with the achievement of positive financial results.

Turning his attention to the responsibilities of corporations in societies, the Holy Father reminds all that "the entire financial system has to be aimed at sustaining true development. Above all, the intention to do good must not be considered incompatible with the effective capacity to produce goods."[17] The social responsibility of corporations includes the interests and well-being of all stakeholders who contribute to the success of the enterprise, and this includes the local communities where they are located and operate.

The "short term" thinking that often drives businesses to meet specific stock market and shareholder expectations is judged inappropriate because of the negative impact such activity can have on social and ecological concerns and responsibilities. "What should be avoided is a speculative *use of financial resources* that yields to the temptation of seeking only short-term profit, without regard for the long-term sustainability of the enterprise."[18]

Alternative Faith Based Models

Followers of particular faiths have created many different economic models and practices. One immediately thinks of cooperatives, microfinance schemes and credit unions. These models have, for the most part, operated on the margins of the prevailing financial systems though they may at times avail themselves of some of the credit mechanisms and services that the system offers. One example is the Mondragon system that was created in Spain. From its origins 40 years ago as an employee-owned cooperative manufacturing paraffin stoves, Mondragon has grown to 160 employee-owned cooperatives, involving 23,000 member owners, with sales grossing $3 billion dollars U.S. in 1991. Statistics show the Mondragon cooperatives to be twice as profitable as the average corporation in Spain with employee productivity surpassing any other Spanish organization. It has its own bank, a research institute, an entrepreneurial division, insurance and social security institutions, schools, a college, a health maintenance system and a health insurance cooperative. It is focused on relational cooperatives dedicated to the common good.

On the margins and the edges of the formal and dominant financial sector, one finds a variety of models of financing and economic activity that were initiated and shaped by both the beliefs and values of the individuals, communities and the institutions that use and participate in them. Many place limits on some of the usual practices that operate in the market place in favor of those activities that support a more communitarian risk sharing approach. These models and activities are grounded on the virtues of justice, community, solidarity, love and sharing.

Pope Benedict XVI encourages these types of activities and developments by suggesting that "space also needs to be created within the market for economic activity carried out by subjects who freely choose to act according to principles other than those of pure profit, without sacrificing the production of economic value in the process. The many economic entities that draw their origin from religious and lay initiatives demonstrate that this is concretely possible."[19]

New and creative prospects for investment in local initiatives and communities continue to emerge and provide opportunities to the faith inspired or responsible investor. Many of these are at a fixed rate of interest that is below the market rate but are connected to local communities and created to promote and sustain strong local neighborhoods and communities. These community development loan funds and institutions provide an excellent opportunity for believers to make investments that are consistent with their faith and active participation in local community development.

The *shari'a*-compliant funds that have been established by followers of Islam who seek to integrate the principles of their faith into the management of their financial assets, are clear examples of answers to the call by the Holy Father to create alternative faith based funds and practices for believers. These exist and operate both parallel to and on the margins of the dominant financial system, and are grounded on the practice of faith and founded on a vision of community well-being that is consistent with the Islamic tradition.

Conclusion

This review of the teaching of the Roman Catholic tradition as it relates to finance and financial systems and their activities set out to explore the contribution of the tradition and how that living tradition continues to inform and evaluate contemporary economic activities and financial systems and guide the decisions and behavior of investors. This included an elaboration of the set of principles that are grounded in the scripture and the lived experience of the community and a consideration of how these principles operate as a moral compass to evaluate a financial system in terms of its contribution to the well-being and future of both people and planet.

It furthermore presented the teaching and universal principles that the tradition offers about the responsibilities of governments to create a legal foundation, establish a regulatory framework for the financial system and develop a reliable structure to monitor the different aspects of economic activity. In reviewing the tradition and the most recent encyclical of Pope Benedict XVI, the chapter highlights the specific analysis and observations on the causes of recent financial crisis as well as the guidance that is offered about the responsibilities of different constituencies to ensure that the financial system functions in the service of the common good. The chapter also looked briefly at some of the specific small-scale projects, initiatives and models that faith communities have established as an alternative to prevailing financial models and practices.

