

Ethics, Practice, and Future of Islamic Banking and Finance

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Over the past thirty years, investment funds constructed to reflect the social, ethical, and environmental (SEE) concerns of modern-day investors have become considerable forces in financial markets. In the United States alone, socially responsible investing (SRI) is the fastest growing segment of financial markets and in 2007 represented over 11 percent of all assets under professional management.¹ Such trends are not limited to the U.S.A. and can be identified across the world in countries such as Australia and the United Kingdom.² These funds attempt to produce competitive financial returns while investing in ventures that resonate with the SEE interests of their investors. In general, there is not a sizeable tradeoff between the financial returns of SRI investments in comparison to conventional funds; some studies show better than average SRI returns whereas others show slightly lower yields.³ One such SRI phenomena is the emergence of Islamic banking and finance (IBF) in the Middle East and elsewhere. From its humble beginnings in Egypt with the founding of Mit Ghamr Savings Bank in 1963, IBF has become the most rapidly developing segment of international financial markets over the last four decades by offering permissible (*halāl*) investments to predominantly Muslim customers and *shari'ah*-compliant businesses.⁴ During the past forty years, IBF saw its greatest expansions during the early 1970s and 2000s with a lag period from 1980 to the late 1990s. These periods of rapid growth were due in large part to the heavy influx of petrodollars to the Middle East which encouraged Islamic investment; conversely, the 1980-1990s were marked by economic

¹ Social Investment Forum, "2007 Report on Socially Responsible Investing Trends in the United States," http://socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf.

² Grant Michelson et al., "Ethical Investment Processes and Outcomes," *Journal of Business Ethics* 52, no. 1 (2004): 1.

³ The studies of Gutner (2000), Bogoslaw (2010), and Schueth (2003) show better than average returns whereas Chang and Witte (2010) show lower levels.

⁴ T.A. Saidi, "Relationship Between Ethical and Islamic Banking Systems and its Business Management Implications," *South African Journal of Business Management* 40, no. 1 (2009): 43.

downturns and bubble bursting.⁵ Wide variance in rates of growth have become characteristic of IBF as an industry. But even so, some contemporary estimates place IBF at nearly \$2.3 trillion in total assets for 2009 with an annual growth rate of fifteen to twenty percent.⁶

From an economics standpoint, this dichotomous performance is troublesome because it seems to place IBF at the mercy of macroeconomic trends such as the balance of trade and petrodollar infusions which are not directly related to IBF activities. Even though some Islamic banks maintain investments in gas and petroleum companies, these investments make up only a small fraction of total IBF assets.⁷ The historical dependence of IBF on outside industries and economic cycles could lead to the conclusion that Islamic banking is simply another economic bubble that will hyper-inflate and soon burst. Without a firm foundation that can withstand economic shocks and accrue deposits not directly tied to oil, IBF may be just a short chapter in the overall SRI movement. It is not contested whether IBF has benefited from SRI trends and large infusions of petrodollars to Middle Eastern countries; it is disputed whether or not it can survive without them.

Therefore, the question becomes whether IBF is an efficient, viable economic alternative to conventional funds or whether it is simply riding on the coattails of the overall SRI movement and macroeconomic expansion. Only through offering investment opportunities that are financially competitive and ethically consistent with the religious beliefs of mainstream Muslims can IBF be classified as a sustainable industry. So, does IBF produce its intended benefits of

⁵ Mahmoud El-Gamal, "Oil, Dollars and Crises: The Global Curse of Black Gold," Islam in the Public Square Lecture Event, Duke Islamic Studies Center, Dansby Classroom, Fuqua School of Business, March 25, 2010(a).

⁶ Isaac John, "Arab Banks' Assets Rise to \$2.26 Trillion in 2009," *Khaleej Times Online*, March 10, 2010, http://www.khaleejtimes.com/DisplayArticleNew.asp?col=§ion=business&xfile=data/business/2010/March/business_March240.xml.

⁷ Rajesh Aggarwal and Tarik Yousef, "Islamic Banks and Investment Financing," *Journal of Money, Credit, and Banking* 32, no. 1 (2000): 94.

competitive returns and ethical investing or does it fall short? This paper seeks to answer this question.

In order to perform this task, three topics must be addressed. First, why has IBF only recently become an internationally recognized economic phenomenon? What factors made the calls for economic reform in Muslim countries so strong that they resulted in the development of Islamic banks and financial institutions? These factors must be addressed in order to understand why IBF developed in the mid-twentieth century as an economic system. Second, what makes IBF different from conventional financing besides the Arabic names of investment vehicles? As a niche market, it has certainly benefited from SRI interests and a reinvigoration of religious awareness amongst Muslims across international borders. Consequently, it is critical to understand the ethical Islamic underpinnings of IBF in order to contextualize its development and ethical validity amongst Muslim investors. Third, how does it perform in contemporary financial markets? In adhering to the ethical mandates of Islam, IBF must also provide strong returns for investors in order to remain economically viable. Through answering these three questions, it becomes clear that IBF is an economically viable form of socially responsible investing.

Historical Development of IBF

As Ahmed El-Ashker and Rodney Wilson observe, “[w]henver Muslims are in a state of despair they turn to their religion for help and assistance.”⁸ From the first fissure in Islam over the caliphate (*fitnah*) to the impact of colonial rule on Muslim nations, calls for religious reform

⁸ Ahmed Abdel-Fattah El-Ashker and Rodney Wilson, *Islamic Economics: A Short History* (Leiden: Koninklijke Brill NV, 2006), 315.

have been ubiquitous in the history of Islam.⁹ Overall, three general types of reform movements have developed in the Middle East as a result of economic or political hardship: traditional, reconciling, and secularized.¹⁰ The traditional movements “call for the return to the Qur’ān and Sunnah in a strict manner” in order to overcome social problems and resist the influence of Western modernization and innovation of *shari‘ah*.¹¹ Examples of these movements are the Wahhābiyyah movement in the Arabian Peninsula during the late eighteenth century, the Idrīsī movement in North Africa during the early nineteenth century, and the Mahdiyyah movement in Sudan during the late nineteenth century. The reconciling movements also call for the return to the Qur’ān and Sunnah but do not object to importing Western culture and knowledge in order to benefit society.¹² Groups such as the Muslim Brothers Society (1928) and Jamaat-i-Islami (1941) were founded under reconciliatory ideologies. Finally, the secularized movements desire to embrace modernity and contend that although Islamic ideals are important, they should be kept at the personal level and not influence governmental affairs.¹³ The Egyptian Taha Husayn is an example of a Muslim reformer who called for a secular approach to modernity.¹⁴ Therefore, it is evident that reform movements have a lengthy history in Muslim countries. But it was not until the advent of Islamic revivalism during the twentieth century that Islamic economics became a focal point of reform.

Islamic revivalism took many forms but can be characterized generally as a renewed emphasis on developing Islamic solutions for social challenges. This approach is certainly not unique to the twentieth century but did come as a response to two major events that occurred

⁹ Ibid., 315-28.

¹⁰ See El-Ashker and Wilson (2006) or Kuran (2004)

¹¹ El-Ashker and Wilson, *Islamic Economics*, 315-9.

¹² Ibid., 315, 319-25.

¹³ Ibid., 315-6.

¹⁴ Ibid., 326-7.

during the mid to the late 1900s. First, the liberation of Muslim countries from colonial rule allowed Muslim leaders to play a larger role in designing and implementing domestic policies.¹⁵ For centuries, Western foreign powers had presided over Middle Eastern governments through colonial rule. In their absence, Muslims were challenged to develop the social, political, and economic systems that would take the place of the colonial governments and policies. It was due to these challenges that many Muslim governments and citizens turned to Islam for solutions.¹⁶ Second, the defeat of the Egyptian, Syrian, and Jordanian armies during the 1967 six-day war with Israel humiliated many Muslims who attributed the defeat to a lack of faith amongst Muslims.¹⁷ The shock of the defeat and loss of the Holy Land created immense popular support for reform and adoption of Islamic ideals in society. So with the social, political, and economic vacuities created by the cessation of colonial rule and the popular support for religious reform following the six-day war, Islamic revivalism began as way to modernize the Middle East and restore national and religious pride amongst Muslims.

Islamic revivalism had four primary features covering religious, social, political, and economic matters. First, the movement was marked with a resurgence of Islamic religious practices that were virtually absent during colonial times. Men of all ages began growing thick beards, women started to wear the veil more often, mosques were more frequented, and the Qur'ān was read more and quoted more often.¹⁸ Muslims began to practice the teachings of Islam with greater zeal and purpose. Second, socio-political organizations began to develop in order to reinforce the teachings of Islam in society. Groups such as the Muslim Brothers reappeared and

¹⁵ Ibid., 328.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid., 329.

others such as the Organization of the Islamic Conference (OIC) were founded.¹⁹ The OIC was specifically designed to strengthen “solidarity and cooperation amongst Islamic states in political, economic, cultural, scientific and social fields.”²⁰ All of these groups strengthened the ties between Muslim nations and allowed Islamic revivalism to influence all corners of society.

Third, this period was marked by intellectual development and establishment of Islamic research centers.²¹ After the termination of colonial rule, Islamic thought was once again allowed to prosper and numerous organizations were established to aid in the process. Many of these institutions focused on ways to encourage social development in Muslim nations through economic and political means. Most notable among them were the International Centre for Research in Islamic Economics (1977), Islamic Research and Training Institute (1981), International Institute of Islamic Thought (1981), and numerous universities in countries such as the United Kingdom, Malaysia, and Pakistan.²² All of these organizations allowed scholars to collaborate and develop Islamic solutions to the challenges of social and institutional development.

Finally, Islamic revivalism impacted Middle Eastern economics through the creation of international economic institutions and the total Islamization of certain Muslim economies.²³ By far, the establishment of the Islamic Development Bank in July 1975 had the most profound effect of promoting the social and economic development of member Muslim nations through *shari‘ah*-compliant methods.²⁴ Even today, this bank continues to finance ventures and grant loans to the 57 member nations of the OIC.²⁵ Some governments decided to completely

¹⁹ Ibid., 329-31.

²⁰ Ibid., 330.

²¹ Ibid., 338-46.

²² Ibid.

²³ Ibid., 331-7.

²⁴ Ibid.

²⁵ Islamic Development Bank, *Annual Report* (Jeddah: IDB, 2008), 3-6.

Islamicize their economies during the Islamic revivalism movement. They include Pakistan, Iran, and Sudan.²⁶ But it was not until February 1976 when the First International Conference on Islamic Economics (FICIE) was held that the study of Islamic economics became nationally and internationally recognized.²⁷ Beforehand, it was perceived as a mere adjunct of Islamic revivalism and not as an independent area of study.²⁸ However, the FICIE brought together Muslim scholars and economists into an open forum to discuss Islamic economics as a system tied to Islamic revivalism but independent as a realm of study. The conference also helped coordinate the development and awareness of Islamic economic literature that served as the foundation of contemporary IBF. Further development of Islamic economic literature came from religiously motivated scholars who supported Islamic revivalism, sponsoring institutions and organizations such as Al-Ahzar Academy in Egypt that offered IBF research opportunities, religious societies that stimulated popular support for *shari'ah*-compliant economic practices, Muslim student organizations that aided in the publication of Islamic economic literature, and dedicated publishing houses that were motivated by religion rather than profit to publish the works.²⁹

Islam has a strong history of reform movements that vary from traditional to secular but are similar in that they all respond to challenges faced by Muslim societies. Islamic revivalism developed during the twentieth century due to the social, political, and economic voids that colonial rule left and the humiliating defeat of Muslim armies during the six-day war. The former required that Muslim nations develop laws and institutions that provided for their citizens and the latter renewed the calls for Islam to be the solution for all societal problems. Furthermore, the

²⁶ See Nomani and Rahnema (1994) or Iqbal and Molyneux (2005).

²⁷ El-Ashker and Wilson, *Islamic Economics*, 349.

²⁸ *Ibid.*, 350.

²⁹ *Ibid.*, 349-55.

heavy influx of petrodollars from 1970 to 1980 and from 2000 onward gave IBF its financial base to build upon.³⁰ In this context, Islamic economics developed as an independent area of study amongst Islamic scholars and economists who designed it as an alternative to other economic systems. But what makes Islamic economics and IBF different from other economic systems and conventional modes of finance? This question must now be addressed.

Moral Tenets of Islamic Banking and Finance

Although IBF has grown rapidly over the last forty years, there remain numerous misunderstandings amongst scholars about the underlying ethics and objectives of banking within an Islamic economy. As a result, many studies subscribe to a positive approach in describing IBF and assume the normative precepts that give IBF its moral sanction.³¹ Usually, these assumptions converge upon a narrow understanding of interest prohibition and equity-like transactions. But while the prohibition of *ribā* is important, other injunctions exist that are equally important to IBF. Without a thorough understanding of these injunctions and the broader goals of an Islamic economy, it is impossible to contextualize the birth of Islamic banking and its subsequent growth in the marketplace.

The objectives of an Islamic economy have been widely discussed by Muslim theologians in the past and into the present day. Most notable amongst the medieval theologians that discussed Islamic economics was the prolific scholar Abu Hamid Al-Ghazālī (1058-1111 A.D.) who wrote extensively about economic and theological matters in his famous book *Ihya-*

³⁰ See El-Gamal (2010a) and (2010b).

³¹ In this context, the adjective “positive” is being used as a contrast to normative economics. Positive economics is the factual, cause-and-effect study of how certain conditions affect economic outcomes (for instance, how an increase in per capita income affects car purchases). However, it merely reports economic conditions and correlations without making any recommendations as to whether certain economic policies are beneficial or should be enacted. Conversely, normative economics incorporates value judgments into economic theory and makes recommendations about what economic policies should be endorsed based on the social value of each policy’s outcome. For more information, see Gaus (2008) or Hausman (2006).

ulum-al-Dīn.³² As S.M. Ghazanfar and Azim Islahi note, “an overriding theme throughout his works is the concept of *maṣlaḥah*, or social welfare or utility (“common good”), a concept which encompasses all human affairs, economic and others, and which establishes close links between the individual and society.”³³ The promotion of the common good is the common denominator of all human activities and is especially important to economic affairs. Contemporary scholars such as Charles Tripp agree with this interpretation and posit that “the ‘public good’ and ‘social benefit/welfare’ (*al-maṣlaḥāt al-ijtima‘iyah*) should become the yardsticks by which social transactions would be judged.”³⁴ In *Ihya-ulum-al-Dīn*, Al-Ghazālī ties economic performance to the welfare of society through pursuing and preserving five basic goals: religion (*dīn*), life (*nafs*), progeny (*nasl*), property (*māl*), and reason (*‘aql*).³⁵ At the most elementary level, an Islamic economy must protect to all of these on the level of necessities through allowing access to basic items such as food, clothing, and shelter.³⁶ Without such rights, Muslim individuals are not given the freedom or ability to seek success (*falāḥ*) in this life or the Hereafter. As Muhammad Siddiqi writes, success is “the end of all human activities” and the purpose of human life on Earth.³⁷ Consequently, Islamic economics must promote the success of the individual in addition to the common good.

However, Al-Ghazālī also defines two additional but not obligatory levels of needs that an Islamic economy should strive to provide. First is the beneficial level which “comprises all activities and things that are not essential to the five foundations, but, rather, are needed to

³² Hamid Hosseini, “Understanding the Market Mechanism before Adam Smith: Economic Thought in Medieval Islam,” *History of Political Economy* 27, no. 3 (1995): 548.

³³ S.M. Ghazanfar and Azim Islahi, “Economic Thought of an Arab Scholastic: Abu Hamid Al-Ghazālī,” *History of Political Economy* 22, no. 2 (1990): 383.

³⁴ Charles Tripp, *Islam and the Moral Economy* (New York: Cambridge University Press, 2006), 70.

³⁵ Ghazanfar and Islahi, “Economic Thought of an Arab Scholar,” 383.

³⁶ *Ibid.*, 384.

³⁷ Muhammad Siddiqi, *Some Aspects of the Islamic Economy* (Delhi: Ishaat-e-Islam Trust Publications, 1972), 30.

remove impediments and difficulties in life.”³⁸ For example, the incorporation of a common currency of exchange purposes falls under this category because it alleviates the difficulties and additional transaction costs associated with a barter system.³⁹ Second is the desirable level that “includes activities and things that go beyond the limits of conveniences; it includes matters that complement, brighten or adorn life.”⁴⁰ For instance, the incorporation of efficient investment institutions into the fabric of society as enhancements of economic exchange falls within this category. These two additional levels are meant to complement the Five Necessities and augment the welfare of society beyond the most basic level. Every Muslim society should aspire to realize the desirable level of Islamic economics once the necessary and beneficial levels are met. In this way, the common good and individual success are maximized. As such, Al-Ghazālī considers economic development to be one of the “divinely ordained, socially obligatory duties (*fard-e-kifaya*)” of Muslims in an Islamic society.⁴¹ Therefore, the goals of Islamic economics are to promote the welfare of society and success of the individual at the highest level possible.

