Islamic Finance: Practitioners, Scholars, Regulators – Who Is Driving the Industry?

CIEF Seminar Report
January 13, 2015

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Islamic Finance: Practitioners, Scholars, Regulators – Who Is Driving the Industry?

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Cite this report as: Nienhaus, Volker, 'Islamic Finance: Practitioners, Scholars, Regulators – Who is Driving the Industry?' A seminar organized by the Center for Islamic Economics and Finance, at College of Islamic Studies, Hamad Bin Khalifa University in Doha, Qatar on January 13, 2015.

ABSTRACT

The report delves into the vexed question of who is driving the Islamic finance industry, which has multiple players – Islamic scholars, regulators and, finally, practitioners – in the fray. It outlines the historical evolution of the industry and concomitantly the roles of its disparate stakeholders during the different stages of development. Starting with a few isolated and independent initiatives, the industry has evolved to acquire the robust shape it has today. It continues to grow as it tries to respond to the challenges presented to it, albeit through greater cooperation and collaboration among stakeholders.

SEMINAR REPORT [1]

Modern Islamic finance started half a century ago in the early 1960s. Over the past five decades, the character of Islamic finance has changed, and different groups have determined its nature and the direction of its evolution in different phases. The history of operational Islamic finance in practice began when pioneers took initiatives to put their visions into practice:

1. Pioneers as Practitioners with a Developmental Perspective

Ungku Abdul Aziz observed that Muslims of small means often applied detrimental techniques to finance their hajj. They kept cash under the mattress where it was exposed to devaluation by inflation or theft, borrowed funds from money lenders at usurious rates of interest, or sold off land and property to finance

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1 This seminar report has been edited and selectively updated by the author.

the pilgrimage. Ungku Abdul Aziz identified the lack of a ribā-free savings scheme as the root cause of this behavior and submitted "A Plan to Improve the Economic Position of Potential Pilgrims" to the Malaysian government in 1959. This plan became the basis for the Pilgrims Saving Corporation, launched in 1963, which later became Tabung Haji (the Pilgrims Fund),[2] a financial institution that collects savings of prospective pilgrims and invests them in halal businesses. What started as a modest scheme to support persons of small means in rural areas has grown into one of Malaysia's largest Islamic fund managers.

Ahmed El-Naggar launched a seminal project for community development, efficient capital formation, and the financing of small and medium-sized enterprises (SMEs) through trustworthy ribā-free financial institutions in the small Egyptian town of Mit-Ghamr in 1963. His starting point was the observation that persons of small means such as farmers saved parts of their current income for future use, acquiring real assets like gold, jewelry and durable consumer goods rather than financial assets. These assets were purchased from traders and later, when liquidity was needed, sold back to the traders who earned profit margins twice. Apart from high individual transaction costs, there were also significant macroeconomic costs: Savings in real assets is actually consumption, and consumed resources are not available for productive investments (as savings should be). If the savers could be convinced to change the form of their savings – from real to financial assets (such as a savings book or bank account) – then the saved resources could be channeled into productive investments. This would boost the national capital formation without any additional reduction of the real consumption of the savers (who will benefit individually from much lower transaction costs). A precondition for a switch of the savings form is that trustworthy financial institutions are within the reach of savers in rural areas. Trust can be gained when savers see how their money is put to good use. Therefore, a significant part of the funds mobilized locally had to be invested locally in SMEs. Furthermore,

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2 Mannan (1996) and http://www.tabunghaji.gov.my/background#

trust requires that the financial institution does not violate the religious beliefs of the people, i.e. it had to operate ribā-free. El-Naggar's ribā-free savings bank was able to change the savings behavior of the people and to mobilize substantial amounts of investible funds. [3]

While the Malaysian Tabung Haji flourished, the Egyptian Mit-Ghamr experiment was rather short-lived for political reasons. However, its community orientation is a core element of several smaller Islamic financial institutions in countries such as Sudan, Bangladesh and Indonesia.

Although Islamic finance had evolved by the end of the 20th century into an industry with approximately $2 trillion assets under management, there was still room for pioneers and the realization of visions as the example of Muhammad Amjad Saqib shows. He is the driving force behind the most successful Islamic microfinance finance institution, Akhuwat, established in Pakistan in 2001. This is an outstanding example of a community and development-oriented financial institution based on qarḍ hasan loans. [4]

The direct impact of pioneers on the development of the Islamic finance industry was limited. Still, visions were taken up by some regulators and lawmakers in a few countries (e.g. Malaysia and Indonesia).