We have seen, in this brief excursus through the teaching and reflection of the Catholic tradition on financial activities and practices and on the specific practice of lending at interest, that the intersection of the teaching with the lived experience of the community across the European continent was the source of vigorous debate and resulted in a doctrine that evolved over time. A salient feature of that process was the way in which teachers and thinkers drew on the broad currents of civil, legal, political and theological developments of the period to formulate the principles they developed to guide behavior in the market place.

This practice was most evident during the scholastic period where thinkers, philosophers and legal scholars, who were looking for a broader natural law foundation for the theological revealed teaching of the tradition, participated actively in the dialogue that was emerging because of the new and innovative practices in the commercial sector. This was entirely consistent with the broader conversation between faith and reason that both intrigued and fueled the centers of learning during of the time. The presence of the supreme teaching authority of the papacy to define acceptable practices at different periods was also an essential ingredient in the evolution of the teaching and understanding.

These unique developments, from within the Catholic tradition, could prove to be a fertile field for study and dialogue with the Islamic tradition as they each continue to reflect on their participation and relationship with the assumptions and practices of the dominant contemporary financial system. Can the traditions working together be a source of critique and analysis of the benefits and social purpose of specific economic activities and financial institutions that are part of the dominant financial system? With the stream of new products and innovative services that the financial sector continues to uncover and create, the combined wisdom, experience and insights of the traditions may be invaluable in both guiding the practitioners of the respective faiths and engaging the constantly evolving world of finance.

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Faith and Finance: Value-Guided Pursuit of Interests

Mohammad Nejatullah Siddiqi

Introduction

From time immemorial, there has existed an important relationship between faith and finance among different civilizations Although contemporary conventional wisdom separates faith and finance, this division has not served modern society well.[1] Faith impacts finance through motivation and value-orientation, which, in turn, influences wealth creation as well as the use of wealth for enhancing wellbeing.

All wealth is jointly produced by both natural and man-made elements. Natural inputs such as land, air, water, minerals, sunlight and other forms of energy need to be combined with human resources, such as ideas, accumulated knowledge, new skills, trust, hope and sympathy for a sustainable wealth creation. Some forms of wealth creation, such as partnerships, necessitate sharing wealth among those involved in its creation. Product-sharing, profit-sharing, renting and wage contracts all involve a distribution of wealth, although renting and wage contracts are more vulnerable to disparity among the parties involved. The rules regarding sharing joint products are usually put in place by regulators. The regulators are called upon to ensure fairness in sharing joint products through dedicated legislations and periodically issued guidelines to streamline market practices. The regulation of business practices is a well-established tradition dating back to the earliest periods of history. Its earliest forms were the obligation to fulfill promises and tell the truth. Not tampering with socially approved weights and measures and not indulging in clipping metallic coins soon followed.[2]

Natural elements, which include faith-inspired values, reflect morality in human relationships. In the absence of faith, moral values have to be anchored to pragmatism, depriving morality of the strength needed to prevent predatory practices. To assert that these values reflect the evolutionary necessity to preserve and promote vital interests ensuring survival does not

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contradict their essentially moral nature. There need be no conflict between morality and the pursuit of survival. Faith provides the trust needed to remove any fear of dissonance between life-enhancing values and survival interests. By increasing trust, morality reduces transaction costs and increases efficiency.

Therefore, this chapter examines the dynamics of value-guided pursuit of interests through the relationship between faith and finance. It makes a case for the inextricability of faith and finance in this pursuit, as the ethical dimensions of business is becoming more prominent than ever in the modern world. Thus, it is argued that faith has the strong potential to positively influence financial markets. Such efforts toward molding the human behavior in accordance with moral values would positively impact the global financial markets in the long run. These efforts would ultimately address the faltering ethical standards in global business.[3]

The Islamic Tradition

Though there are other worldviews on how faith positively impacts finance, this chapter primarily focuses on the Islamic tradition. According to Islamic teaching, since the beginning of time, God has recommended guarding our nature against excessive desire. God gave mankind the essential teaching of *tawhid*, the exclusive oneness and omnipotence of God, along with basic moral guidelines to foster a moderate and peaceful society. Among the teachings of the prophets, who relayed this message, was the recommendation for societies to behave justly in all economic interactions. In the Quran, God relates the story of Prophet Shu'aib who said:

> O my people! Worship God! You have no other *Ilah* (god) but Him. Verily, a clear proof (sign) from your Lord has come unto you; so give full measure and full weight and wrong not men in their things, and do not do mischief on the earth after it has been set in order. That will be better for you, if you are (true) believers (7:85).[4]