In this context, IBF has developed a way to meet the desirable level of Islamic economics by offering ethical investment opportunities that support the economic and moral progress of Muslim populations.⁴² The contemporary role of banks as financial intermediaries places them at the nexus of connecting both goals of common good and success because they allow Muslims to make permissible investments that benefit themselves and society. Individuals receive both economic and ethical benefits because they are engaging in *shari‘ah*-compliant investments that deliver financial returns; society benefits because of the economic development

³⁸ Anas Zarqa, “Islamic Economics: An Approach to Human Welfare,” in *Studies in Islamic Economics*, ed. Khurshid Ahmad (Leicester: The Islamic Foundation, 1980), 14.

³⁹ Ghazanfar and Islahi, “Economic Thoughts of an Arab Scholastic,” 391-2.

⁴⁰ Anas Zarqa, “Islamic Economics,” 14.

⁴¹ Ghazanfar and Islahi, “Economic Thoughts of an Arab Scholastic,” 384.

⁴² Muhammad Khan, *An Introduction to Islamic Economics* (Islamabad: International Institute of Islamic Thought, 1994), 1-15.

that takes place. Such development is not possible under capitalist or socialist economies due to the egoistic materialism of the former and illegal seizure of property (*ghaṣb*) in the latter.⁴³

Therefore, the Islamic economy is necessary as an alternative to mainstream economic systems in order to promote the common good and individual success.

In order to accomplish these ethical goals, Islamic economics has four primary injunctions: (1) promotion of trade and cooperation, (2) prohibition of *ribā* and of profiting without risk, (3) prohibition of *gharar* and *maysir*, and (4) requirement of charity and altruistic acts. Each of these has many facets and will be discussed in relation to Islamic banking practices. In effect, they provide the background of IBF and the means through which the development of IBF can be appreciated. It is impossible to contextualize the development of IBF without a firm understanding of the ethical foundations that support it. Therefore, the ethical underpinnings and financial implications of each injunction will now be discussed.

Promotion of trade and cooperation. Islam is uniquely explicit in its promotion of trade and commerce for its followers, with some Muslim scholars placing it “on the same footing [as] *jihad*.”⁴⁴ From its birth in the Arabian Peninsula, trade has always been an integral component of Muslim economies and attention is paid to it in the Qur’ān and Sunnah. The Qur’ān contains numerous references to trade (*at-tijārah*) and considers commercial profit and social bounty to be important elements of a Muslim society (Q 2:16, 2:198, 2:275, 22:28, 62:10). Verse 2:198 confirms the legitimacy of commerce by stating that there “is no sin for you that you seek the bounty of your Lord.” However, verse 62:10 goes even further: “when the [Friday congregational] prayer is ended, disperse abroad in the land and seek of Allāh’s grace, and remember Allāh much, that you may be successful.” All Muslims are instructed to be dynamic

⁴³ See Ismail (1989), Gambling and Abdel Karim (1991), Iqbal (2002), or Nomani and Rahnema (1994).

⁴⁴ Hosseini, “Understanding the Market Mechanism before Adam Smith,” 543.

and industrious members of society in order to reap the bounty of Allāh, with resources in the world being viewed as abundant rather than scarce. However, a distinction must be made between the secular definitions for wealth and bounty and the usage of those terms in the Qur’ān and Sunnah.

The most popular version of secular economic theory holds wealth and bounty to be directly related to positive fiscal measurements such as per capita income, gross domestic product, and trade surplus.⁴⁵ Nations are compared using metrics and ratios of abstract terms that give rise to frequent ambiguities given the plethora of computational methods and cultural traditions. Calls have been made to refine the process and include other indicators to improve its statistical significance, but the overall process still lacks transparency.⁴⁶ Conversely, the Islamic conceptualizations of bounty and wealth (*māl*) require that common good and individual success be taken into account in addition to the maximization of certain secular figures. Commerce and monetary gain are important, but only insofar as they conform to Islamic teachings. Unethical economic behavior is condemned in Islam because those “who buy error for guidance and chastisement for forgiveness; how bold they are to challenge the Fire!” (Q 2:175). Injudicious, *ḥarām* (forbidden) activities both ethically invalidate the associated commercial gains and condemn the miscreant participants. Therefore, wealth and bounty are only fully manifest if they are morally justified, with individual profit ideally being subjugated to the social good. Granted, such an absolute criterion adds some complexity and subjectivity to the measurements of wealth and bounty; however, it is a necessary distinction to make in an Islamic economy.

⁴⁵ Debra Straussfogel, “Redefining Development as Humane and Sustainable,” *Annals of the Association of American Geographers* 87, no. 2 (1997): 280-2.

⁴⁶ Willem de Vries, “Meaningful Measures: Indicators on Progress, Progress on Indicators,” *International Statistical Review* 69, no. 2 (2001): 324, 328-9.

In promoting the common good and individual success, the Qur'ān also encourages cooperation and collaboration amongst economic agents. However, due to either carelessness or lack of knowledge, some Muslim groups have been too quick in promoting these ideals and misapply different Qur'ānic verses in the process. One such example is the use of verse 2:148 in justifying inter-Muslim cooperation. This verse states that “everyone has a goal to which he turns [himself], so vie with one another in good works. Wherever you are, Allāh will bring you all together.” The Deen Research Center uses this verse on their online homepage to support their observation that it “is the Qur'an's [sic] message for all individual [sic] on earth to unite... towards achieving a common goal.”⁴⁷ However, this represents a gross misapplication because as Maulana Muhammad Ali notes in his commentary on the Qur'ān, this verse only applies to a “unity of purpose” for all Muslims in attaining and spreading of the good rather than simple economic cooperation.⁴⁸ Life is not a race for material benefits, but rather a unified race to attain the greatest good, social welfare, and individual success.⁴⁹ But in this race, the Qur'ān calls Muslims to pursue different economic goals and even compete with one another in the process, so long as the end results are good works. Therefore, this verse is misapplied in the context of supporting economic cooperation amongst Muslim economic agents. Rather, it supports economic diversification and competition. Consequently, this verse applies to Islam's promotion of trade rather than cooperation.

But verses such as 2:148 do not conflict with others that promote economic cooperation for Muslims. One such verse is 5:2 which calls on Muslims to “help one another in righteousness and piety, and help not one another in sin and aggression, and keep your duty to Allāh. Surely

⁴⁷ Deen Research Center, “Welcome to the Deen Research Center,” <http://deenresearchcenter.com/>

⁴⁸ Maulana Muhammad Ali, *The Holy Qur'ān and Commentary* (Columbus: Ahmadiyya Anjuman Ish'at Islam Lahore, Inc., 2002), 67.

⁴⁹ Ibid.

Allāh is Severe in requiting (evil).” This verse is different from verse 2:148 because it calls for Muslims to cooperate with others in good works rather than compete. Furthermore, Muslims should never conspire in evil works or else they will face the punishment of Allāh. So how can verses 2:148 and 5:2 be harmonized with regard to competition or cooperation? The answer is that both delimit good works as the ultimate results of Muslim interactions.⁵⁰ Whether Muslim economic agents compete or cooperate, the outcome must be good works that support the ideals of an Islamic economy. Competition is advantageous from a social and economic viewpoint because it forces businesses to produce goods at the lowest price and greatest social surplus. Cooperation is beneficial because multiple modes of production must be coordinated in order to obtain the social progress and economic independence of Muslim nations.⁵¹ Therefore, they are both integral to Islamic economics.

However, there is strong evidence of poor economic cooperation between contemporary Muslim nations even with the influence of international development organizations such as the OIC and IDB.⁵² Although numerous authors have argued that high levels of intra-Muslim nation trade are necessary to develop Muslim nation economies and free the countries from Western influences, intra-trade rarely exceeds 25 percent of total exports for OIC member states.⁵³ At these levels, economic diversification is discouraged for Middle Eastern economies because there is no incentive to manufacture capital goods that can easily be imported from abroad. Furthermore, the *ummah* has become progressively more fractionalized and as Carolyn Warner and Manfred Wenner note, many of these divisions lie along ethnic lines.⁵⁴ But in any case,

⁵⁰ Sachiko Murata and William C. Chittick, *The Vision of Islam* (St. Paul: Paragon House, 1994), 151-4.

⁵¹ Muhammad Al-Hashimi, *The Ideal Muslim Society* (Riyadh: International Islamic Publishing House, 2007), 287-330.

⁵² El-Ashker and Wilson, *Islamic Economics*, 381-6.

⁵³ *Ibid.*, 384-5.

⁵⁴ Carolyn Warner and Manfred Wenner, “Religion and the Political Organization of Muslims in Europe,” *Perspectives on Politics* 4, no. 3 (2006): 457-462, 471-3.

cooperation remains an important ideal for Muslim societies and has direct implications for Islamic economics.

The impact of the promotion of trade and multinational collaboration on IBF is vast and enjoin banks to be aggressive pursuers of economic activity with trustworthy associates in morally-sanctioned ventures. Joint-effort is essential and banks are required to take active interests in their ventures. In choosing investment opportunities, it is the bank's responsibility to ensure that its funds are being used in *shari'ah*-compliant methods because the bank and its investors remain morally culpable for any misdeeds or unscrupulous activities that their capital is used for. The moral responsibility for any loaned financial capital does not wholly transfer to the borrower upon the signing of a contract; instead, the providers of capital take part in its ownership and are morally credited with either the good or evil of the venture as well. This explains why Islamic banks must be so vigilant in their investment activities. Not only must the ventures be economically sound, but also morally just. For instance, banks cannot invest in businesses that participate in forbidden activities such as pig farming, alcohol production, or gambling. Such activities clearly violate Qur'anic injunctions, the good of society, and piety of the participating individuals.⁵⁵ The moral and eschatological consequences of unscrupulous enterprise activity are borne equally between the user and supplier of capital because both have ownership in the effort.⁵⁶ Some scholars posit that even ventures that are not forbidden but do not provide for the *needs* of the people should be avoided. This would include industries such as

⁵⁵ Prohibitions on pork: Q 2:173, 5:3, 6:145, 16:115. Prohibitions on alcohol: Q 2:219, 5:90-92. Prohibitions on gambling: Q 2:219, 5:3, 5:90-92.

⁵⁶ The moral risk of contributing capital to a venture cannot be relegated to other entities in IBF because of the ownership that the bank must retain in the exchange. However, some authors such as Ali (2008) have shown that the Islamic Work Ethic (IWE) seems to reinforce mutual commitment and cooperation in projects and make entrepreneurs less likely to engage in nefarious activities because of the social aspect of Islamic economics and exchange.

luxury cars or high-fashion apparel that consume factors of production at the loss of essential industries.

In this regard, Islamic economics can be viewed as needs-based economy instead of demand-driven.⁵⁷ In theory, a needs-based allocation of capital and production of goods is always more efficient in promoting social welfare because necessities are being produced rather than goods that fetch the highest price. For instance, let us assume that a certain factory can only produce two goods: chickens (a staple food) or mascara (a luxury item). Let us also assume that only one good can be produced at any given time and there is an equal demand for each in the marketplace. However, mascara can be sold at a much higher price with lower input costs, thus making it much more profitable. In a secular economy, it would be rational to produce only mascara because it will generate the greatest returns. However, mascara is not a necessity for society by any means; it is much more attune to vanity rather than good hygiene. In such a situation, the Islamic factory would instead choose to produce chicken because it is a staple food and satisfies a need in society, rather than a want. Wants are based on desires and socio-economic stratification; needs reflect the essential requirements of society. Therefore, a needs-based approach to economics is more efficient in promoting the welfare of society than a demand-driven economy. Islamic banks must be socially-responsible institutions that contribute capital to worthy causes in order to benefit itself, its partners, and society as a whole.

Prohibition of *ribā* and of profiting without risk. Unlike secular economics, Islam prohibits profits that are made without effort or risk to the lender. Such returns represent a process of money being made from money, which is unethical given the purpose of money. The first person to write about the nature of money, and still the most quoted, was Aristotle in

⁵⁷ Gillian Rice, "Islamic Ethics and the Implications for Business," *Journal of Business Ethics* 18, no. 1 (1999): 346-7.

Politics. In it, money is described as a means to promote commerce with no inherent value in itself. Accordingly, money is “barren.” For centuries, Muslim scholars have used this understanding of money to justify the moral prohibitions of *ribā* (translated as usury or interest) and profiting without risk.⁵⁸ According to Natalie Schoon, “in the *sharia*’a [sic] framework, money is seen as nothing more than a means to facilitated trade (rather than a store of value).”⁵⁹ If it did have real value, then it would be permissible to profit from it alone. However, “value” must be understood in the Islamic sense rather than in the secular monetary concepts of time preference rate or opportunity cost of capital. Strictly speaking, for an object to have value in Islam, it must be recognized as permissible under *shari’ah*, meaning that it cannot be a prohibited good like pork or wine. Money does not have inherent value because it is only a means of transaction. Consequently, profiting from the exchange of money regardless of elapsed time is prohibited in Islam. In this context, the dual prohibitions of *ribā* and profiting without risk can be elucidated.

As discussed in the previous section, Islam enjoins its followers to promote trade and engage collectively within the marketplace. Islamic banks become active participants in their commercial activities by taking part in the ownership of the underlying asset or venture. With this ownership comes considerable risk of damage, theft, macroeconomic recession, etc. Therefore, a necessary corollary from the requirement of ownership is a prohibition of profiting without risk. Ownership and zero risk cannot coexist, an axiom proven recently by the worldwide economic recession started by the supposed risk-less commodification, insurance, and trading of toxic assets. Furthermore, it is well known that financial and capital markets face many uncertainties and are prone to widespread swings and cycles. As a result, the success or

⁵⁸ S.M. Ghazanfar, “The Economic Thought of Abu Hamid Al-Ghazali and St. Thomas Aquinas: Some Comparative Parallels and Links,” *History of Political Economy* 32, no. 4 (2000): 873-6.

⁵⁹ Natalie Schoon, “Islamic Finance – An Overview,” *European Business Organization Law* 9, no. 1 (2008): 631.

failure of an enterprise often rests as much on the aptitude of the entrepreneur as it does on the cycle of the overall market.⁶⁰ Given the many uncertainties that businesses face, it is unethical to delimit a set return for any participant in a venture that does not bear risk with its outcome. However, this practice is wide-spread in secular economics and has been so for the last five centuries, primarily in the form of interest.⁶¹ Following the Reformation, economics became divorced from religion and its study became a secular endeavor. Contemporary authors such as Scott Meikle even mention with regard to economics and ethics that “what should seem surprising is that they should ever have been thought to be connected.”⁶² However, Islam does not allow the separation between religious and temporal affairs; thus, the prohibition of *ribā* is a critical component of IBF to discuss.⁶³

Roughly translated as usury or interest, *ribā* literally means excess or an increase in Arabic and stems from the root *r-b-w*.⁶⁴ Its precise definition has always been hotly debated and continues to be discussed in academic and religious circles. The liberal side holds that *ribā* is an archaic term used to describe the usurious behavior of pre-Islamic Arabian lenders.⁶⁵ They argue that translating it as contemporary, competitive interest rates would be out of context and erroneous.⁶⁶ On the other hand, the conservative viewpoint is that *ribā* is a ban on any type of interest or variable increase in the principle of a loan.⁶⁷ This viewpoint requires a strict

⁶⁰ Diego Comin and Mark Gertler, “Medium-Term Business Cycles,” *The American Economy Review* 96, no. 3 (2006): 523-4, 549-550.

⁶¹ Siddieq Noorzoy, “Islamic Laws on Ribā (Interest) and Their Economic Implications,” *International Journal of Middle East Studies* 14, no. 1 (1982): 8-9.

⁶² Scott Meilke, “Aristotle on Money,” *Phronesis* 39, no. 1 (1994): 44.

⁶³ Trevor Gambling and Rifaat Abdel Karim, *Business and Accounting Ethics in Islam* (New York: Mansell, 1991), 28.