2. Muslim Economists as Advocates of a Systemic Alternative

Theoretical concepts of a genuine Islamic economic system date back to the 1940s when the idea of a separate Muslim state on the territory of British India after the retreat of the colonial power took shape. The goal was to create an economic system fundamentally different from the known economic systems of that time, namely the British type of (colonial) capitalism and the Soviet type of

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3 Ready (1967), El-Naggar (1978)

4 https://www.pakpedia.pk/dr-muhammad-amjad-saqib/; Saqib and Malik (2019)

(atheistic) communism. The system should be based on private property and entrepreneurship, but the financial sector should adhere to the instructions and principles of the Qur'an and Sunna and operate ribā-free. When Pakistan became a reality in 1947, this Muslim state was rather secular in its institutions, including the economy. Hence, the debate on the appropriate economic and financial order continued. In particular, Muhammad Nejatullah Siddiqi's approach of financial institutions based on profit and loss sharing (PLS)[5] found many supporters. The idea of a replacement of interest-based debt finance by equity-based partnership finance was formalized by Islamic economists such as M. Umer Chapra, Monzer Khaf and M.A. Mannan (who later became a practitioner in Bangladesh [6]) in the 1970s and 1980s.[7] It became known as the "two-tier-muḍārabah" model because the proposed PLS contracts were conceptually close to classical muḍārabah partnerships. They should be applied both in the savings and in the financing business of the Islamic financial institutions. The literature usually called PLS-based financial institutions "Islamic banks," and in theory, a system of PLS-based Islamic banks could be more just, stable and efficient than a ribā-based system. It could also boost economic development and facilitate poverty reduction.[8] Their writings have shaped the public perception of what Islamic finance ought to be,[9] but their models of banking based primarily on profit and loss sharing (PLS) had only a limited impact on the practice, if at all.[10]

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5 Siddiqi (1973/1983), (1983)

6 Mannan was one of the founders of the Social Investment Bank Limited (renamed the Social Islamic Bank Limited) in Dhaka, Bangladesh, established in 1995; Nisar (2009)

7 Mannan (1970), Kahf (1978), Chapra (1985)

8 See, for example, Ahmad (1980), Ahmed, Iqbal and Khan (1983), Khan and Mirakhor (1987)

9 Even publications of international organizations such as the IMF or World Bank often cultivate this "idealistic" view; see, for example, Hasan and Dridi (2010), Mohieldin (2012), Iqbal and Mirakhor (2013), Kammer et al. (2015)

10 According to the Islamic Financial Services Board (https://www.ifsb.org/psifi_02.php), PLS modes of financing accounted for a meager 5.3% of the Shari'ah compliant financing of Islamic banks in 2018Q2.

In recent years, the terminology shifted from PLS to the somewhat broader term of risk-sharing, which is now often considered the hallmark of Islamic finance.[11] Risk-sharing goes beyond banking and also comprises equity-based securities as well as Sharīʿah compliant mutual insurance (takaful). Still, the new term has not led to a new practice in Islamic banking.

3. Pioneers as Practitioners with a Commercial Perspective

The pioneering projects with a community and development orientation in the 1960s were isolated experiments. An Islamic finance industry emerged only after Islamic commercial banks came into existence since the mid-1970s and expanded rapidly since the 1990s. The driving forces behind their establishment were often successful businessmen (particularly traders and contractors) like Saeed Bin Ahmed Al Lootah, who established the Dubai Islamic Bank in 1975 or Saleh Abdullah Kamel who set up a group of Islamic banks (Albaraka) in several countries from 1978 onwards. These businessmen – as well as a group teamed up with Prince Muhammad Al-Faisal Al-Saud who established several Islamic banks since 1977 – had used conventional banking products and services and wanted to get functional equivalents for these products and services on a ribā-free basis.[12] In contrast to Islamic economists, these practitioners did not aim at a systemic transformation from a debt-based to a PLS-based financial system. For them, Islamic banking was primarily a business model and not a tool for community development or poverty eradication. Hence the direction of the emerging industry became interest-free commercial and retail banking with the same risk-aversion that characterizes "traditional" banks. PLS techniques imply risk-taking and therefore are not the choice of banks, in contrast to investment companies or venture capital firms (which did not exist in Islamic finance at that time).

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11 See, for example, Askari, Iqbal, Krichene, and Mirakhor (2012)

12 Alim (2014)

4. Sharīʿah Scholars as Facilitators

Monzer Since Islamic banks did not exist before, all CEOs of the first Islamic banks had a background in conventional banking, and they were the drivers of the emerging industry. However, to meet the expectations of the founders, close cooperation with Sharīʿah scholars was necessary. Since the Islamic commercial law (fiqh al-muʿāmalāt) was abandoned during the colonial period, very few contemporary Sharīʿah scholars had studied this branch of fiqh. The design of Sharīʿah-compliant instruments for modern banking was not a topic widely discussed among Sharīʿah scholars at that time. Hence, the few available scholars made individual efforts (ijtihād) to meet the needs of the new Islamic banks. It seems that most scholars were initially restrictive insofar as they approved only financing techniques based on nominate sales and rent contracts found in classical fiqh books.[13] The direction of the Islamic finance industry during this period was determined firstly by the preference of CEOs for risk-minimizing techniques, and secondly by the restrictions imposed on their toolboxes by Sharīʿah scholars. During this formative period, Islamic banks offered only basic banking products and services.