Prophet Shu'aib's advice is repeated in a later chapter, a sign of its importance:

> O my people! Worship God, you have no other *ilah* (god) but Him, and give not short measure or weight. I see you in prosperity and verily I fear for you the torment of a Day encompassing. / And O my people! Give full measure and weight in justice and reduce not the things that are due to the people, and do not commit mischief in the land, causing corruption. / That which is left by God for you (after giving the rights of the people) is better for you, if you are believers. And I am not a guardian over you. (11: 84, 85, 86)

First, it is important to note that the guideline for economic justice immediately follows the call to belief; its juxtaposition indicates that economic justice is largely based on belief from the Islamic perspective. This belief includes fear, love and respect for God that, in turn, necessitates that one respects the rights, including economic rights, of fellow human beings. Second, Prophet Shu'aib notes that his people may enjoy temporary *prosperity* from unethical economic practices, yet this delusion can lead to social disequilibrium and corruption if they refuse to adhere to God's tenets. He points to the essence of faith and notes that people have the responsibility to protect others from allowing this profit to delude them. In another noteworthy example in the Quran, *Surah Al-Mutaffifun* (The Chapter of the Defrauders) focuses on economic justice and harmony:

> Woe to *Al-Mutaffifun* (those who give less in measure and weight). / Those who, when they have to receive by measure from men, demand full measure, / And when they have to give by measure or weight to (other) men, give less than due. (83: 1, 2, 3)

This example points to another symptom of greed—selective application of rules. It is often human nature to accept ethical rules, but to apply them only when it benefits the individual. The above verses clearly suggest that these divinely legislated economic guidelines must be interpreted and applied holistically *and* impartially. Some of the greatest social ills have arisen from certain individuals getting more than their due and denying others their rights, or exempting themselves from ethical rules of justice. The Islamic conception of justice prevents such unequal treatment.That is not to say that Islamic principles are meant to curb financial practices through these rules; rather, faith and economics promote financial success in a way that is healthy for the individual and society. The infusion of morality into economics enables this healthy financial activity. We saw this example through the life of the Prophet Muhammad, a merchant known as *Al-Amin*, the honest, even before his prophethood. His wife Khadijah, one of the wealthiest traders in Mecca, was also known for her just dealings, as were many Companions of the Prophet, such as Abdur Rahman bin Auf, who achieved financial success while adhering to Islamic principles. Even some later Islamic empires followed this faith-finance unity. For instance, the earliest Muslims came to India as traders, in a *shari'a*-guided financial system that stretched through parts of Asia, Africa and Europe.[5]

In the 19th, 20th and 21st centuries, however, there has been a gap between faith and politics due to the separation of church and state mostly in western countries.[6] Faith has often been replaced by interest in impressive growth in a society where there is disparity in wealth distribution. Today's

mega-cities, divided into luxurious living quarters with shiny suburbs on one side and dark, dilapidated slums lacking basic amenities such as clean drinking water and schools on the other side, are largely a product of economics that has purged faith and morality. Despite the claim that these economic principles are guided by reason, modern economic ideologies have led to a most unreasonable scenario—what is aptly called the global village.

Flowing from the traditional understanding of faith and finance in the Islamic tradition, there has been some revival in emphasizing the ethical values of financial transactions.[7] This is what is now known as Islamic finance.[8] The revival of Islamic finance did not occur until the 1960s and it is important as we discuss the future of Islamic finance that we understand its basic purpose as a value-guided pursuit of interests. In other words, while Islamic finance legitimizes profit-making, it reinforces such practice with moral values. This is a confluence between money and morality.

Faith impacts finance through answers to questions such as why produce and for whom to produce. In Islam, it is believed that the strength of one's faith is reflected in the intensity of one's efforts to produce. It is also reflected in what one does with one's earnings. The nature of our faith determines where we stand in the broad spectrum from exclusive pursuit of self interest to reaching out to all humanity. Faith broadens the scope of and widens the horizon for these productive efforts. The realistic middle ground (to which most of us stick) is to avoid harming others while serving one's self-interest, and to aspire to do good to others if and when circumstances call for it. Faith does this through generating a moral obligation toward others. Such moral obligation is a cardinal part of modern business ethics.[9]