⁶⁴ Aly Khorshid, *Islamic Insurance: A Modern Approach to Islamic Banking* (London: RoutledgeCurzon, 2004), 31-3.

⁶⁵ Muhammad Iqbal, “A Broader Definition of Ribā,” *Pakistan Institute for Development Economics*, June 2006, [http://www.pide.org.pk/pdf/psde 18AGM/A Broader Definition Of Ribā.pdf](http://www.pide.org.pk/pdf/psde%2018AGM/A%20Broader%20Definition%20Of%20Ribā.pdf).

⁶⁶ See Kuran (1995, 2004, 2007), Kula (2008), or Tripp (2006).

⁶⁷ See Ismail (1989) or Siddiqi (1972, 1988).

interpretation of the Qur'an and Sunnah with no room for innovation.⁶⁸ As Ahmed El-Ashker and Rodney Wilson note, “[i]nnovation in religious rules...is not permissible and is regarded as *bid'ah*, and every *bid'ah* is *dhalalah* (misguidance), and every *dhalalah* is Hell Fire.”⁶⁹

However, both sides can agree upon the well-documented past of *ribā* in pre-Islamic times (*al-Jahiliyah*) which is necessary in contextualizing the overall debate and ethics of *ribā* prohibition.

Before the time of Muhammad, moneylenders were infamous in their usurious practices and often caused the financial ruin of their debtors. During this time, two primary forms of *ribā* were practiced: debt usury (*ribā al-duyūn*) and trade usury (*ribā al-buyū'*). In debt usury, money was generally borrowed by families for survival reasons due to the death or impairment of the family breadwinner.⁷⁰ If the debtor was unable to repay the loan for any reason, both the interest and payment period were doubled. For instance, if a man borrows 20 pounds of barley and fails to return it in a predetermined amount of time (say one year), he would be required to return 40 pounds of barley to the creditor at the end of next year. Or, if 100 dinars is borrowed in year one and not returned in time, it would double to 200 in year two, 400 in year three, and 800 in year four. As Neş'et Çağatay describes, it was the “pre-Islamic usury based on doubling and redoubling of interest that had prepared ground for the financial collapse of families.”⁷¹ The loans soon became impossible to repay and the creditors used the outstanding balances to force their debtors to sell whatever assets they still possessed, including their homes, date farms, and anything else of value. As a result, pre-Islamic lenders became extremely rich and powerful. In

⁶⁸ Muhammad Ismail, *Critical Analysis of Capitalism, Socialism, and Islamic Economic Order* (Lahore: Oriental Publications, 1989), 317-337.

⁶⁹ El-Ashker and Wilson, *Islamic Economics*, 315.

⁷⁰ Timur Kuran, *Islam and Mammon* (Princeton: Princeton University Press, 2004), 1-38.

⁷¹ Neş'et Çağatay, “Ribā and Interest Concept and Banking in the Ottoman Empire,” *Studia Islamica* 32, no. 1 (1970), 56.

contemporary economic terms, such loans are best described as consumption loans because rarely were they used for anything other than subsistence.⁷²

Trade usury was similar to debt usury in its practice of doubling and redoubling of debt; it only differs in its subject matter.⁷³ Whereas debt usury caused the financial ruin of families in need of necessities, trade usury had the same effect on traders who lacked the financial capital to sustain their business. Goods had to be bought well before their sale dates and the principle had to be repaid regardless of the outcome of the venture. Without prompt repayment, the loan was once again doubled and traders were swept into a cycle of ever-increasing debt. But even with its detrimental social consequences, trade usury was widely used as a means of trade finance in pre-Islamic Arabia and resulted with trade becoming synonymous with *ribā*.⁷⁴

From an ethical point of view, pre-Islamic lending practices were iniquitous for a number of reasons. First, *ribā* represented the transfer of money from the poor to the rich. Only the richest members of society had the financial capital available to lend to others. As a result, the practice of *ribā* only increased the socio-economic stratification of society and left the less-affluent in a hopeless predicament. Second, it guaranteed financial returns without any risk or effort on behalf of the creditor. As already discussed, this represented an unjust means of wealth accumulation because of the unfair treatment of the debtor. Finally, it was injurious to society at large because the rich were allowed to prosper through the sweat, blood, and tears of the poor without any commitment or concern over their ventures. Nothing can be more reproachable than taking advantage of the weak in order to benefit the strong, whether in the early days of Islam or in modern era.

⁷² Tripp, *Islam and the Moral Economy*, 126-7.

⁷³ Sa'idu Sulaiman and Bashir Galadanci, *Islamic Banking and Finance: General Framework and Case Studies* (Kano: International Institute of Islamic Thought, 2003), 4-24.

⁷⁴ Q 2:275.

Therefore, *ribā* was prohibited under Islam because it was detrimental to social and individual welfare. The Qur’ān commands pious Muslims to “devour not *ribā*, doubling and redoubling, and keep your duty to Allāh, that you may be successful.” (Q 3:130). This is an obvious reference to the practices of debt and trade usury from the Age of Ignorance.

Additionally, it promises a harsh punishment and “painful chastisement” for those who do not respect this prohibition (Q 4:161). However, many of Muhammad’s companions were confused by this prohibition because *ribā* had become synonymous with trade.⁷⁵ If this relationship were true, this would have completely contradicted Islam’s promotion of commerce. Furthermore, an abolition of trade would inevitably cause the social and economic disintegration of the early Muslim society. However, this quandary was clarified by verses Q 2:275-278:

Those who swallow *ribā* cannot arise except as he arises whom the devil prostrates by [his] touch. That is because they say, Trading is only like usury. And Allāh has allowed trading and forbidden *ribā*. To whomsoever then the admonition has come from his Lord, and he desists, he shall have what has already passed. And his affair is in the hands of Allāh. And whoever returns [to *ribā*] — these are the companions of the Fire: therein they will abide. Allāh will blot out *ribā*, and He causes charity [*ṣadaqāt*] to prosper. And Allāh loves not any ungrateful sinner. O you who believe, keep your duty to Allāh and relinquish what remains [due] from *ribā*, if you are believers. But if you do [it] not, then be apprised of war from Allāh and His Messenger and if you repent, then you shall have your capital. Wrong not, and you shall not be wronged.

Verses Q 2:275-278 elucidate several important aspects of Islamic economics. First, trade is permitted and encouraged for Muslims to engage in. This reinforces the earlier section on Islam and commerce. Second, *ribā* is separate from trade and explicitly damned. Although trade usury had become equitable with commerce before Muhammad’s revelations, Allāh firmly and unquestionably separated them in Q 2:275. The other component of charitable acts (*ṣadaqāt*) will be discussed in the subsequent section of this paper on charity and altruistic acts. However, the

⁷⁵ Q 2:275.

presence of this verse illustrates the ubiquity of *ribā* as a pre-Islamic Arabian practice. Even so, the Companions of Muhammad required further clarification in order to understand the exact definition of *ribā* that the Qur'ān prohibited. Therefore, they asked Muhammad for an explanation.⁷⁶

According to the reported *aḥādīth* of Muhammad, there are two types of *ribā*: barter *ribā* (*ribā al-fadl*) and credit *ribā* (*ribā al-nasia*). Barter *ribā* is best understood as an increase in payment from one actor to another in the spot market. The *aḥādīth* compilations of Al-Bukhārī and Muslim record that Abu Saeed Khuzri, Umar Ibnul Khattab, Abu Baker and others heard Muhammad saying:

Exchange of gold with gold is *ribā* unless it is done on the spot in equal quantities; exchange of silver with silver is *ribā* unless it is done on the spot in equal quantities; exchange of wheat with wheat is *ribā* unless it is done on the spot in equal quantities; exchange of dates with dates is *ribā* unless it is done on the spot in equal quantities; exchange of salt with salt is *ribā* unless it is done on the spot in equal quantities.⁷⁷

Spot market transactions of the same substance between participants must be in equal amounts according to this *ḥadīth* and numerous others. However, debate soon developed over whether this saying applies only to the explicitly-mentioned goods or if they are symbolic for others.⁷⁸ Gold and silver are generally taken to mean any type of currency since they were generally used during the time of Muhammad as such.⁷⁹ But interpretations of the other four goods varies from *ribā* applying only to them, only to staple foods, or to any good that can be traded in the spot market.⁸⁰ Furthermore, there exist some different wordings between the collections of *aḥādīth*

⁷⁶ Neş'et Çağatay, "Ribā and Interest Concept and Banking in the Ottoman Empire," 55.

⁷⁷ Muhammad ibn Ismail Al-Bukhārī, *Sahīh Al-Bukhārī*, trans. Muhammad Khan (Riyadh: Maktaba Dar-us-Salam, 1996), 477.

⁷⁸ Çağatay, "Ribā and Interest Concept and Banking in the Ottoman Empire," 59-64.

⁷⁹ Noorzoy, "Islamic Laws on Ribā (Interest) and Their Economic Implications," 15.

⁸⁰ El-Ashker and Wilson, *Islamic Economics*, 50-5.

regarding *ribā*.⁸¹ The existence of various, somewhat unclear *aḥādīth* continue to fuel the debate over what the exact definition of barter *ribā* is.

Credit *ribā*, also known time-delayed *ribā*, involves a loan to a debtor that is collected in the future with interest on the principle. Al-Bukhārī and Muslim also report that “there is no *ribā* except in transactions involving credit.”⁸² This saying comes almost immediately after the preceding quotation from the two compilers of *aḥādīth* and is similar but different to barter *ribā*. Instead of prohibiting the unequal exchange of goods in the spot market, it prohibits the practice of increasing the nominal rate of a loan that is due in the future. However, few reliable *aḥādīth* exist on credit *ribā* and it remains up the interpretation of the scholar to amalgamate it with barter *ribā*.⁸³ This is because soon after Muhammad revealed the most powerful and important verses on *ribā* (Q 2:275-278), he passed away in Medina.⁸⁴ As Al-Bukhārī records ‘Umar ibn al-Hattab as saying, “the last verse revealed to the Prophet was on *ribā* and he died before we could question him on the subject,” but the historicity of these *aḥādīth* remain open to question.⁸⁵ Therefore, the debate continues about what the exact definitions of barter and credit *ribā* are. It is commonly accepted that the historical practices of barter and credit *ribā* are prohibited; however, contemporary scholars continue to diverge on barter and credit *ribā*, especially given the development and subsequent pervasiveness of competitive capital interest rates in the past century.

The conservative interpretations of barter and credit *ribā* converge to a total prohibition of interest for any type of exchange. Muhammad Ismail argues that all credit transactions should

⁸¹ Çağatay, “Ribā and Interest Concept and Banking in the Ottoman Empire,” 55-60.

⁸² Ibid., 55.

⁸³ Noorzoy, “Islamic Laws on Riba (Interest) and Their Economic Implications,” 13.

⁸⁴ Çağatay, “Ribā and Interest Concept and Banking in the Ottoman Empire,” 55.

⁸⁵ Al-Bukhārī, *Sahīh Al-Bukhārī*, 696.

be prohibited in Muslim nations and exchange should be made only in the spot market.⁸⁶ Charles Tripp highlights the repugnant features of charging interest on capital that many Muslim scholars agree upon.⁸⁷ First, there is the assumption that loans are only sought when people are in need. Therefore, any profits made on the misfortune of others are immoral. Second, interest-bearing loans place undue risk on the debtor and allow the creditor to make a profit regardless of the venture's outcome. This arrangement can be unjust to either the debtor or the lender under different conditions.⁸⁸ For instance, in the event of total business failure, it is unfair to require the debtor to pay back the principle and interest on the capital loan. Ideally, the IBF creditor should be in a partnership with the debtor and fully vested in the venture's outcome. Unless the failure of the venture is due to neglect or immoral behavior on behalf of the debtor, he should not be required to repay the loan given the economic misfortune of his business. On the other hand, the charging of interest can be unfair to the bank in the event of an extremely successful venture. As partners in the project, they should be due the full proportion of the profits. According to the conservative Muslim scholars, the only possible case in which the charging of interest is not unjust is when the interest rate exactly equals the portion of profits that the bank is due. However, this is highly unlikely and cannot be known in advance. Otherwise, the charging of interest can be unjust either to the entrepreneur or the bank itself. Finally, there is the classical aversion to the Aristotelian proscription of making money with money.⁸⁹ If money is only meant as a means of exchange without any inherent value, why would it be fair to make money from nothing? Charging interest does not promote cooperation or economic justice, according to the conservative viewpoint.

⁸⁶ Ismail, *Critical Analysis of Capitalism, Socialism, and Islamic Economic Order*, 356-91.

⁸⁷ Tripp, *Islam and the Moral Economy*, 131-3.

⁸⁸ Schoon, "Islamic Finance," 630.

⁸⁹ *Ibid.*, 628.

Conversely, the liberal interpretation of the prohibition of *ribā* differentiates the pre-Islamic practice of the doubling and redoubling of loans from the contemporary, competitive rates of interest that are charged for capital loans. Although this was a minority viewpoint during the early and middle ages of Islamic development, recent decades have witnessed the development of a vociferous contingency of Muslim and secular scholars who argue that a total prohibition of interest is both un-Islamic and detrimental to the social and economic development of Muslim nations.⁹⁰ Their arguments are vast and diverse, but can generally be condensed into three main points. First, Timur Kuran goes to great lengths in order to show that only consumption loans given to needy people with excessive interest rates are against Islamic principles.⁹¹ This differs markedly from contemporary capital loans that are used by businesses to expand become more efficient, thereby benefiting in the process. Furthermore, the literalist interpretation of the Qur'ānic prohibition on the “doubling and redoubling” of interest and principle simply is not economically possible under modern-day, competitive interest rates. For instance, interest rates in the United States for home mortgages and student loans in 2008 were around five percent.⁹² With a 2008 inflation rate of 3.8 percent, this brings the real interest rate down to 1.2 percent annually.⁹³ Therefore, by this metric it would take nearly sixty years to double the principal on the loan. Even with a high interest rate of ten percent available to consumers with any credit score, it would still take over ten years for the principal to double. This is much different from the aforementioned pre-Islamic Arabian practice of doubling the loan and interest annually. Only the usurious practices of the ancient barter and credit *ribā*, especially on consumption loans, should be prohibited according to this reading of Q 1:130.

⁹⁰ See Kuran (1995, 2005, 2007), Kula (2008), or Noorzoy (1982).

⁹¹ See Kuran (1995, 2004, or 2007).

⁹² CNNMoney.com, “Loan Center,” http://money.cnn.com/pf/loan_center/index.html.

⁹³ US Inflation Calculator, “Current Inflation Rates: 2000-2010,” <http://www.usinflationcalculator.com/inflation/current-inflation-rates/>.

Second, Siddieq Noorzoy points out that barter and credit *ribā* are contradictory in economic terms because whereas the former describes real value, the latter describes nominal value.⁹⁴ This becomes a problem when the economic conditions of inflation or deflation are present.⁹⁵ For instance, the real purchasing power of a loan for \$1000 in year one with a ten percent inflation rate decreases to \$900 in real value in year two. To avoid committing barter *ribā*, only the nominal value of the loan (\$1000) should be repaid at year two. This decreases the real purchasing power of the creditor by \$100. However, the avoidance of credit *ribā* would require that the real value of the loan be repaid, in this case being \$1100. Under deflationary conditions, the opposite would be true. Barter *ribā* would still stipulate a payment of \$1000 and thereby entail an increase in the purchasing power of the creditor. Assuming a deflationary rate of ten percent, a payment of \$900 would be necessary to avoid credit *ribā*. This contradiction is important because both cannot be complementary under either inflationary or deflationary conditions. Only when the value of money maintains its current value in the future under zero-inflationary conditions are the interpretations of barter and credit usury in harmony. Muhammad Ismail argues that the focus should be on stabilizing monetary values rather than harmonizing the two forms of *ribā* prohibition because solving the former would resolve the latter.⁹⁶ In the process, this would theoretically solve the dichotomy. However, the proposed solutions of going back to a precious metal-supported currency and maintaining a spot market in international trade is too idealistic and not practical for contemporary Muslim nations. Therefore, the contradiction between barter and credit *ribā* on loans remains a relevant critique of the conservative interpretation of *ribā*.

⁹⁴ Noorzoy, "Islamic Laws on Ribā (Interest) and Their Economic Implications," 10-3.

⁹⁵ Ibid., 12-3.

⁹⁶ Ismail, *Critical Analysis of Capitalism, Socialism, and Islamic Economic Order*, 338-50.