With growing expertise, Sharīʿah scholars became more flexible and creative. At the turn of the century, their attitude has changed from restrictive to permissive. They understood their role increasingly as advisors in Islamic law and facilitators for Sharīʿah compliant functional equivalents of conventional instruments.[14] When CEOs were looking for more sophisticated products or advanced financing techniques (such as derivatives, credit cards, or capital market instruments), Sharīʿah scholars engaged in "contractual engineering." While the financial "mechanics" of an innovative instrument was structured by financial experts (including consultancies and structuring departments of conventional Western banks), Sharīʿah scholars found suitable

13 On Islamic contracts in finance see, for example, Nethercott and Eisenberg (2012) and Saleem (2012)

14 Bakar (2016) offers an inside look into "Shari'ah minds" in Islamic finance

contractual arrangements. Tawarruq structures were applied in various settings, and unilateral promises (waʿd) became the silver bullet for the design of synthetic products.

The growing diversification of instruments and sometimes divergent or even conflicting views of individual scholars on the Sharīʿah compliance of particular products gave rise to calls for more consistency of fatawa. The idea of Sharīʿah standards issued by a body of scholars who represent all schools of Islamic law (madhāhib) and actual practices in different jurisdictions was taken up and put into practice by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Its first Sharīʿah standard was issued in 2000. However, this international standard never became the driver of the industry. As AAOIFI Sharīʿah standards are not mandatory in most jurisdictions, Sharīʿah boards of Islamic financial institutions do not have strong incentives to prefer an AAOIFI standard over their own Sharīʿah interpretation. An illustration for this behavior is the AAOIFI Sharīʿah standard on investment ṣukūk, issued in May 2003. In November 2007, the chairman of the AAOIFI Sharīʿah board criticized that 85% of muḍārabah and mushārakah ṣukūk issued in the Gulf did not comply with Sharīʿah rules as specified in the standard. Nevertheless, the Sharīʿah compliance of Gulf ṣukūk had been certified by prominent scholars who should have known and understood the standard.[15]

Bank practitioners were the driving force of the industry. They set the agenda for the scholars. With the rapid growth of Islamic banking in the 21st century, the influence of the founders of the first Islamic banks on the direction of the global Islamic finance industry faded away, and the new CEOs – supported by Sharīʿah scholars – determined the course of the industry. There was a strong tendency towards “form over substance” and a “conventionalization” of Islamic finance (which evoked sharp criticism from various parties, including many Islamic

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15 It would be interesting to see whether some of the certifying scholars have even been members of the AAOIFI Sharīʿah Board.

economists). It should be noted that this trend was reinforced by the growing involvement of Western financial institutions in Islamic finance. Conventional global players offered customized Islamic products to selected clients (in particular high net worth individuals and family offices in the Arab Gulf region). Their motivation was not community development, SME financing, or a better financial system, but profit. The Western institutions combined their experience in financial engineering with the legal expertise of leading Sharīʿah scholars to launch, for example, Sharīʿah-compliant replications of complex wealth management products.[16] Western investment banks were also instrumental in the development of the Islamic capital market, in particular, the sukūk market. In summary, the commercial interests of financial institutions drove the direction of the Islamic finance industry during the first decade of the 21st century.

5. Authorities and Regulators between Indifference and Proactivity

Islamic banking achieved a market share of 15% and more of total bank assets by end-2013 in the eight mixed financial systems[17] of Saudi Arabia, Kuwait, Brunei, Yemen, Qatar, Malaysia, the UAE and Bangladesh.[18] While governments and regulatory authorities widely accepted a level playing field for Islamic finance, only a couple of countries have actively promoted Islamic finance in the past (in particular Malaysia and Sudan since the 1980s and Pakistan during the 1980s). In recent years, a few more governments and regulators took a proactive stance (in particular in Turkey, Indonesia, Bangladesh, the UAE and – again after a

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16 A hotly debated instrument based on an elaborate wa'd structure – the "total return swap" – has been outlined in a whitepaper published by Deutsche Bank in 2007. The Shari'ah-related issues of wa'd were expounded at length by a team of prominent Shari'ah scholars. A fundamental critique of the total return swap was articulated by DeLorenzo in 2007-08: "The fatwa giving blanket approval for this misguided stratagem may well be referred to as the Doomsday fatwa for Islamic Finance." Another critical assessment was given by Laldin (2009).