However, all societies have not generated this moral obligation. Though there are large corporations across the world that are philanthropic and indeed donate part of their wealth to charity, the pursuit of self interest as a means to social well-being has practically disentangled the nexus between faith and finance. The natural tendency of faith to generate morality is ruptured by false notions about the efficacy of amoral behavior in delivering social good. The overriding focus on shareholder value maximization has disregarded other stakeholders such as customers, employees and society at large. A moral approach to finance has the potential to take a stakeholder approach, to be focused on the long-term, and to address the issue of compensation based on fairness and equity. Faith emphasizes inclusive growth while vested interests care only about impressive growth.[10]

The cause of affliction lies in a moral deficit in the contemporary structure of social, political and economic edifice. This moral deficit lies in the lack of concern for the good of others, which sometimes degenerates further into exploiting others in pursuit of one's own gain. The moral deficit itself

is caused by the absence of faith; sometimes a weak faith or a faith diluted by confusing worldviews produces the same result: impotent faith incapable of moral uplifting. A robust faith brings into focus the oneness of mankind as owing existence to the same Creator. Brotherhood, equality in dignity, and respect for God-given resources of the environment and of human relations, all belong to this focus and are sustained by it. Regaining this focus is imperative.

Ground Reality and Desired State of the World

Going forward one needs to explore two parallel concepts: the actual conditions pertaining to faith-finance relations in contemporary society and the potential of faith to correct finance's current course. I begin with the latter, the potential of faith to ameliorate the contemporary economic crisis. The nature of finance is too complex to issue a simple list of "dos" and "don'ts" in the name of faith. Its ever-changing nature defies any list of prohibitions and obligations to function well in all places and times. However, the crucial values that promise to help secure fairness in changing conditions are: the concern for others' well-being, the will to abstain from harming others even at the cost of personal sacrifice, and the willingness to submit to enacted social regulations. Most of the recent adversity in financial markets is rooted in the absence of these values.[11] For example, the Chicago school, which has been influential since the early 1980s, openly warns against firms and individuals trying to care for others. The ruling dogma is that one best serves society by serving oneself.[12] No wonder the other two values, the will to abstain from harming others and a willingness to abide by rules, also evaporated under the encouragement of unlimited self-interest. Given this environment, who would not twist rules to make them serve one's own interest?

The answer necessitates pondering over the quest for fairness in financial systems. In the absence of regulations capable of ensuring fairness, it is an understanding of morals that matters. People who want to behave will find ways to do so, if not straight away then through experimentation. They may even find ways to constrain deviants and minimize the loss of social harm due to individual perfidy. Much has been made of lack of full information to economic decision-makers in debunking the idea of caring for social good.[13] The reality is that there is no way to have full information about future values. The falsity of the assumption that market mechanisms can somehow solve this human predicament has been exposed by a succession of crises. Man must try to compensate for the inevitable information deficit by experimentation, pooling of available information and sharing the consequences of ill-informed decisions. One can do this at the individual level

as he or she has been doing at the societal level. Faith is a positive aid insofar as it creates an incentive to cooperate for the social good.

People of faith have learned some lessons in the past during the quest for fairness. These lessons deserve to be our starting point in a similar quest today. As I proceed to summarize them, I beseech you not to quibble over the variety of interpretations and controversies surrounding the circumstances in which they are applicable. I would also like to underline the fact that these constitute the first steps to be taken in man's search for a just and fair financial system, and by no means are sufficient to usher in a wholly just society.

Pillars of Fair Finance

The prerequisites of fairness in finance include the prohibition of interest, fraud (in its myriad forms), gambling and transactions involving excessive uncertainty (*gharar*). These prohibitions should be viewed from the perspective of private ownership, freedom of enterprise and the supervisory role of the state as guardian of the poor and weak. Faith encourages charitable giving, which includes lending to the needy and expecting to receive no more than what was given. Regarding business loans, shifting all risk onto the borrower is repugnant to faith; encouraging partnership and profit sharing suits faith. Gambling is playing with chance. Financial transactions that thrive on trade involving excessive risk are examples of gambling. Some activities are surrounded by excessive uncertainties to an extent that contractual relationships built around them are problematic. Such contracts are not transparent in offering the same information to all concerned, and because just sharing is missing, it is better to avoid these contracts.