Third, Erhan Kula shows that contemporary interest rate theory is not necessarily un-Islamic in its underlying principles.⁹⁷ On one hand, interest-bearing loans are not risk-less in nature because of the chances of delayed payment or total default. The current home mortgage crisis in the U.S. is evidence of this because of the many defaults on loans and foreclosures on homes that cannot be resold at reasonable prices in the secondary markets. Foreclosures rose by sixty percent in February 2008 alone and continue to plague banks as toxic, illiquid assets.⁹⁸ Additionally, the components of the time preference rate of interest are compatible with Islamic principles except for its assumption that consumers are impatient.⁹⁹ The Qur'ān promotes patience and scolds impatience (Q 16:1, 19:84, 46:35, 70:19). However, pure time impatience is also loathed by secular philosophers as well.¹⁰⁰ Therefore, other than the mutually-detested impatience component of time preference rate of interest, there is nothing un-Islamic about this theory of interest.

In studying the economic implications of Islam's prohibitions of profiting without risk and *ribā*, it is necessary to take either a conservative or liberal interpretation of *ribā* into account because the two are mutually exclusive. In its current form, Islamic banking and finance defines *ribā* as any form of interest on any type of loan. Therefore, this paper will also use this mainstream definition as its operational meaning because only in this manner will the subsequent sections on Islamic investment vehicles and the positive performance of IBF be relevant. But as a note, this distinction is made only to contextualize the current form of IBF and does not assign a greater ethical value to the conservative interpretation over the liberal stance.

⁹⁷ Erhan Kula, "Is Contemporary Interest Rate in Conflict with Islamic Ethics?" *KYKLOS* 61, no. 1 (2008): 57-9.

⁹⁸ Ben Rooney, CNNMoney.com, "Foreclosures Up 60% in February," http://money.cnn.com/2008/03/13/real_estate/foreclosures_feb/index.htm.

⁹⁹ Kula, "Is Contemporary Interest Rate in Conflict with Islamic Ethics?" 57-60.

¹⁰⁰ See Rawls (1972).

From an ethical standpoint, the prohibition on profiting without risk requires banks to utilize investment vehicles that have variable returns according to the outcome of the investment.¹⁰¹ This is accomplished primarily through profit-and-loss sharing agreements (PLS). Rental agreements are also permissible because there is no prohibition on profiting from charging rent in the Qur'ān or Sunnah so long as the bank maintains ownership of the underlying asset.¹⁰² PLS contracts are partnership-like agreements in which the bank assumes a proportion of the profits or losses of the venture. This is completely in accordance with the aforementioned promotion of cooperation between Muslim agents and requires the bank to take an active interest in the performance of the enterprise. Some theorize that this aspect of PLS loans promotes an efficient allocation of capital because money is lent only to business ventures that have the most promise, rather than to entrepreneurs who have the most creditworthiness.¹⁰³ However, this has yet to be proven in any comprehensive studies. Rather, such a practice can theoretically result in inefficient capital allocations because of the high forecasted returns and profitability rates that potential business projects must meet in order to gain funding.¹⁰⁴ Logically, all banks are only willing to supply credit to enterprises that will earn returns. But because the bank's assets and income are tied to the exact investment outcomes in IBF, the threshold that prospective ventures must meet is even higher than in conventional banking. This has the effect of promoting investment in only the industries with the highest rates of return (such as information technology) at the expense of investment in more socially important sectors (such as agriculture, water treatment, and infrastructure).¹⁰⁵ Of course, this is also true of conventional lending

¹⁰¹ Aggarwal, "Islamic Banks and Investment Financing," 95-9.

¹⁰² I'jāz Ahmad Samadani, *Leasing (Ijārah) Process in Islamic Banking System* (Karachi: Darul Ishaat, 2008), 12, 30-2.

¹⁰³ See Iqbal (2002) or Sulaiman and Galadanci (2003).

¹⁰⁴ S. Ramachandran, "Banking Regulations and Islamic Finance," *Economic and Political Weekly* 24, nos. 51&52 (1989): 2836-7.

¹⁰⁵ Kuran, *Islam and Mammon*, 125-30.

practices. The only factor that can distinguish IBF from conventional banking in this case is that the needs-based aspect of Islamic economics diverges from the secular demand-driven economic structure. In an ideal needs-based economy, only the ventures that have the greatest social value will be produced, assuming that social values can be empirically known. In an Islamic economic system, the social value of goods and services could be assigned given their promotion of the common good and individual success at the necessary, beneficial, and desirable levels. But even this is qualitative at best. However, there are no practical economic incentives to promote this type of investment behavior and banks are loathe to adopt it because such a move will affect their bottom lines and competitiveness. Combining ethical injunctions with economic incentives remains a recurring problem in this situation.

Rent-based contracts are a legitimate form of business because there is nothing in the Qur'ān or Sunnah that prohibits the collecting of rent for a profit. Under these contracts, the bank purchases an asset and rents its usufruct to a customer while still retaining its ownership. The bank is responsible for all major repairs and damages that might happen to the asset so long as it is not a result of negligence on behalf of the renter.¹⁰⁶ Rent-like agreements have a long history in Islamic economics and are recently well-documented in Yemen during the nineteenth and early-twentieth centuries.¹⁰⁷ These agreements are similar to conventional leasing contracts and will be covered in greater detail in the *gharar* and *maysir* section of this paper.

The ban on *ribā* as any form of interest has obvious economic implications because the entire conventional banking system is established as an interest-bearing industry. The most important result of the ban on interest is that different investment vehicles must be utilized that garner profit through means other than interest rates. This includes PLS contracts, rental

¹⁰⁶ Samadani, *Leasing (Ijārah) Process in Islamic Banking System*, 13-7.

¹⁰⁷ Linda Boxberger, "Avoiding Ribā: Credit and Custodianship in Nineteenth- and Early-Twentieth Century Hadramawt," *Islamic Law and Society* 5, no. 2 (1998): 196-213.

agreements, and mark-up financing. However, the latter vehicle has not come without its fair share of objections. Whereas PLS contracts and rental agreements are universally accepted as Islamic investment instruments, mark-up financing has been criticized as a “window dressing” for an interest-bearing loan.¹⁰⁸ This is because the additional fee on the loaned capital is usually matched with a benchmark rate of interest in the financial markets, such as the London Interbank Offer Rate (LIBOR).¹⁰⁹ However, the window dressing conclusion is erroneous for three reasons.

First, the additional fee is justified because it compensates the bank for the “deferred delivery and the payment date” that is characteristic of mark-up financing.¹¹⁰ Usually, this type of arrangement is used in trade financing or capital input purchases when the bank must take ownership of the goods receivable and wait to be compensated for them in a later period. An example could be an iron-refining business that cannot purchase its necessary raw iron ore to begin the process of smelting it into the final product. It would not make sense to use a rental or PLS agreement in this example because (1) the ore is being consumed, not rented, and (2) it would be extremely difficult and costly to draw up a PLS contract that proportions profits and losses according to the outcome of the particular shipment of iron ore. There are many inputs in the process of iron refining and accounting methods make it extremely complex to assign a level of profit or loss according to a set amount of capital input. Therefore, because the customer needs financing and the PLS and rental agreements are ineffectual in this instance, mark-up financing by charging an additional fee on the loan is both ethical and more efficient. It is more efficient because there are no better Islamic options and it is ethical because the bank bears risk by owning the asset for a set period of time without the incorporation of an interest-based penalty for late payment.

¹⁰⁸ Delwin Roy, “Islamic Banking,” *Middle Eastern Studies* 27, no. 3 (1991): 436-7.

¹⁰⁹ See El Gamal (2006) or Samadani (2008).

¹¹⁰ Schoon, “Islamic Finance,” 633.

The second reason for why the “window dressing” critique is unfounded is because even though the mark-up is nominally similar to an interest-rate profit, this does not in itself make the mark-up a form of interest. Rather, this is merely an economics-based phenomenon since the Islamic banks are generally competing with conventional banks for customers. If the additional fee is more than the interest rate, then customers would likely purchase their assets through conventional banks instead. Of course, some Muslim investors might choose to do business with IBF institutions even if they charge higher rates because they also experience the moral benefit of engaging in permissible activities instead of ones that are forbidden. In economic terms, this benefit factors into their preferences for loan consumption; however, it is unclear as to how much it affects their preferences and subsequent indifference curves.

In theory, the relationship between moral benefits, financial returns, and preferences for loan consumption is testable and even quantifiable. To assign an economic value to the moral benefits of permissible investing, a study can be conducted that measures the proportion of Muslim customers that discontinue business with an IBF institution due to increases in the mark-up rate compared to a benchmark interest rate. If a high proportion of customers leave due to a small increase in the mark-up fee, this would suggest that they do not place a high value on the moral benefits of permissible loans. Conversely, if many customers continue to conduct business with an IBF institution even though the mark-up fee increases sharply, this suggests that they place a high value on the moral benefits of permissible investing. But few scholarly papers have addressed this relationship in detail.

How much IBF institutions can charge its Muslim customers in relation to conventional banking is dependent on how strong the customers’ preferences are for interest-free banking. Most studies suggest that the demand curve for Islamic banking is not completely inelastic, even

amongst Muslim customers.¹¹¹ And it must also be considered that Islamic banks are not only trying to amass funds from Muslim individuals and *shari'ah*-compliant businesses, but from other demographics as well. Unless potential customers have funds that are derived from forbidden activities, Islamic banks compete furiously for their deposits and business. Charging more for services would affect these customers the most because their demand curves are even more elastic than Muslim customers at the margin. Therefore, competition is what forces Islamic banks to charge similar nominal fees as conventional banks, not the particular investment structures.

Finally, the window-dressing argument also posits that debt-like financings simply put form over substance in investing activities. That is, the form of such financings is different from conventional banking but the substance is not. Therefore, they are no different than their conventional banking counterparts.¹¹² From a strict, positive economic point of view, this may be true because the cost of loans is the same to customers under either circumstance. A \$1000 loan with a five percent interest rate is the same as a \$1000 loan with a \$50 mark-up. However, this viewpoint fails to appreciate that the form of religious activity *determines* its substance. For example, let us assume that there are two slaughter houses operating on the same street of a small town. Let us also assume that they buy their cattle and chickens from the same farm and offer the same products from each. The only difference between the businesses is that one is *shari'ah*-compliant in its slaughtering methods (*dhabīḥah*) and the other is not. Whereas the former business must slaughter the animals in a particular way according to Islamic law, the latter is free to do whatever it deems most efficient. From an Islamic point of view, this small difference is

¹¹¹ Goolam Vahed and Shahia Vawda, "The Viability of Islamic Banking and Finance in a Capitalist Economy: A South African Case Study," *Journal of Muslim Minority Affairs* 28, no. 3 (2008): 464-7.

¹¹² Jane Pollard and Michael Samers, "Islamic Banking and Finance: Postcolonial Political Economy and the Decentring of Economic Geography," *Transactions of the Institute of British Geographers* 32, no. 3 (2007): 325.

what makes the meat of former business permissible and other forbidden. The ethical status of the substance produced (meat) is dependent on the form (pathway) in which it was produced. In a similar fashion, the substance of Islamic investments is dependent on their ethical form.

Whereas conventional banks can use whatever legal means they want to earn a profit, IBF institutions must develop investment vehicles that emulate the relevant Islamic injunctions.

Otherwise, the investments are considered forbidden. Therefore, the critique that Islamic debt-like financings are form over substance is invalidated because form is integral to the substance of Islamic investing.

Prohibition of *gharar* and *maysir*. *Gharar* and *maysir* both relate to types of risk that are banned in business contracts. Although the prohibition of profiting without risk may seem to push Islamic banks toward taking on more risk in their ventures, *gharar* and *maysir* do the exact opposite because they limit the types of risk to which contractual parties can be exposed. *Gharar* is best defined as risk or hazard that can precipitate perilous events.¹¹³ In Islamic economics, *gharar* generally applies to doubtfulness or uncertainty in the terms or consequences of an exchange contract.¹¹⁴ This uncertainty has its roots in the pre-Islamic practice of *‘habal-il-ḥabālā* in which “one would pay the price of a she-camel which was not born yet and would be born by the immediate offspring of an extant she-camel.”¹¹⁵ This practice added risk to trade because it consisted of the selling of a thing that was not yet existent and might not materialize (in the case of *‘habal-il-ḥabālā*, the unborn fetus). Subsequent *ijtihād* on this *ḥadīth* expanded its meaning

¹¹³ Hans Wehr, *A Dictionary of Modern Written Arabic* (Ithica: Spoken Language Services, Inc., 1994), 782.

¹¹⁴ Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (New York: Palgrave Macmillan, 2005), 14-7.

¹¹⁵ Al-Bukhārī, *Sahīh Al-Bukhārī*, 479.

into any uncertainties that are present in a contract.¹¹⁶ The prohibition of *gharar* covers many instances and can be elucidated through a few examples of *gharar* activities:

1. Selling or purchasing a bag of nuts, the type and/or quality of which is unknown.
2. Selling a car that one does not possess.
3. Selling a house without a clear date of sale.
4. Selling the harvest of next year's crop.

This list is not exhaustive and only illustrates a few examples of *gharar*. Islamic contracts must contain all of the relevant characteristics, quantities, delivery dates, and finality. Furthermore, the possession, existence, and price of the good must also be established. However, not all activities involving *gharar* are prohibited. Muslim scholars make the distinction between substantial *gharar* (*gharar fāhish*) and trivial *gharar* (*gharar yaṣīr*). Substantial *gharar* is prohibited because it constitutes uncertainties that are avoidable and would complicate the enforcement of a contract if there is disagreement between the parties. For example, if A drafts a contract to sell horses to B but the breed is not included, conflict could develop if B does not like the horses that A supplies and sues to receive a different type. This instance is avoidable because inclusion of breed in the contract would have cleared it up *ex ante*. On the other hand, trivial *gharar* is allowable if the process of gathering information to resolve unknowns will cause great damage to one of the parties.¹¹⁷ For instance, Munawar Iqbal and Philip Molyneux supply the example of the seller of a house who is asked about the type of foundations that support it.¹¹⁸ As it would take much time and compromise the structural integrity of the building to reveal the foundation, the “lack of knowledge does not violate contracts.”¹¹⁹ The buyer must trust that the seller is telling the truth in cases of trivial *gharar*. Therefore, *gharar* is prohibited insofar as it constitutes a contractual risk that is avoidable through reasonable effort from the relevant parties.

¹¹⁶ Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 14-7.

¹¹⁷ *Ibid.*

¹¹⁸ *Ibid.*, 13-5.

¹¹⁹ *Ibid.*, 14.

Maysir literally describes the “ancient Arabian game of chance” played with headless and featherless arrows for “stakes of slaughtered and quartered camels.”¹²⁰ It was a game of total luck in which there was a good possibility of total loss to a majority of the participants and inordinate rewards to a fortunate few. Usually, it is compared to modern-day constructs such as the lottery or card games. The Qur’ān explicitly prohibits *maysir* in verse 5:90:

O you who believe, intoxicants and games of chance and (sacrificing to) stones set up and (dividing by) arrows are only an uncleanness, the devil’s work; so shun it that you may succeed.

Maysir includes an element of uncertainty similar to *gharar* in that it is avoidable and unnecessary. However, *maysir* is more extreme because it can result in total loss to participants on a game of pure chance. So, as Natalie Schoon points out, “*maysir* has elements of *gharar*, but not every *gharar* is *maysir*.”¹²¹ But cannot it be argued that everything in life contains uncertainties and risks associated with it? Do not all human actions contain some element of risk and therefore gambling that the anticipated outcome will be realized? And if so, would a prohibition of *maysir* relegate all activities as being reprobate? Surely, this is not true. Instead, distinctions must be drawn between the types of risk that humans face. Munawar Iqbal and Philip Molyneux define three types of risk that are present in social and economic dealings: entrepreneurial, natural, and manufactured.¹²² The first two are necessary and unavoidable because the former is tied to social development and the latter to natural causes (i.e. an earthquake). However, risks that are manufactured through games of chance are unnecessary and avoidable. Therefore, it is to this fabricated risk that *maysir* applies.

¹²⁰ Wehr, *A Dictionary of Modern Written Arabic*, 1297.

¹²¹ Schoon, “Islamic Finance,” 630.

¹²² Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 15-9.