17 The market share is 100% in the fully Islamized systems of Iran and Sudan.

18 IFSB (2014), pp. 9-10. By 2019Q3, the number has increased to 11: Yemen is no longer listed, Djibouti, Jordan, Palestine and Bahrain were added; IFSB (2020), p. 13

prolonged interruption – Pakistan). These regulators are not only interested in the growth and stability of the Islamic finance industry, but also in its qualitative orientation. For example, Islamic finance in Indonesia has a strong microfinance orientation, and the government assigns the industry a role in rural development and poverty reduction programs. The Islamic finance industry in Malaysia is globally the most advanced in terms of sophistication and diversity of products and institutions with a robust Islamic capital market and an elaborate support infrastructure (including specialized law firms, consultancies, rating agencies, institutions for training, media, academic education and research). Nevertheless, also in Malaysia, this industry is seriously deficient in PLS financings. In their deposit business, Islamic banks have been applying PLS contracts in a very blurry manner by announcing expected profit rates and using various smoothing techniques so that actual profit payouts matched the expectations of the account holders.[19] All these practices combined look and feel like interest.

Seemingly, the ideals of economists – in particular risk-sharing – have found a sympathetic ear of the government and the central bank of Malaysia: The Malaysian Islamic Financial Services Act of 2013 makes a clear distinction between Islamic deposits and Islamic investment accounts. The central bank clarified:[20] Islamic deposits are funds accepted by banks based on a qarḍ or waḍīʿah contract. The banks are obliged to repay the funds in full, implying that Islamic deposits are risk-free. Islamic investment accounts can be based on muḍārabah, mushārakah or wakālah contracts which all have a PLS dimension. Money paid into Islamic investment accounts is exposed to a commercial risk: The bank invests the money on behalf of the account holders, and losses have to be borne by them. The bank is obliged to repay only the net value of the funds received after the deduction of investment losses. Banks are required to point out unmistakably that money

19 On profit smoothing in general, see IFSB (2010)

20 Bank Negara Malaysia (2014)

paid into investment accounts is exposed to market risks by eye-catching risk warnings on all promotional material. They have to disclose to retail customers the investment objectives and strategies, risk factors, data on the past and realistic projections of the future performance, as well as details of the profit distribution policy. The central bank explicitly prohibits the smoothing of profit payouts. Islamic banks have to satisfy themselves that a particular investment account is suitable for the needs and loss-bearing capacities of the individual client. Malaysian investment accounts will become risk-sharing products in form and substance.

However, this will become a real game-changer only if accompanied by more PLS transactions in the financing business. This shall be achieved by the recently announced Investment Account Platform (IAP),[21] where fund-seeking SMEs can tap into investment account funds that Islamic banks may invest via the IAP. A portion of these funds could be channelled into PLS modes of financing. Operating for a possibly large number of banks, the IAP could provide expert services for the evaluation of SME business plans that are too expensive for an individual bank. With pooled services, problems resulting from information asymmetries, moral hazard, and adverse selection in PLS structures could be overcome.

6. Conclusion

The IAP in Malaysia, the support of rural Islamic banks in Indonesia, or financial inclusion programs with participation of Islamic financial institutions in other countries show how proactive governments and regulators can influence the direction of the industry. Thus, they could drive Islamic finance somewhat closer to the visions of developmental pioneers and the investment-intermediation models of Islamic economists. This would lead to more genuine Islamic products and more distinctiveness or authenticity of Islamic finance.

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21 https://iaplatform.com/

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Acknowledgement:

This seminar was moderated by Dr. S. Nazim Ali, who was supported by Bahnaz Al-Quradaghi and Wijdan Tariq of the Center for Islamic Economics and Finance, College of Islamic Studies, Hamad Bin Khalifa University in Doha, Qatar.

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Prof. Dr. Volker Nienhaus received his doctorate in economics (1979) and his post-doctorate (1985) from the University of Bochum. He was a full professor of economics at the German universities of Trier (1989-1990) and Bochum (1990-2004) where he also was director of the Institute of Development Research and Development Policy and vice-rector for structure, planning and finance from 2000 to 2003. He was president of the University of Marburg from 2004 to 2010.

He was a Visiting Professor at the ICMA Centre, Henley Business School, University of Reading (U.K.) (2010-2016) and Adjunct Professor at the International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur (Malaysia) (2012-2018). Besides, he was Visiting Scholar at the University of Malaya (2010/11) and Visiting Professor at the Faculty of Islamic Studies of Qatar Foundation, Doha (2011). He served as a member of several academic advisory committees and boards in Germany, and he was a consultant to the Islamic Financial Services Board. His current research interests are in service sector economics and Islamic economics and finance.