In Islam the jurists have worked hard to translate the three principles listed above—prohibition of interest, prohibition of gambling and minimization of *gharar*—into rules governing business relationships. But the ever-changing nature of these relationships, which are largely shaped by changing technologies, makes it impossible to use an unchanging net of rigid rules. Innovation in ways of doing business necessitates making new rules, thus the process of rule-making must go on!

Protecting the weak from the strong and the poor from the rich necessitates some socially imposed restraints to human freedom, including freedom of enterprise. Securing fairness would, however, need more than imposing restraints. That is where the values mentioned above—concern for others, readiness to limit one's potential gains and following democratically enacted laws—become relevant. We need to harness human ingenuity to positively enhance justice and equity, not only to prevent injustice. Faith is capable of doing so.[14]

Faith Versus Cult

Faith knows no land, race, language or culture. But people of faith sometimes develop strong attachments to one or more of these to the extent that they identify their religion with a particular land, race, language or culture. As a result, faith loses its power to generate moral values overriding narrower interests. This provides an answer to the second query made above: the actual condition relating to the faith-finance nexus. In today's world, faith has had little influence on finance since faith has been made a tool of national, racial and other social ambitions.[15] Religion is the expression of faith, translating faith's demands into individual rules of conduct. Over time these rules have often been twisted to suit particular interests.

The rejuvenation of faith necessary to transform the current financial system would first involve the disentangling of faith from other narrower loyalties such as state or citizenship. Faith in its purest form—that is faith detached from state, citizenship, etc.—has the capability to cut across all ideologies and promote morality. By creating positive sympathetic relationships with others, faith would make men accountable and responsible to each other. But faith in its current state—faith that is made subservient to nationalism or imperialism—fails to do so. Impure faith creates an artificial distinction between morality and faith. Loyalty to a nation or race, for example, can dictate certain ethics and priorities that are generally in conflict with those of another nation or race. Faith cannot impact finance unless and until barriers, including the major barrier of human greed, are removed.

Islam's contribution to universalizing faith-generated morality lies in pushing back these barriers to their proper secondary positions. The best periods of Islamic history were the early periods when tribal or racial loyalties were kept in check and morality reigned supreme.[16] Conversely, the worst period occurred when tribal and racial identities surpassed morality in the creation and sharing of wealth. The resilience of the Islamic morality suggests the need to review the financial system in light of Islamic ideals of justice and equity (*adl* and *ihsan*). The 50-year-old movement of Islamic banking and finance is a recent example.

Diluting Faith's Mandate

The original position of people of faith was that charging interest on consumption loans to the needy was considered immoral, while charging interest on commercial loans was considered unfair as it amounted to shifting risk to the borrower. As is well known, this position was later modified by many faith groups to allow moderate rates of interest on commercial loans.[17]

The distinction made between loans for consumption purposes (which do not result in anything marketable) and loans for productive purposes

has no basis in the texts to which these faith groups adhere. This was supposedly done on pragmatic grounds to facilitate financial transactions between owners of money capital and users of money capital for creating additional wealth. It was argued that interest payment was needed to compensate for the lender's loss of opportunity to profitably employ their capital, ignoring the fact that no opportunity for guaranteed profit existed.[18] Man's environment is characterized by uncertainty of future value productivity of capital, as Frank Knight demonstrated in his 1921 book *Risk, Uncertainty and Profit*.[19] Furthermore, any legitimacy accorded to interest in one sector permeates throughout the economy with the passage of time.[20] Islam eliminated that possibility by declaring excess payment above the initial amount lent as prohibited *riba*. As the Quran says:

> Believers! Have fear of God and give up all outstanding interest if you do truly believe. But if you fail to do so then be warned of war from God and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged. (2: 278–80)

The Quran does not recognize the distinction between low and high rates of interest or between loans for business and loans for need-fulfillment. The presumption that commercial loans were not prevalent at that time has no basis in history.[21] On the contrary, *riba* in seventh century Arabia was overwhelmingly common in commerce. This is underlined by the declaration made by the Prophet Muhammad in his last Hajj sermon canceling all interest owed to his uncle, Abbas bin Abdul Muttalib. Abbas advanced money capital to date growers in Medinah as well as to grape growers in Taif. Failure to pay at the time the loan was due then justified an increase in the amount to be repaid.