The prohibitions of *gharar* and *maysir* have broad implications for contract law and investment vehicles for Islamic banks. First, they reduce the amount of unknowns and asymmetric information in contracts because all of the asset characteristics, payment terms, and timeframe must be included in the contract. There can be no ambiguities and any vague information would render the contract invalid. This is similar to efficient secular economic systems where any risks that are inexpensive enough to circumvent are eliminated. Lower asymmetric information has the direct effect of lessening the transaction costs in an exchange because fewer risks are involved in completing the contract. Furthermore, the asset must be real and in possession of one of the parties to avoid a situation similar to *'ḥabal-il-ḥabālā* and she-camels. This precludes any types of hedging or short selling that have become commonplace in secular investment strategies. The only exception to this rule is in trade financing when neither the bank nor customer is in possession of the good when the contract is drafted. However, Muhammad permitted this practice so long as all of the attributes of the good are clearly delineated in the contract and the contract remains valid only if that exact good is purchased by the bank and then resold to the customer.

Requirement of charity and altruistic acts. It is no surprise that Islam encourages charity from its followers and rewards altruistic individuals in the Hereafter. This is supported by numerous verses in the Qur'ān and is further elaborated upon by the Sunnah of Muhammad.¹²³ In fact, one of the five pillars of Islam is the obligatory alms-giving known as *zakāt*. This early form of Islamic taxation was praised for its redistributive powers and support of socially beneficial activities, but contemporary scholars question whether it is as effective in the modern

¹²³ For instance, verses Q 2:276, 2:280, 12:88, 21:73, 33:35, and 57:18. Not exhaustive.

era.¹²⁴ Even so, *zakāt* remains a religious obligation for all Muslims *shari'ah*-compliant businesses. Furthermore, it is required even in the event of poverty, as illustrated by the following *ḥadīth* narrated by Abu Musa and collected by Al-Bukhārī:

The Prophet said, 'Every Muslim has to give in charity,' The people asked, 'O Allāh's Prophet! If someone has nothing to give, what will he do?' He said, 'He should work with his hands and benefit himself and also give in charity (from what he earns).' The people further asked, 'If he cannot do even that?' He replied, 'He should help the needy who appeal for help.' Then the people asked, 'If he cannot do that?' He replied, 'Then he should perform all that is good [i.e. enjoin *Al-Ma'rūf* (what is known to be good)] and keep away from all that is evil [i.e. disbelief, polytheism, and all that Islam has forbidden] and this will be regarded as charitable deeds.'¹²⁵

Therefore, every Muslim is obliged to be charitable with his wealth, time, and enjoining of good and forbidding of evil, if lacking the former two elements. Alms-giving is not an optional action required of only certain segments of society. Even the poor are obligated give charity by promoting the welfare of society.

The Qur'ān also contains language that is specific to creditors who have made loans to others who become unable to pay it back expediently. Verse Q 2:280 commands that "if (the debtor) is in straitness, let there be postponement till (he is in) ease. And that you remit (it) as alms is better for you, if you only knew." In this case, it is not the obligatory alms-tax that is referenced but rather the optional alms-giving known as *ṣadaqāt*. This optional alms falls outside of the five pillars of Islam but is strongly encouraged for Muslims and *shari'ah*-compliant businesses. As verse Q 2:280 shows, even though optional alms-giving is promoted, postponement of the payment of loans is required from the lender. So long as the debtor is not intentionally trying to delay payment of the debt, *shari'ah*-compliant businesses are required to

¹²⁴ Timur Kuran, "The Economic System in Contemporary Islamic Thought: Interpretation and Assessment," *International Journal of Middle East Studies* 18, no. 2 (1986): 143-9.

¹²⁵ Al-Bukhārī, *Sahīh Al-Bukhārī*, 361.

be lenient and give them extra time. In this sense, Muslims and *shari'ah*-compliant businesses must be altruistic in their economic dealings by giving the obligatory alms-tax and postponing the payment of debt at the lowest level and forgiving debt at the highest.

Charity benefits society and rewards the pious individual. The benefit to society is straightforward because of the transfer of money from rich to poor, enhanced concern for communal well-being, and support of worthy causes.¹²⁶ However, the individual benefit is much more robust and contains both present and eschatological rewards. Charitable deeds purify the benefactor and enhance his spiritual life, with these benefits being immediately realized for the pious Muslim and continued into Judgment Day as well.¹²⁷ In the Hereafter, Allāh increases their portion as shown in verse Q 57:18:

The men who give in charity and the women who give in charity
and set apart for Allāh a goodly portion, it will be doubled for
them, and theirs is a generous reward.

Charity is looked on very favorably and is ultimately attributed to Allāh, the Most Charitable of all. Innumerable verses highlight His generosity, especially with regard to the forgiveness of man's transgressions (Q 2:3, 2:39, 2:254, 2:284, 3:25, 3:180, 5:88, 8:114-5, 13:22, 13:26, 31:20, 42:12, etc.). Therefore, it is no surprise that altruism is required of man as well.

It is clear that Islamic banks must act altruistically while also pursuing a reasonable profit. Verse 2:280 commands that all Muslims should extend the payment periods of loans until the debtor is sufficiently able to pay. Therefore, Islamic banks must also adhere to this mandate. So long as the debtor is not able to make payments due to justifiable causes (i.e. not from gross negligence or unfounded aversion to pay even though there are sufficient funds available), a *shari'ah*-compliant bank must compromise and find a solution that not injurious the debtor. This

¹²⁶ Thierry Kochuyt, "God, Gifts and Poor People: On Charity in Islam," *Social Compass* 56, no. 98 (2009): 99-112.

¹²⁷ *Ibid.*, 102-12.

differs from conventional banks that charge excess fees for delayed payments of debt, usually in the form of higher interest rates. Instead of charging late fees, IBF institutions generally require high levels of collateral and pledges to lessen the risk of loan defaults.¹²⁸ Late fees cannot be charged by IBF institutions for profit and any such collections must be contributed to charity instead.¹²⁹ Additionally, Islamic banks must consider altruistic options first and are encouraged to forgive loans in the most desperate of cases, as explained in Q 2:280. However, an Islamic bank's altruism is not limited to cases of debtor desperation or default. Banks must also perform regular acts of charity including the donation of a 2.5% *zakāt* rate that must be given to a *shari'ah*-sanctioned group or activity.¹³⁰ Therefore, the economic implications of charity for Islamic banks are threefold: (1) preferential treatment of debtors during difficult times, (2) encouragement of loan forgiveness, and (3) regular donation of *zakāt* funds to acceptable ends.

To recapitulate, the Qur'ān and *Sunnah* are explicit in their enjoining of commerce and proscription of forbidden activities. All of the aforementioned injunctions are fundamental to IBF activities and command IBF institutions to be active shareholders in permissible investments with clearly-defined contracts. Furthermore, the institutions must be benevolent entities that serve the greater purpose and needs of society rather than the individual profit of its shareholders. These requirements differentiate IBF from other modes of finance and even from related investment funds found within SRI. With this information in mind, the discussion now turns to the investment strategies that contemporary IBF institutions use to fund their activities,

¹²⁸ Hennie van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (Washington, D.C.: The World Bank, 2008): 126-7.

¹²⁹ John Ferry, "Scrapped by Sukūk," *Risk* 23, no. 1 (2010), 90.

¹³⁰ According to Q 9:60, "*Zakāt* expenditures are only for the poor and for the needy and for those employed to collect [*zakāt*] and for bringing hearts together [for Islam] and for freeing captives [or slaves] and for those in debt and for the cause of Allāh and for the [stranded] traveler – an obligation [imposed] by Allāh. And Allāh is Knowing and Wise."

the mechanisms in place to ensure that the Islamic mandates are observed, the range of motivations for IBF investors, and the historical performance of IBF.

IBF Investment Vehicles

Broadly speaking, IBF investment vehicles can be broken down into three financial classes: equity-based instruments, debt-like transactions, and charitable advances. Equity-based instruments are most closely associated with the profit-and-loss sharing principle discussed earlier and enjoin the banks to become shareholders in the venture. These include *mudārabah* and *mushārahah*. Debt-like transactions, on the other hand, usually involve the purchasing of an asset by the bank and reselling of it back to the debtor at a fixed, mark-up price or renting is usufruct to the customer. These include *ijārah*, *istisna'ā*, *bay' al-salām*, and *murābaḥah*. The final type of instrument is known as *qarḍ al-ḥasan* and is given as an altruistic loan to select customers free of charge or PLS agreement. It can be voluntarily repaid at an undefined time in the future at the original price. Although there is some variance in the exact titles and procedures of IBF investment instruments in different geographies and cultures, they can historically be condensed into the preceding groups and this paper will treat them as such.

Mudārabah. In *mudārabah* contracts, the bank provides all of the capital and the entrepreneur contributes his time and effort to the project.¹³¹ Profits are distributed according to the terms of the contract (for example, the entrepreneur might receive sixty percent of the profits and the bank collects the remainder). In the event of net losses or liquidation, the entrepreneur

¹³¹ Muhammad Imran Ashraf Usmani, *Meezanbank's Guide to Islamic Banking* (Karachi: Darul Ishaat, 2002), 105-13.

loses his contributed time and effort whereas the bank loses the relative share of financial capital. It is most similar to a silent partnership agreement.¹³²

Mushārahah. *Mushārahah* contracts are similar to *mudārahah* agreements in that the bank gives capital to the entrepreneur and shares in the economic returns of the venture. However, the entrepreneur also contributes a share of the capital in addition to his time and effort. Profits are distributed according to the terms of the contract and losses are divided according to the share of capital that each party contributes. But unlike *mudārahah* contracts, these contracts also allow the bank to serve on the board of directors for the business (although banks usually relegate this responsibility). It is most similar to a conventional partnership agreement. Combined with *mudārahah*, equity-like instrument usually comprise less than 15 percent of Islamic banks' assets.¹³³

Murābahah. *murābahah* is a classic trade-financing instrument in which the bank purchases an asset for the customer and resells it to him at a predetermined, cost-plus price. Payment can be made either as a lump sum or in installments. Assets such as business equipment, industrial machinery, and property are purchased in this manner and the bank retains ownership of the asset until the customer makes his final payment. Until then, the bank is required to perform maintenance and major repairs on the asset. Historically, these loans comprise nearly 65 to 90 percent of Islamic banks' balance sheets.¹³⁴

Ijārah. Similar to Western leasing agreements, *ijārah* financing consists of the bank purchasing an asset and renting its usufruct out to the customer. Vehicles are the most common assets included in *ijārah* agreements. Rent for the usufruct of the asset is generally paid either monthly or quarterly and the bank retains ownership of the asset. Ownership is transferable upon

¹³² See Vahed (2008) or Pollard (2007)

¹³³ Ibid.

¹³⁴ Ibid.

completion of the lease and banks are required to perform maintenance and major repairs on the asset while the customer is responsible for its general upkeep.¹³⁵

Istisna'ā. This contract is specific for developed property and consists of the bank purchasing a piece of property and developing it either on its own or through a subcontractor. It is then sold to the customer at a predetermined, mark-up price.¹³⁶

Bay' al-Salām. This is the only type of agreement in which payment can be made in advance by the purchaser and delivery deferred by the supplier. Such a contract might appear to be against the Islamic prohibitions of *gharar* and *maysir*; however, Muhammad allowed this practice during his lifetime so long as the quantity and nature of the assets are clearly defined in the contract along with the price and time and place of delivery. These contracts are generally used to meet the financial capital needs of businesses through advanced purchasing of assets.¹³⁷

Qarḍ al-ḥasan. This is the only purely-charitable form of lending that entails no profit-sharing or mark-up pricing. It is also the only unsecured form lending permitted under *shari'ah*.¹³⁸ By nature, these loans have a negative net present value for banks under inflationary conditions and do not make up a large part of banks' balance sheets. In the 1980s, these loans made up around ten percent of the aggregate IBF loans; however, they witnessed a steady decline from 10.5 percent of total investing in 1984 to only 0.63 percent in 2000.¹³⁹ Today, they make up even less than this.

¹³⁵ Samadani, *Leasing (Ijārah) Process in Islamic Banking System*, 12-20.

¹³⁶ 2008 Annual Report, Dubai Islamic Bank, 12.

¹³⁷ Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 47-9.

¹³⁸ Hans Dieter Seibel, "Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation, and Supervision," *Journal of Social Issues in Southeast Asia* 23, no. 1 (2008): 87

¹³⁹ Aggarwal and Yousef, "Islamic Banks and Investment Financing," 103.

Shari'ah Boards and IBF

The *shari'ah* board is a distinguishing component of Islamic banks and ensures that all of the bank's activities are in compliance with the respective Islamic injunctions. Usually, it consists of three to five Muslim scholars who review the bank's activities and issue a report of its findings to the shareholders as an independent opinion. This report is generally included in the introduction of the IBF institution's annual report. The board is absolutely integral to the ethical standing of IBF because without proper oversight, Islamic banks could turn into mere window dressings for conventional banking.¹⁴⁰ Both form and substance could collapse. As an interface between Islamic ethics and economic activities, *shari'ah* boards play a critical role in maintaining the perceived ethical standing of Islamic economics. They act as the visible enforcers of Islamic mandates and provide informal marketing to Muslim customers that rely on the *shari'ah* board to uphold the ethical underpinnings of Islam.¹⁴¹ Whatever creative finance tools the bank comes up with, it is at the ultimate discretion of the *shari'ah* board for whether they are permissible or not.

At first, this might appear like a conflict of interest because the *shari'ah* board is also paid directly by the bank to examine their activities and determine permissibility. Conventional banks are not exposed to this factor and only have to answer to auditors. However, the dire social and economic outcomes that could result from the discovery of sinful collusion between a bank and *shari'ah* board are enough of a combined disincentive to relegate this possibility. This is because the relationship between IBF institution and customer is based on trust due to the "lack of institutional and regulatory structures" for IBF in many Muslim

¹⁴⁰ Pollard and Samers, "Islamic Banking and Finance," 315.

¹⁴¹ Greuning and Iqbal, *Risk Analysis for Islamic Banks*, 126-7.

countries.¹⁴² If Muslim investors do not trust a certain IBF institution because of a puppet *shari'ah* board or outright fraud, the institution will ultimately fail. The case of the Anatolian holding companies (AHCs) in Turkey is a good example of this. These companies developed during the early 1970s as a people's sector initiative to generate financial returns for small and medium investors.¹⁴³ Due to weak institutional frameworks and multiple failures, the companies lost favor with investors and were nearly defunct by the end of the decade. However, they experienced a reemergence during the 1980s as they became tied to Islamic reforms being made in Turkey following the military coup in 1980. Subsequently, they gained many customers and AHCs such as Jet-Pa grew to over 25,000 depositors in the 1990s.¹⁴⁴

But during the early 2000s, many AHCs were going bankrupt because of managerial corruption and incompetence. Some holding companies “collected savings but invested in nothing” and others stole investor's funds outright.¹⁴⁵ Similar to the 1970 AHC failures, poor oversight due to a lack of institutional and regulatory structures was what ultimately allowed for the many abuses and widespread defrauding of customers.¹⁴⁶ Once the bankruptcy reports surfaced, the public again mistrusted AHCs and immediately tried to withdraw funds from the companies. Even the most successful AHCs such as Ihlas Holding collapsed in the process.¹⁴⁷ Not only did the customers lose faith in the banks and rush to withdraw their funds, but many of them suffered substantial financial losses in the process. Such a situation can also occur with contemporary IBF institutions that do not ascribe to Islamic tenets or conspire with their respective *shari'ah* boards to circumvent them. Any IBF institution that is shown to be

¹⁴² Gül Berna Özcan and Murat Çokgezen, “Limits to Alternative Forms of Capitalization: The Case of Anatolian Holding Companies,” *World Development* 31, no. 12 (2003): 2074.

¹⁴³ *Ibid.*, 2067-9.

¹⁴⁴ *Ibid.*, 2069-74.

¹⁴⁵ *Ibid.*, 2074-5.

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*, 2074.

fraudulent will ultimately lose its customers and go bankrupt in a similar fashion to the AHC case in Turkey. Therefore, the social and economic outcomes that could result from sinful collusion between a bank and *shari'ah* board are enough of a combined incentive to lessen this possibility.

In addition, outside agencies such as the Islamic Fiqh Academy in Jeddah, Saudi Arabia, perform the task of issuing non-binding legal opinions (*fatwāwā*) as to the permissibility of investment practices for all IBF institutions to reference.¹⁴⁸ Usually, the opinions of such groups are adopted by Islamic banks in order to maintain their Islamic image amongst different populations. Customers must trust that their IBF institutions are adhering to the relevant Islamic mandates and the adoption of international Islamic economic legal opinions by the institutions adds an extra level of ethical validity to their transactions. And as customer trust is tied to economic performance, there is an economic incentive for IBF institutions to espouse these legal opinions. This further reduces the risk of IBF fraud and collusion between IBF institution and *shari'ah* board.