Some have tried to grant legitimacy to interest arguing that it is analogous to rent. Unlike money, which must first be spent to acquire real goods and services, rented goods like machines and real estate are useable right away. Islam, like other religions, allowed people to charge rent as a price for *usufruct*. Jurists often absolve the lessee from the obligation to pay rent should the rented property lose its ability to provide the expected *usufruct*.

Legitimacy of profit and rent is hedged with the provisions directed against monopoly and hoarding in order to maintain fair competition. The rest is largely left to the market functioning under the watchful eyes of the social authority. Abu Bakr, the first ruler succeeding the Prophet Muhammad, described the ruler's duty as protecting the weak from the strong.[22]

Speculation in financial markets often takes the form of betting on the uncertainty of the outcome of future events. Regulators must realize that such trading in risk is no more than gambling and serves no legitimate financial purpose. As such, regulators should prohibit such trades and they should closely examine all associated financial instruments, such as derivatives, for characteristics of uncertainty.

Conclusion

Faith has the potential to influence financial markets by molding human behavior in accordance with moral values. Thus, people of faith have devised institutions to realize the ideal of a just society, through means such as the Islamic finance framework and other faith-based initiatives introduced in the Christian world. Rapid technological changes necessitate adapting these institutions in order to realize social goals while the institutions continue to innovate in financial markets. These rapid changes constantly present new challenges for regulators, so the quest for fairness in finance becomes a continuous process.

Endnotes

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Glossary

'adl – justice and fairness. It means to give every party what he or she deserves at the appropriate time.

'ain – determinate property in Islamic law or the material substance of an asset. This term is often used in respect of real assets.

'amal – work; labor or conduct; any work performed including any valuable service rendered by a person, which may or may not attract a consideration in the form of wages.

amana – trust. The status or duty of a trusted person (*amin*); one of two basic relationships toward property, which entails absence of liability for loss except in breach of duty; compare daman, other entities do not have this quality.

arbun – a down payment with revocation option akin to a call option in the conventional sense. However, the contract is a sale of a good for which the down payment is part of the price, while the option is about the right to purchase and the price for this right is lost. In classical *fiqh* it is controversial, but accepted at the Hanbali School of Islamic law.

bait al-mal – the treasury of the Muslim community (umma); historically, the *bait al-mal* as an institution was developed by the early caliphs that soon fell into disrepair. The *bait al-mal* contained funds meant to be spent on the needs of the umma, e.g., supporting the needy.

bay ' al-salam – purchase with deferred delivery.

darar – harm; the dire state of hardship, which the law is meant to prevent in all situations.

daruriyat – (sing. *darurat*) basic needs, necessities or the essentials. These are the things or activities that are absolutely necessary for the preservation of the five foundations of the social life of an individual—llife, religion, intellect, family lineage and wealth.

fatwa/fatawa – (pl. *fatawa*) a formal judgment or ruling issued by a Muslim jurist (*faqih*) called a *mufti*, in response to a question relating to Islamic law (*shari'a*).

fiqh – Islamic jurisprudence. The *fuqaha* (sing. *faqih*) or Muslim jurists are those whose rulings constitute the entire body of *fiqh*.

gharar – lit., peril, risk, uncertainty. In the juristic sense, *gharar* means a sale of probable commodity, which has an uncertain or risky nature as a result of its inexistence or speculative tendencies.

hajiyyat – (pl. *hajiyyaat*) needs or exigencies; legitimate interests that are complementary to the essentials (*daruriyat*), but not as crucial. Absence of the *hajiyyat* leads to hardship, though short of severe disruption. This is the second level of public interest or welfare (*maslaha*); lower than *daruriyat* but higher than *tahsiniyyaat*.

halal – permissible, lawful; said of a deed that is not prohibited in Islam. Opp. *haram*.

haram – impermissible, illegal, unlawful. Opp. *halal*.

hiba – contract of gift.

hiyal – (sing. *hila*) legal artifices or stratagems to circumvent or avoid legal principles and rigid constructs.