In their assessments, *shari'ah* boards look at four different criteria to determine whether the IBF institution is acting according to Islamic principles.¹⁴⁹ First, the contracts, transactions, and dealing of the bank must accord to Islamic principles. Infringements could include the receipt or payment of *ribā*, inclusion of elements of impermissible *maysir* or *gharar* in financial contracts, etcetera. Second, the allocation of profit and losses must be administered according to the ratios approved by the board. For instance, a profit-and-loss sharing contract cannot be participated in that has different ratios for profit and loss sharing (i.e. 70/30 for profits and 60/40 for losses). Third, the board must ensure that all economic ventures of the bank are in *shari'ah*-

¹⁴⁸ Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 105-22.

¹⁴⁹ "Annual Report 2008," Kuwait Finance House, 34.

compliant companies. Earnings cannot be made from pork farming, wine production, or any other forbidden activities. Finally, the board audits the bank's calculation of the obligatory alms tax to make sure that the correct share is given to the needy. In the event of the bank infringing on any of these matters, it is the duty of the *shari'ah* board to report it to the bank's management and shareholders. This is an extra step of protection for Muslim investors because any transgressions committed by the institution with their money are incumbent on them as well. Therefore, the *shari'ah* board is an integral component of IBF because it aids in determining which financial instruments are used by IBF institutions and enforces the relevant Islamic injunctions.

Investor Motivations for IBF

Numerous studies have been conducted to determine the motivations that investors have for choosing IBF over other modes of finance. And even though contemporary IBF developed in the context of Islamic revivalism, it is not purely religious reasons that motivate Muslims to frequent IBF institutions. Alternatively, other studies show why some Muslims choose *not* to invest in IBF even when facilities are present. The paper presented by Gül Özcan and Murat Çokgezen (2003) discussed in the preceding section is a good example of this but other studies exist. From an ethical standpoint, it is important to understand these motivations because they relate to the perception of IBF institutions as ethical entities. From an economic perspective, these motivations are what fuel IBF and define it as a niche market.

Religion does play a large part in motivating Muslims to invest in IBF. Studies by Mokhtar Metwally (1996), Mohammed Almosawi (1998), and H. Şaduman Okumus (2005) list religion as being the primary motivator for IBF investing. On the margin, Islamic institutions are

more pure than their secular counterparts and therefore are the best options for religiously-motivated investors. The sentiments of Islamic revivalism remain strong motivational forces for IBF investment. On the other hand, studies by Cenzig Erol and Radi El-Bdour (1989), Cenzig Erol et. al (1990), and Asyraf Dusuki and Nurdianawati Abdullah (2006) find that investors choose IBF institutions based on their reputations and the services that they provide rather than any perceived moral benefit. Positive reputations of IBF institutions are critical because they reinforce the trust that must exist between the banks and customers. And a plethora of financial services such as online banking and multiple branches are necessary because they allow IBF institutions to compete with conventional banks that are already well-entrenched; without these services, many Muslims choose to conduct business with conventional banks instead.¹⁵⁰ But overall, the majority of studies provide a hybrid account of investor motivations between religious sentiments, banking reputations, services, and financial return.¹⁵¹ Muslim investors have a standing desire for permissible forms of investment but also require that the financial institution provides competitive returns and amenities similar to conventional banking. Additionally, the investors must have faith that the IBF institution is dependable and adheres to the mandates of Islam.

Conversely, there are also explanations for why some Muslims choose not to invest in IBF institutions. The most important reason for lack of IBF investment amongst Muslim populations is a lack of trust between bank and customer. Usually, this mistrust is created through events such as the failure of the Anatolian holding companies described earlier. Sometimes, even rumors of insolvency can cause a run on IBF institutions such as in the case of

¹⁵⁰ Asyraf Wajdi Dusuki and Nurdianawati Irwani Abdullah, "Why Do Malaysian Customers Patronise Islamic Banks?" *International Journal of Bank Marketing* 25, no. 3 (2007): 145-8.

¹⁵¹ See Gerrard and Cunningham (1997), Naser et. al (1999), or Ahmad and Haron (2002).

the al-Rayan Islamic investment company in 1986.¹⁵² Additionally, there remains a persistent lack of knowledge amongst Muslim populations as to the existence of IBF and *shari'ah*-compliant investment vehicles.¹⁵³ One must remember that IBF is only a recent economic phenomenon and it takes time for it to become recognized outside of professional and academic circles. While awareness is rising, popular ignorance remains as a formidable challenge for IBF. Mistrust and lack of awareness cause many Muslims to choose conventional banking over IBF; strong religious desires, positive reputations, comparable financial services, and competitive economic returns have the opposite effect.

Historical Performance of IBF

Islamic banking has witnessed explosive growth over the past forty years and has remained strong even in the face of the global economic recession. However, there is a large degree of variance between different reports of IBF total assets due primarily to dissimilar accounting procedures between Islamic banks and somewhat ambiguous terms used for different financial assets.¹⁵⁴ For instance, some studies placed IBF at nearly \$150 million in 1997 whereas others were more conservative at \$30 million.¹⁵⁵ The methodologies for such studies also vary according to survey samples and treatment of factors such as inflation and currency exchange rates.¹⁵⁶ Nonetheless, there is general agreement between the studies on the high rate of growth

¹⁵² See Springbong (1989) or Kuran (2004).

¹⁵³ See Hamid and Nordin (2000) or Bley and Kuehn (2004).

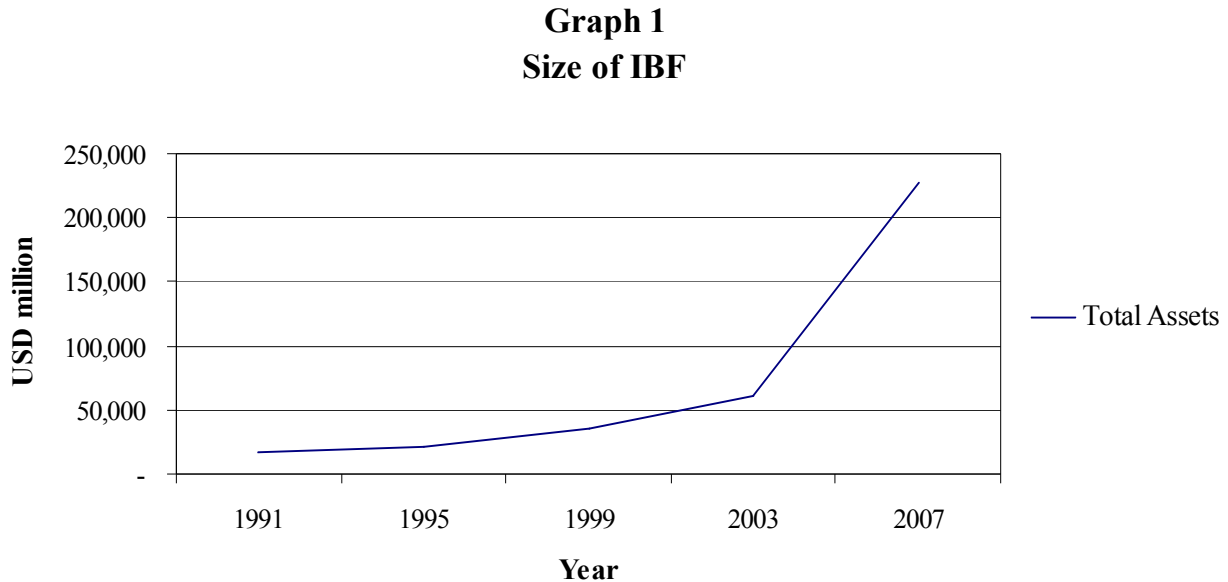
¹⁵⁴ El-Ashker and Wilson, *Islamic Economics*, 402-3.

¹⁵⁵ See Vahed and Vawda (2008) or IBIS (2009).

¹⁵⁶ Donsyah Yudistira, "Efficiency in Islamic Banking: An Empirical Analysis of 18 Banks," <http://129.3.20.41/eps/fin/papers/0406/0406007.pdf>.

that IBF has experienced. Usually, this value is placed between ten and fifteen percent annually.

Below is a graph that shows a conservative estimate of IBF total assets from 1991 to 2007:¹⁵⁷



This information was taken from the Islamic Banks and Financial Institution Information (IBIS) division of the Islamic Research and Training Institute (IRTI) that was mentioned in the historical development section of this paper.¹⁵⁸ Although it gives low estimates of IBF total assets compared to other studies by Goolam Vahed and Shahid Vawda (2008), Paul McNamara (2009), and Isaac John (2010), the graph does illustrate the accelerating rate of growth for IBF during the period. The assets grew from \$16.9 billion in 1991 to \$226.8 billion in 2007, corresponding to an annual growth rate of 77.4 percent. This high percentage is due primarily to the large increase in IBF total assets from \$61.2 billion to \$226.8 billion during the 2003 to 2007 period. As IBF grew larger, it also grew at a faster pace. Therefore, the average growth rate of 77.4 percent for the overall period is skewed because of the 2003 to 2007 results. In any case,

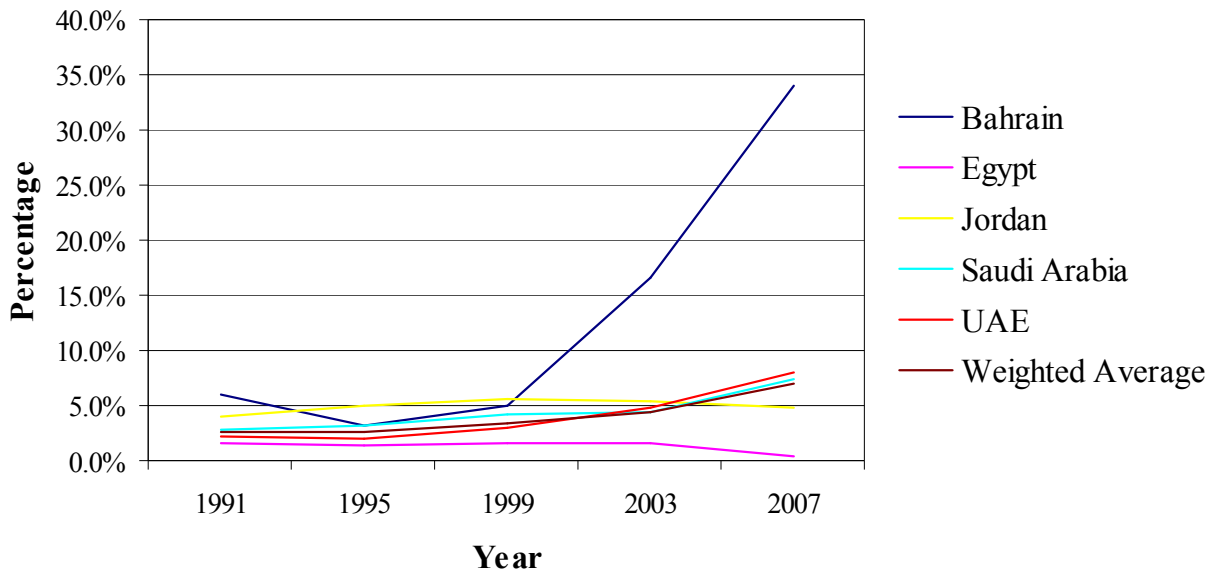
¹⁵⁷ Source: Islamic Banks and Financial Institutions Information System (IBIS), http://www.ibisonline.net/Islamic_Banks/IndustryHighlights.aspx.

¹⁵⁸ See page 7.

this data shows the remarkable growth and economies of scale that IBF has witnessed over the past two decades.

As a result of IBF expansion, the relative market share of IBF has also increased in comparison to conventional banking. The graph on the next page illustrates the growth in IBF market share for select countries in the Middle East where conventional banks are allowed to operate alongside:¹⁵⁹

Graph 2
IBF Market Share in Select Countries

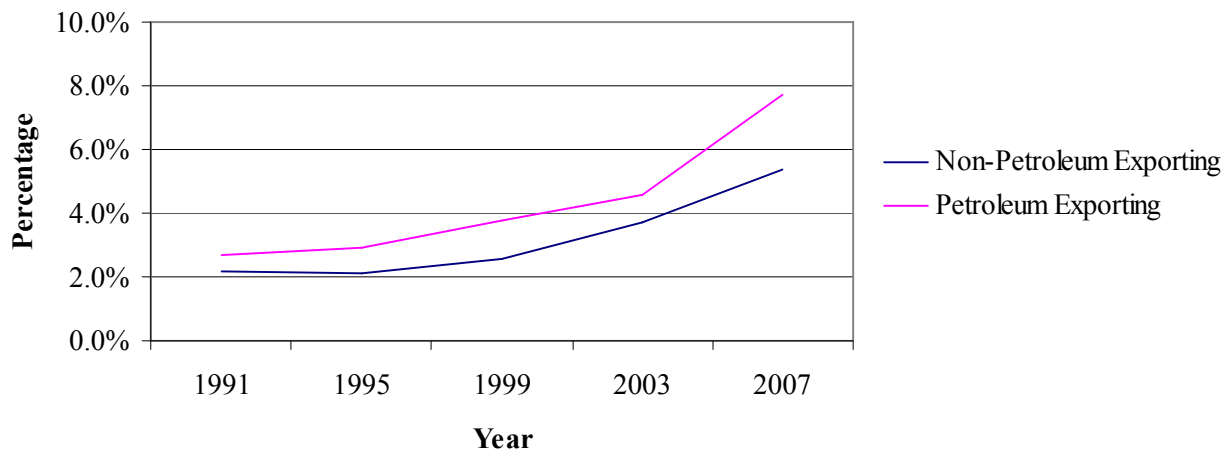


IBF market share increased in all of the surveyed countries except for Egypt over the sixteen year period. The market share in Bahrain increased the most from 5.9 percent in 1991 to 34.1 percent in 2007 whereas it fell from 1.6 percent to 0.5 percent in Egypt over the same period. Overall, the weighted average IBF market share increased steadily from 2.5 percent in 1991 to 7.0 percent in 2007. This increase indicates that IBF has grown at a faster rate than conventional

¹⁵⁹ Source: Islamic Banks and Financial Institutions Information System (IBIS), http://www.ibisonline.net/Islamic_Banks/IndustryHighlights.aspx.

banking over the surveyed period and is true for petroleum-exporting (PE) and non-petroleum-exporting (NPE) countries as well. Bahrain, Egypt, and Jordan are classified as NPE whereas Saudi Arabia and UAE rank amongst the top ten PE nations.¹⁶⁰ However, while it is true that IBF market share is increasing for each type of country, there remains a difference in the aggregate market share of each. The graph below indicates the aggregate market share of IBF according to PE/NPE classification in the surveyed countries:¹⁶¹

Graph 3
IBF Market Share by Country-Type



This graph shows that IBF market share in PE countries is consistently above that of NPE countries for the entire period. The IBF market share for PE countries increased from 2.7 percent in 1991 to 7.7 percent in 2007 whereas it increased from 2.2 percent to only 5.4 percent for NPE countries. This difference indicates that infusions of petrodollars have a significant impact on the investing habits of Muslim populations and is consistent with the historical development of

¹⁶⁰ Central Intelligence Agency, "The World Factbook," <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2173rank.html>.

¹⁶¹ Source: Islamic Banks and Financial Institutions Information System (IBIS), http://www.ibisonline.net/Islamic_Banks/IndustryHighlights.aspx.

IBF.¹⁶² During Islamic revivalism, petrodollar and macroeconomic cycles correlated closely with the oscillations in IBF size, indicating that they were all economically related.¹⁶³ However, both aggregate market shares are growing at similar rates which means that the influx of petrodollars has less influence on IBF growth during the past two decades than it once did. IBF in PE countries is more developed due to its historic dependence on petrodollars, but similar growth rates in NPE countries means that it is moving away from this crutch.

In all, IBF has grown over the last forty years into an industry that few thought would become as large as it is. Using the ethical injunctions from the Qur'ān and Sunnah, business experts and Islamic scholars have worked together to expand IBF and diversify the balance sheets of Islamic banks. Great attention has been paid to isolating the most efficient tools of investment and allocating funds respectively. Therefore, this discussion now turns to the economic performance of IBF in recent years with particular emphasis on the type of investments that are being made and what has been found most profitable. Two conventional banks will also be included in analysis to determine how the Islamic banks are performing in relation to interest-based banking. Using this information, it will then be discussed whether IBF institutions have been successful in earning competitive returns through Islamic modes of finance. Certain trends will also be discussed as they relate to IBF performance.

IBF Performance in Recent Years

Eight financial institutions have been chosen as a survey sample to indicate IBF performance in recent years. Their names and countries of origin are as follows: Rajhi Bank (Saudi Arabia), Faisal Islamic Bank (Egypt), Dubai Islamic Bank (Dubai, U.A.E), Kuwait

¹⁶² El-Gamal, "Oil, Dollars and Crises (2010a)."

¹⁶³ Ibid.

Finance House (Malaysian branch), Arcapita (Bahrain), Al Baraka (Bahrain). These have been chosen as a representative group of contemporary IBF because of their various sizes and locations. Arcapita is the only institution that is financed by share capital whereas the others receive funds primarily through consumer deposits. Al Baraka is a bank holding company with ties to numerous international Islamic banks. The largest IBF institution is Rajhi Bank with \$44 billion in assets and the smallest is Kuwait Finance House with \$2.9 billion. All values have been equalized to 2008 USD values using the Consumer Price Index (CPI) deflator method and the relevant exchange rates.¹⁶⁴ Thus, these values reflect the real purchasing power of U.S. dollars in 2008 terms. Abu Dhabi Commercial Bank (Abu Dhabi, U.A.E.) and Jordan-Kuwait Bank (Jordan) have been included as examples of conventional (interest-based) banks operating in the Middle East for comparison purposes. Even with their large sizes, Iranian banks have been excluded from the survey sample because of their divergent lending practices and concerns over the influence of the Iranian government on banking affairs. Only Sunni banks will be discussed.

The historical performance of IBF shows that it has grown at remarkable rates as a niche market. In 2009, estimates placed total IBF assets between \$1 and \$2.3 trillion with this variance largely due to differences in accounting standards and study methodology.¹⁶⁵ However, no studies reported IBF total assets under \$1 trillion in 2009. Analysis of the latest annual reports from the survey of Islamic banks confirms this trend. On the next page is a table that lists the total assets of the respective institutions:¹⁶⁶

¹⁶⁴ Data compiled from: International Monetary Fund, *International Financial Statistics*, (Washington, D.C.: IMF, 2009), 166-71, 460-7, 706-11, 828-33, 1114-7, 1314-5, 1324-35.

¹⁶⁵ See Arab News (2009), McNamara (2009), or John (2010).

¹⁶⁶ Data compiled by author from annual reports of respective banks. See Appendix I: List of Annual Reports, by Financial Institution for complete listing.

Table 1
Total Assets by Bank, 2005-2008 (USD million)

Bank	Location	2005	2006	2007	2008
Rajhi Bank	Saudi Arabia	29,691	32,161	35,586	43,981
Abu Dhabi Commercial Bank	U.A.E.	18,249	24,792	31,062	40,226
Faisal Islamic Bank	Egypt	23,412	25,635	26,381	23,816
Dubai Islamic Bank	U.A.E.	13,593	19,700	24,671	23,153
Al Baraka Banking Group	Bahrain	6,875	8,149	10,459	10,920
Arcapita ¹⁶⁷	Bahrain	2,033	--	3,939	5,137
Jordan-Kuwait Bank	Jordan	2,557	2,817	3,269	2,909
Kuwait Finance House	Malaysia	152	886	1,934	2,886
Total		96,561	114,141	138,300	153,029

Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

This table shows the remarkable growth that IBF institutions of all sizes have experienced from 2004-2008. In the aggregate, the six IBF institutions grew from \$75.8 billion in 2005 to \$109.9 billion in 2008 at an annual rate of 15.0 percent. The Kuwait Finance House – Malaysia [KFH(M)] grew at the highest annual rate of 600 percent while Faisal Islamic Bank (FIB) grew the slowest at a negligible rate (<0.6 percent). This compares to the conventional banks which experienced dissimilar growth rates. Abu Dhabi Commercial Bank (ADCB) grew at 40.1 percent annually and Jordan-Kuwait Bank (JKB) increased by 4.6 percent annually. All of the Islamic financial institutions except for FIB grew at a faster rate than JKB but only two grew quicker than ADCB (KFH(M) and Arcapita). This comparison is significant because it shows that the surveyed Islamic institutions are growing at rates either surpassing or comparable to the rates of the conventional banks. So by this economic indicator, IBF is performing well.

The growth of IBF institutions of all sizes is evidence that the market for Islamic banks remains receptive to both large and small firms. For large firms such as Rajhi Bank (RB), they are able to observe economies of scale and record increases like RB of nearly \$8.5 billion

¹⁶⁷ Arcapita's assets for 2006-2007 are recorded as an 18-month period that ended June 30, 2007.

between 2007 and 2008. This expansion is significant because few Islamic banks operate with assets of over \$7 billion, yet RB grew by twice this amount from 2007-2008. On the other hand, smaller firms such as Arcapita have increased in size from \$2.0 billion in 2005 to \$5.1 billion in 2008, corresponding to an annual growth rate of 50.9 percent. This has allowed Arcapita to more than double in size over this period. In all, the surveyed Islamic banks have grown at outstanding rates in the last five years and continue to remain strong. But what trends explain this performance?

The growth in the surveyed banks can be attributed to two factors: increased consumer deposits and more efficient lending practices. Consumer deposits are the lifeblood of banks and dictate the types of ventures they can engage in. Small banks are limited by the types of projects they can fund because a lack of adequate liquid capital in their coffers precludes investment in high-cost ventures. And because Islamic banks cannot borrow on interest, it is more difficult for smaller banks to access additional capital given that there are fewer options available.¹⁶⁸ This is especially true for markets where both conventional and IBF institutions are operating concurrently and gives conventional banks an advantage over the latter. Therefore, any increase in consumer deposits increases the investment opportunities of the smaller Islamic banks, allowing them to choose from a larger set of possible ventures before deciding on the one with the highest expected rate of return.

On the other hand, large banks generally have enough liquid assets to be able to finance their larger projects. But investment in such projects renders the capital fixed and illiquid for other ventures and payment of consumer deposit withdrawals. Large banks require vast pools of

¹⁶⁸ Usually, these secondary funding sources include other Islamic banks and international agencies, such as the Islamic Development Bank (IDB). However, both of these are fairly limited in comparison to the options available to conventional banks such as larger conventional banks, open market operations of the central bank, and international agencies such as the International Development Bank (IDB).

money to finance their high-end deals while maintaining the required liquidity at the same time. Like the smaller IBF institutions, they are also under the constraint of not having many options for access to additional capital outside of consumer deposits. Therefore, any increase in consumer deposits has a beneficial effect on Islamic banks irrespective of size by allowing them to choose from a larger choice set of options in selecting the best ones.

The table below details the increases in consumer deposits that the surveyed banks have experienced from 2005-2008:

Table 2
Total Consumers' Deposits by Bank, 2005-2008 (USD million)¹⁶⁹

Bank	Location	2005	2006	2007	2008
Rajhi Bank	Saudi Arabia	21,904	22,441	26,286	31,096
Abu Dhabi Commercial Bank	U.A.E.	10,729	13,268	16,716	22,971
Faisal Islamic Bank	Egypt	21,181	23,370	24,629	21,956
Dubai Islamic Bank	U.A.E.	10,556	14,594	19,060	18,088
Al Baraka Banking Group	Bahrain	5,810	6,569	8,368	8,872
Jordan-Kuwait Bank	Jordan	1,432	1,499	1,771	1,683
Kuwait Finance House	Malaysia	38	467	675	1,291
Total		71,650	82,208	97,506	105,957

Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

In total, the consumers' deposits in the surveyed Islamic banks grew from \$59.5 billion in 2005 to \$81.3 billion in 2008, corresponding to an annual growth rate of 12.2 percent. Once again, KFHM grew at the astounding rate of 1100 percent whereas FIB grew the slowest at 1.2 percent. As for conventional banking, ADCB grew at a respectable 38 percent annual rate whereas JKB only grew at a rate of 5.8 percent. The growth of consumers' deposits in relation to the growth in total assets is significant because although the deposits grew by 12.2 percent

¹⁶⁹ Arcapita funds are excluded because they originate from share capital and five-year syndicated *Murābaḥah* facility.

annually, the total assets increased by 15.0 percent each year. This difference of 2.8 percent reflects the earnings that IBF have been able to make and retain within the bank.

The Islamic banks have clearly been performing well in securing deposits and can this be attributed to two factors. First, Islamic banks have become relatively more efficient and profitable over the course of the last decade. Higher returns on investments through more efficient practices have led to greater returns for investors and consequently, more people and businesses are willing to deposit money in IBF institutions. From an investor-confidence point of view, it is crucial to remember that IBF began only 47 years ago with the founding of Mit Ghamr in Egypt.¹⁷⁰ It takes time for consumers to put faith in revolutionary investment techniques and portfolios; therefore, measurable economic proof that IBF institutions are profitable and competitive is essential for increased customer faith and IBF growth. This will be discussed more in the efficiency section of this paper.

Second is the standing desire amongst Muslim populations for permissible methods of investment. Through Islamic revivalism, the quest for religious piety has become a strong force for social change in recent decades.¹⁷¹ In this context, IBF has received much attention from Muslims even in nations like Australia where Islamic banks must compete alongside conventional banks.¹⁷² However, there does remain a persistent lack of knowledge amongst investing Muslims about the products that IBF institutions offer.¹⁷³ Instead of investigating the underlying practices of Islamic banks, many Muslims simply assume that the investment vehicles are *shari'ah*-compliant either because of their Islamic names or by word of the bank's

¹⁷⁰ El-Ashker and Wilson, *Islamic Economics*, 366-7.

¹⁷¹ Mohammad Nafissi, "Reformation, Islam, and Democracy: Evolutionary and Antievolutionary Reform in Abrahamic Religions," *Comparative Studies of South Asia, Africa and the Middle East* 25, no. 2 (2005): 432-5.

¹⁷² Hussain Rammal and Ralf Zurbruegg, "Awareness of Islamic Banking Products Among Muslims: The Case of Australia," *Journal of Financial Services Marketing* 12, no. 1 (2007): 65, 72-4.

¹⁷³ See Rammal and Zurbruegg (2007) or Erol and El-Bdour (1989).

shari'ah board. This occurrence is problematic from an ethical standpoint because it is possible for the institutions to become less accountable in the long run if they are not scrutinized by independent investors. Better transparency of IBF transactions will make the institutions more accountable and compliant with the ethical injunctions of Islam. However, there is evidence that these trends are fading given the increases in IBF awareness shown in places such as Australia, Indonesia, and South Africa.¹⁷⁴

Notwithstanding the possibilities for moral hazard amongst Islamic banks in a largely unregulated market, IBF institutions in its current form allows for their customers to invest according to the ethical injunctions laid out in the Qur'ān and Sunnah, thus reinforcing the Islamic identity and piety of such individuals. Also, the economic expanse of IBF has been a source of pride for Muslim investors because it shows that Islamic institutions are able to compete with conventional secular institutions. All of these factors contribute to the vast expansion of IBF in recent years. But which types of customers are investing the most in IBF ventures? And which types of deposits do they make? These questions are important to answer because they directly relate to IBF trends and reflect the relative performance of different deposit types and the financial goals of the depositors.

For this discussion, Kuwait Finance House – Malaysia will be used as a model example of the classes of depositors and the types of deposits they engage in. The table on the next page shows the different classes of depositors that held money in KFHM from 2005-2008:

¹⁷⁴ See Hussian and Zurbruegg (2007), Vahed and Vawda (2008), or Seibel (2008).

Table 3
Types of Depositors, Kuwait Finance House – Malaysia,
2005-2008 (USD million)

Type of Depositor	2005	2006	2007	2008
Business Enterprises	29	253	619	1,122
Individuals	0.5	4.0	4.5	32
Subsidiaries	7.7	3.5	0.7	3.9
Other	0.2	207	51	133
Total	38	467	675	1,291

Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

Of the four groups, business enterprises command the most deposits at \$1.1 billion (86.9 percent) while subsidiaries control the least at \$3.9 million (0.30 percent). The fact that business enterprises contribute the vast majority of deposits is significant because it shows that profit-seeking corporations recognize the return on financial capital that Islamic banks such as KFH(M) provide. In contemporary financial markets, IBF has shown that it can provide competitive returns through permissible investments. These returns have caught the attention of Muslim and non-Muslim corporations alike. For the non-Muslim corporations, the act of depositing funds in Islamic banks can be explained through the return on deposits that they provide. So long as the return on deposits in Islamic banks is greater than the interest rates of conventional banks in the region, rational depositors will place their funds in Islamic banks. Additionally, investment in IBF institutions allows customers to diversify their holdings and lessen the risk and volatility of investments.

For *shari'ah*-compliant businesses, they enjoy the economic benefits of depositing liquid assets in IBF institutions as well. However, they also realize an additional ethical benefit through depositing in permissible investments. Any returns from funds placed in IBF institutions are ethically-justified because they are made through allowable means. Conversely, funds placed in

interest-bearing investments such as those in JKB and ADCB generate unlawful returns according to Islamic principles and any appreciation in assets must be donated to charity.¹⁷⁵ Also, depositing funds within IBF institutions allows Muslim organizations to promote their Islamic images to different population segments.¹⁷⁶ This image can then be marketed to appeal to a larger group of potential clients and the business will grow as a result. Therefore, many *shari'ah*-compliant businesses have chosen to deposit their funds in Islamic banks for the economic and ethical benefits that they supply.

However, individuals still make up a slim minority of deposits at \$32 million (2.5 percent). This is somewhat surprising given that taken in the aggregate, individual investors have more liquid capital when compared to business enterprises. However, this issue is complicated by the availability of said capital to be placed in bank deposits. Many citizens in Muslim-majority nations have limited amounts of money that they can realistically part with for the period of time necessary to realize significant financial gains. Socioeconomic stratification places only a small percentage of the population in the financial realm where depositing money in banks is reasonable. Additionally, there is also the social habit amongst citizens of Muslim-majority nations of keeping financial assets in the form of precious metals such as gold which is then kept safe at home. For example, Aksam estimated that the value of gold held by Muslims in Turkey as savings topped \$500 billion in the early part of this decade.¹⁷⁷ Many countries such as Turkey have been trying earnestly to convert these large pools of savings into aggregate funds that can then be invested in social development programs but such efforts have not been met with any

¹⁷⁵ Michael Bonner, "Poverty and Economics in the Qur'ān," *Journal of Interdisciplinary History* 35, no. 3 (2005): 397-8.

¹⁷⁶ Kuran, *Islam and Mammon*, 73-9..

¹⁷⁷ Kula, "Is Contemporary Interest Rate in Conflict with Islamic Ethics?" 59.

great deal of success.¹⁷⁸ Events such as the collapse of the Anatolian holding companies are still remembered by many skeptical Muslim investors. However, there is proof that socioeconomic stratification of Muslim-majority nations and social habits their citizens are changing given the increase in individual deposits that the KFH(M) example demonstrates. Individual deposits increased from \$0.5 million in 2005 to \$32 million in 2008, corresponding to an annual growth rate of 2100 percent. If this trend continues in tandem with public policy measures to support progress, it will not be long before some of the vast savings of individuals in Muslim-majority nations are converted into liquid, investment-grade funds.

The other important distinction to make in customers' deposits is the types of deposits that they are making. Like conventional banks, Islamic banks have different classes of deposits that cater to the different economic needs and risk-preferences of different customers. KFH(M) offers three classifications of deposits: *qard*, *mudārabah*, and *murābaḥah*. *Qard* deposits are also known as demand deposits because their principle is guaranteed and can be withdrawn at any time. For this reason, they cannot garner any returns because Islamic deposits cannot have both guaranteed principle and positive returns without risk involved. This would imply *ribā*. *Mudārabah* deposits are split into savings and general investment deposits with the depositor giving money to the bank in a profit-and-loss sharing venture. The bank then uses the money to fund investments and gives the depositor a predetermined share of the profits or losses. The principle in these deposits is not guaranteed. *Murābaḥah* deposits are a recent development in IBF and only appear on KFH(M)'s balance sheets starting in 2006. These are a special type of deposit available only to private limited companies and governmental bodies whose deposits are used to purchase commodities by the bank which then sells these commodities to a third party.¹⁷⁹

¹⁷⁸ Ibid., 58-61.