'ibadat – rules pertaining to worship and ritual matters.

ihsan – perfection in worship or to do good. It involves sincerity in acts of worship and doing good to others in human interaction.

ijara – operating leasing (lit. "letting to lease").

ijma' – lit. consensus. The unanimous consensus of the *umma* on a given issue, usually represented by the agreement of the jurists. *Ijma*' has traditionally been recognized as an independent source of law, alongside the Quran, *sunna* and *qiyas* (analogical deduction).

ijtihad – lit. effort, exertion, diligence. The process by which a qualified Islamic jurist (called a *mujtahid*) endeavors to arrive at the correct ruling on a given issue by reflecting on source texts from the fundamental sources of the *shari'a*: the Quran and the *sunna*.

istisna' – contract providing for the manufacture and purchase of a specified item.

Khalifah – man's trusteeship and stewardship of earth; most basic theory of the caliphate; flora and fauna as sacred trust; accountability to God for harms to nature, failure to actively care and maintain. Three specific ways in which *khalifa* is manifested in Muslim practice are: the creation of *haram*

to protect water, *hima* to protect other species (including those useful to man), and resistance to infidel domination over Muslim lands, in jihad.

khiyar ash-shart – an option to rescind a sale contract based on the conditions stipulated by either of the parties. When one of the parties to a sale contract stipulates an option and such is mutually agreed, and the other party fails to fulfill the condition, the stipulating party has the right to rescind the contract within a given period.

khulta – lexically "mix"; in *fiqh*, a mix of properties that belong to two or more parties, such as when four sheep owned by Zayd and five owned by 'Amr are allowed to mingle in one flock.

mafsada – (pl. *mafasid*) harm. Removing harm or ill effects of a phenomenon is one of the twin objectives of Islamic law.

mal – wealth, money, property; any valuable thing that can be possessed.

maqasid al- shari'a – lit. the objectives of the *shari'a.* The term *maqasid al-shari'a* refers to a juristic-philosophical concept developed by the later generations of the classical *fuqaha*, who attempted to formulate the goals and purposes of the *shari'a* in a comprehensive manner to help investigate new cases and organize previous existing rulings.

maslaha – (pl. *masalih*) benefit. This term also means public interest.

maysir – gambling, a game of chance. Originally a game of chance played by the Arabs in the *jahiliyya*, *maysar* came to refer to any game of chance.

milk – lit. possession or property. Tangible or non-tangible asset that belongs to a person. Such asset is usually under someone's possession as opposed to commonly owned properties.

mishpat (n.b. this is a Jewish term) – right judgment or justice embodied in a concrete act or deed.

mu'amalat – dealings or transactions among human beings; compare *'ibadat*.

mudaraba – (also called *qirad*) a form of partnership to which some of the partners contribute only capital and the other partners only labor (some schools do not treat it as a partnership but as a contract sui generis).

murabaha – sale at a percentage markup; one of the sales (bay') in which the price is stated in terms of the sale object's cost to the seller, the others being sale at cost (*tawliya*) and sale at discount (*wadi'a*).

mustawriq **–** person seeking *tawarruq*.

niyyah **–** intention.

qard **–** a loan. A transaction where X lends Y some wealth (e.g., money) to be repaid after a specified period of time elapses.

qard hasan **–** goodwill short term loans with no compensation whatsoever.

qimar **–** (syn. *maysir*) a type of prohibited arrangement where the acquisition of property depends on the occurrence of an uncertain event, as in the case of gambling.

rabb al-mal **–** lit., the owner of the property; a partner who contributes capital.

riba **–** usury as forbidden in the Quran; interpreted in classical *fiqh* as including interest and various other forms of gain in contract.

riba al nasi'a **–** postponement *riba*. Along with *riba al-fadl, riba al-nasi'a* is one of the two categories into which *riba* (see entry) is often divided by the *fuqaha*. *Riba al-nasi'a* takes place when two *ribawi* substances are exchanged, one immediately and the other after a delay. An example of *riba al-nasi'a*: two parties agree to exchange 10 kilos of gold for 2 kilos of silver such that the former is handed over immediately and the latter is to be delivered two weeks from the date the contract is signed. Another example: two traders exchange one metric ton of wheat for two metric tons of barley such that the latter is delivered after one year.

ribawi **–** (adj. of the term *riba*) any goods that exhibit one of the attributes or efficient causes that invoke the application of the *riba* rules. Therefore, the term is sometimes used as "*Ribawi* goods," which implies goods that exhibit on the efficient causes that occasion the application of the *riba* rules.

sadaqa **–** (pl. *sadaqat*) charitable giving.

salam **–** a type of sale where the full price of the goods is paid in advance and the goods are delivered at a specified date in the future.

sedaqah (n.b. this is a Jewish term typically transliterated as tzedakah) – justice; also translated as righteousness.

shari'a **–** Islamic law, based on the Quran and *sunna*.

sharik **–** partner in a contract.

sharika al-wujuh **–** partnership on the basis of credit-worthiness of each of the partners where the ratio of profit and loss is determined by the liability borne by the partners respectively.

shirka **–** (syn. *Musharaka*) any contract between two or more persons who agree to jointly enter a financial enterprise whose profits will be divided between them.

sukuk **–** (sing. sakk) Islamic bonds and certificates.

sukuk al-mudaraba **–** a bond whose underlying activity is based on *mudaraba*.

sukuk al-musharaka **–** a bond whose underlying activity is based on *musharaka*.

sunna **–** the Prophet Muhammad's normative example, as known from the *ahadith*; one of the four roots (*usul*) of f*iqh*.

tabarru' **–** contribution, donation (voluntary contribution).

tahsiniyyah **–** (pl. tahsiniyyaat) "embellishments," legitimate interests that are beneficial, and enhance the quality and refinement of life, yet whose absence leads neither to severe disruption or to hardship. This is the third level of public interest or welfare (*maslaha*); lower than the *daruriyat* and *hajiyyat*.

takaful **–** lit. mutual support. Islamic insurance; based on the concept of mutual financial support, an Islamically acceptable alternative to conventional commercial insurance.

taqwa **–** fear of God. The concept of *Taqwa* in Islam is generally interpreted to mean God's consciousness, which includes piety, love for God, obedience to God and self-restraint.

Tawarruq **–** a practice by which a needy person buys something on credit and at once sells it for cash to a third party in a separate transaction.

tawhid **–** in Arabic it means attributing Oneness to *God* and describing Him as being One and Unique, with no partner or peer in His Essence and Attributes. Strictly singular; reference to One God.

umma **–** the Muslim community.

'umum al-balwa **–** a form of public affliction or common plight that is consistently rampant and extremely difficult to avoid in a given place, whose prohibition will bring hardship to the people.

'urf **–** custom. Common usage and established practice. *Urf* is one of the secondary sources of the Islamic law as long as it does not contradict the primary sources, i.e., the Quran and the *Sunna*.

usul al-fiqh – principles of legal reasoning in Islamic jurisprudence.

wa'ad (wa'd) – promise.

waqf – (pl. *awqaf)* lit. cessation. A standard Islamic transaction where one "freezes" one's property such that it is considered to have been arrested in perpetuity and can neither be sold, inherited nor donated. The term *waqf* frequently refers to the property itself. The use of a *waqf* (e.g., a park) is often reserved for the relief of the poor, for the public at large or for other charitable ends.

wujuh – (sing. *wajh*) reputation. This is a metaphor for someone's reputation or honor.

zakat – (Var. *zakah* or *zaka*) the third pillar of Islam; obligatory alms-giving that every well-off Muslim is required to relinquish to the Islamic authority for distribution to the poor and needy. In the absence of an Islamic authority, well-off Muslims must themselves distribute their alms among the poor and needy, as prescribed by the *shari'a.* The payment of *zakat* is prescribed for all persons having wealth above an exemption limit (*nisab*), as described in the *sunna*.

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It has long been said that Islamic Finance needs its own innovative blueprints to follow the pulse of the industry. Discussions on Islamic Finance as an alternative to conventional finance or a competitor have reached a new milestone: recognition of their cooperation. As the field of Islamic Finance expands and diversifies, so does its ability to cross new venues and cultivate partnerships.

The Ninth Harvard University Forum, entitled "Building Bridges Across Financial Communities," sought to explore these opportunities: What lessons on social responsibility can organizations find in Islamic Finance and other faith traditions? What can conventional banks and Islamic Finance institutions learn from each other, particularly after the financial crisis?

This volume, a selection of 11 papers presented at the Ninth Forum sponsored by the Islamic Finance Project at Harvard Law School, investigates these questions through original research on best practices across and between industries and faith traditions. Essays consider diverse topics ranging from the influence of religion on corporate social responsibility and individual financial choices to the parameters of hedging and portfolio diversification.

As our writers suggest, there is reason to be optimistic about the future of cooperation among financial communities; intellectual inquiry is just a first step along this bridge.