¹⁷⁹ "International Commodity Murābaḥah Deposit," *Kfhone.com*,

In this way, two *murābaḥah* contracts are made: one between the depositor and bank and another between the bank and a third party. Because *murābaḥah* deposits give ownership of the underlying asset to the depositor who then transfers it to the bank, they can be designed with a fixed mark-up return for the depositor. The table below summarizes the types of customers' deposits made with KFHM:

Table 4
Types of Customers' Deposits, Kuwait Finance House – Malaysia,
2005-2008 (USD million)

Title of Deposit	Classification	2005	2006	2007	2008
Demand	Qard	8.1	34	144	78
Savings	Mudārabah	0.1	0.2	0.6	1.8
General Investment	Mudārabah	30	10	51	72
Other	Murābaḥah	0	423	480	1,139
Total		38	467	675	1,291

Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

Murābaḥah deposits have witnessed astronomical growth in their three years of operation and have encouraged many businesses and governmental bodies to deposit funds in KFHM. In 2008, they represented 88.2 percent of total deposits at \$1.1 billion. The development of *murābaḥah* deposits by KFHM is an example of the economic creativity that banks have engaged in during recent years. As Rajesh Aggarwal and Tarik Yousef highlighted, creativity is necessary in order for IBF institutions to reach new market niches, find new efficiencies, and be more competitive in financial markets.¹⁸⁰ Without innovative, specialized financial products to offer to potential customers, IBF institutions will lose any comparative advantage to conventional banks or other niche funds. Therefore, it is necessary for IBF to develop investments such as *murābaḥah* deposits that cater to a larger group of investors and increase

http://www.kfhonline.com.my/kfhmb/ep/kfhContentView.do?contentType=3000&channelId=8127&displayPage=%2Fep%2Fcontent%2Fkfh_editorial_content.jsp&programId=850.

¹⁸⁰ Aggarwal and Yousef, "Islamic Banks and Investment Financing," 118-9.

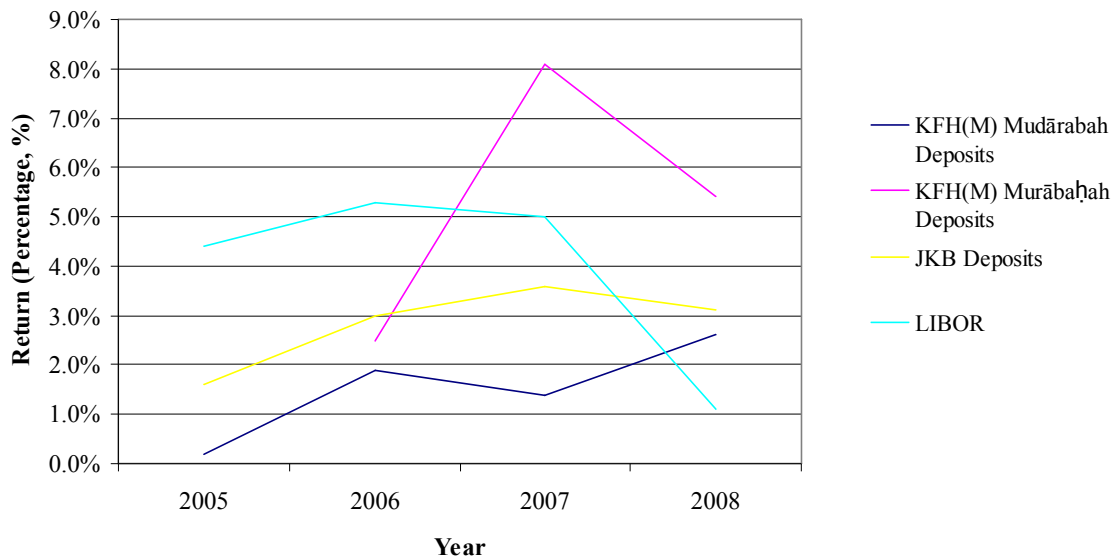
total customers' deposits so that better investment opportunities are available for the IBF institution to engage in.

As for the *qarḍ* and *mudārabah* deposits, these make up a combined \$151.8 million (11.8 percent) of total deposits. Of these, the savings deposits have consistently had the least amount of funds at \$1.8 million (0.14 percent) in 2008. Demand deposits vary the most from \$8.1 million in 2005 to a high of \$144 million in 2007. The differences between *qarḍ* and *mudārabah* deposits represent the relative risk-aversion or risk-loving behavior of predominately-individual depositors. Risk-averse depositors are more likely to deposit money in *qarḍ* funds because the principle is guaranteed in these. Conversely, risk-loving depositors are more likely to place financial capital in *mudārabah* funds that vary in return according to the outcome of the bank's ventures. Of the two, *mudārabah* funds have witnessed the most consistent growth with 2008 being the best year thus far in relation to *qarḍ* deposits. Whereas *qarḍ* deposits decreased from \$144 million in 2007 to \$78 million in 2008 (a decrease of \$66 million, or 45.8 percent), *mudārabah* funds increased from \$51 million in 2007 to \$72 million in 2008 (an increase of \$21 million, or 41.1 percent). Therefore, customers are becoming more risk-loving with their deposits and are putting more faith in IBF institutions to perform well.

These trends can also be explained through an analysis of returns that customers receive for their deposits. The graph on the next page shows the returns for *mudārabah* and *murābaḥah* deposits in KFH(M) compared to the one month LIBOR benchmark rate and return on JKB deposits:¹⁸¹

¹⁸¹ *Qarḍ* deposits have been excluded because they are not profit-generating.

Graph 4
Return on Customers' Deposits, KFH(M) and JKB



From this graph, it is obvious that *murābaḥah* deposits are preferred to *mudārabah* deposits because of the better return they supply. Whereas *mudārabah* deposits have a 1.7 percent weighted average rate of return (WARR), *murābaḥah* deposits were consistently above them and averaged over three times their WARR at 5.4 percent. This explains why the *murābaḥah* deposits have become so popular amongst private businesses and governmental bodies. Overall, the deposits placed with KFH(M) experienced a aggregate 5.1 percent WARR. For the same period, the conventional JKB had a 2.9 percent WARR to depositors with little fluctuation. This is significant because customers are receiving an average of 2.2 percent more return at KFH(M) compared to JKB. Muslim customers at KFH(M) are experiencing both the moral benefits of permissible investments and better economic returns as well. This example is strong evidence that Islamic banks are able to provide competitive, sustainable returns to their customers.

But there are two aspects of this graph that are unexpected from an economic standpoint. First, the *murābaḥah* deposits averaged well above the LIBOR rate for the 2006-2008 period.

The LIBOR rate is generally used by IBF institutions to decide on the mark-up assigned to debt-like financings. For instance, it has already been mentioned that if the LIBOR rate is five percent on a \$1000 loan, IBF institutions would generally choose to assign a mark-up of \$50 to the same loan. However, *murābaḥah* deposits had a WARR of 5.4 percent between 2006 and 2008 whereas the LIBOR rate averaged 3.8 percent for the same period. This difference is partly due to the low LIBOR rate in 2008 of 1.1 percent that significantly affected its three year average. The downward trend in the *murābaḥah* rate of return from 2007-2008 shows that the bank is trying to correct this difference in the meantime. In addition, it also shows that changes in the mark-up of debt-like financings do not react immediately to changes in benchmark interest rates; instead, they experience a lag period. As the graph shows, the slope of the *murābaḥah* return rate is similar to that of the LIBOR but does not match it for all periods. This supports the argument that IBF institutions are trying to mimic interest benchmarks with their mark-ups but are not exact or immediate with their reactions to interest rate fluctuations.

Second, it is unexpected for the rate of return for *mudārabah* deposits to be lower than *murābaḥah* deposits because the former have more risk than the latter. As *mudārabah* deposits vary with the outcome of the IBF institution's financings, they are prone to more risks of fluctuation and uncertainty whereas *murābaḥah* come with a predetermined mark-up. More investment risk should entail more financial reward but *murābaḥah* investments had significantly higher returns for every year of comparison. This may be due in part to the bank's efforts to attract more private business and governmental deposits in comparison to individual deposits that remain at low levels. The former have relatively large accounts on a case-by-case basis and IBF institutions may be pursuing them over the smaller individual accounts. However, the large

difference of 1.6 percent is not due only to this factor and it is likely a result of a lag period in reacting to LIBOR rate fluctuations as well.

The lack of many individual depositors suggests that there is still a need to encourage more individuals to deposit money into Islamic banks and stimulate economic and institutional development in Muslim-majority nations. Recent statistics on customers' deposits are encouraging given the increases in individual and business enterprise deposits, but there remain voluminous amounts of capital that is still un-invested. This can be explained in part by the rather low returns to customers for *mudārabah* deposits from 2005-2008 (WARR 1.7 percent) compared to conventional banks such as JKB (WARR 2.9 percent). As was stated earlier, potential Muslim customers' demands for loans and deposits are not inelastic and will respond to large difference in the returns on deposits. It is possible that this difference of 1.2 percent is having an effect on individual deposits. Therefore, Islamic banks must pursue individual consumer deposits in the same ways as private limited companies and governmental bodies in order to access the vast sums of un-invested capital still available. For instance, a solution could be to make *murābaḥah* deposits accessible to individual depositors. Finding new ways to encourage individuals to deposit funds in Islamic banks will be the next step in increasing IBF deposits and total assets.

Additionally, the maturation of IBF and subsequent popular-familiarity with Islamic lending practices will also encourage more IBF growth.¹⁸² IBF is still only 47 years old and it takes time for institutional changes to develop. The existence of large sums of un-invested capital is encouraging because it remains available for future IBF growth.¹⁸³ Islamic banking is not limited by the number of potential customers that might contribute funds to it. There is no

¹⁸² Seibel, "Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation, and Supervision," 93-7.

¹⁸³ Kula, "Is Contemporary Interest Rate in Conflict with Islamic Ethics?" 59.

foreseeable glass ceiling for IBF in contemporary markets because Islamic banking has only begun to scratch the surface of its economic potential. But in its development so far, this leads to the second point about more efficient lending practices of Islamic banks in recent years. This component of IBF growth now deserves attention.

Banking efficiency is a fairly abstract term that can be used to describe many facets of financial dealings. For this paper, efficiency will be tested according to the return that Islamic banks receive from investments in terms of net income and return on total assets. Attention will be paid to how the Islamic banks perform in both of these categories in contrast to the conventional ADCB and JKB. Afterwards, DIB will be used as a case study to examine which types of Islamic investments are most popular and generate the greatest returns. To isolate this, investments in specific financial instruments, return on assets by financial instrument, and weighted average return on assets by investment class will be examined. However, it is noted that this is not an all-comprehensive study of banking efficiency and is rather a simplified form. But this form does serve the purpose of comparing IBF to conventional banking in the modern era and eliciting which Islamic investments are the most popular and profitable.

Net income is calculated by subtracting the total losses from total revenue on a bank's balance sheet. The table on the next page shows the net income by bank for the surveyed period:

Table 5
Net Income by Bank, 2005-2008 (USD million)

Bank	Location	2005	2006	2007	2008
Rajhi Bank	Saudi Arabia	1,760	2,232	1,889	1,740
Abu Dhabi Commercial Bank	U.A.E.	607	656	581	337
Faisal Islamic Bank	Egypt	143	158	0	85
Dubai Islamic Bank	U.A.E.	336	482	735	471
Al Baraka Banking Group	Bahrain	112	133	209	201
Arcapita	Bahrain	113	--	197	362
Jordan-Kuwait Bank	Jordan	51	69	74	69
Kuwait Finance House	Malaysia	0.1	1.4	6.2	13
Total		3,123	3,731	3,690	3,278

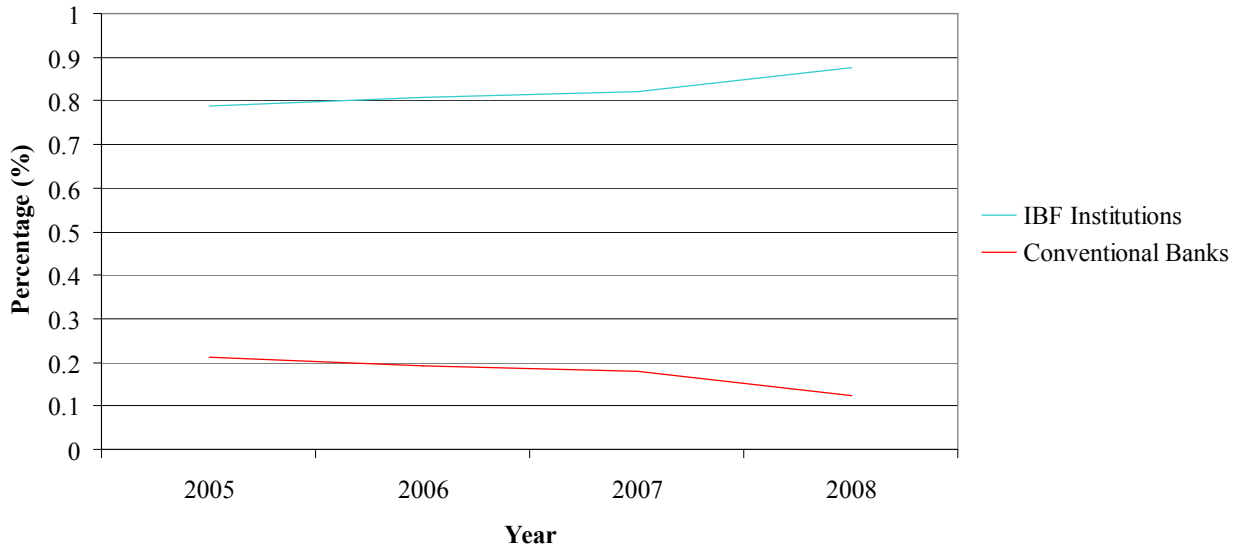
Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

There is a large degree of variance in the growth of net income during the 2005-2008 period. Whereas IBF net income grew from \$2.5 billion in 2005 to \$3.0 billion in 2006 (at a rate of 22.0 percent), it fell from \$3.0 billion in 2007 to \$2.9 billion in 2008 (at a negative rate of 5.3 percent). These two instances provide interesting comparisons for how the net income of IBF institutions has varied in a fashion similar to conventional banks. From 2005-2006, net income grew at a rate greater than total assets (22.0 percent compared to 15.0 percent). During this period, the surveyed Islamic banks were able to earn an aggregate net income that increased in a greater proportion to the same year's increase in total assets, meaning that the banks had a greater return on assets compared to earlier years during this period. However, the negative rate of 5.3 percent from 2007-2008 shows that Islamic banks are still prone to market cycles just as conventional banks are. During the same period, aggregate net income of the conventional banks decreased by 38.0 percent to \$406 million. Such economic swings underscore the importance of the ethical injunction for Islamic banks to be active participants in their financial ventures and collaborate on all of their projects. The 2007-2008 period was marked by a worldwide recession that had profound effects on investment outcomes. However, the surveyed Islamic banks

performed better than JKB and ADCB in the change in net income (negative 5.3 percent compared to negative 38.0 percent) and this is indicative of the relatively efficient lending practices that those banks perform in relation to ADCB and JKB.

As expected, Rajhi Bank (RB) had the greatest net income of all the surveyed banks. It is nearly double the size of its nearest Islamic competitor, Faisal Islamic Bank (FIB), and reported over \$1.7 billion in net profits. However, its share in the overall net income has fallen from a high of 56.4 percent in 2006 to 53.1 percent in 2008. A financial institution's share of the overall market income is a noteworthy economic indicator because it reflects the market share that the institution has in relation to its competitors. The decrease in RB's share of market income from 56.4 percent to 53.1 percent shows that although larger Islamic firms have strong, consistent profit ratios that dominate the majority of net income, other smaller firms are beginning to take a larger share of the profits. Two good examples of this are DIB and Arcapita. Whereas DIB represented 10.8 percent of the net income in 2005, they represented 14.4 percent in 2008. Likewise, Arcapita represented 3.6 percent in 2005 compared to 11.0 percent in 2008. The net income of KFHM also went from \$0.1 million in 2005 to \$13 million in 2008 at an annual growth rate of 4300 percent. By comparison, the conventional banks lost market share due in large part to the net income of ADCB going from \$607 million (19.5 percent) in 2005 to \$337 million (10.3 percent) in 2008. The loss of a 9.2 percent market share is significant and the small increase in the net income of JKB of \$51 million (1.6 percent) to \$69 million (2.1 percent) could not cover this dive. The relationship between the relative shares of market income for IBF and conventional financial institutions are shown in the graph on the next page:

Graph 5
Share of IBF and Conventional Financial Institutions
in Total Net Income

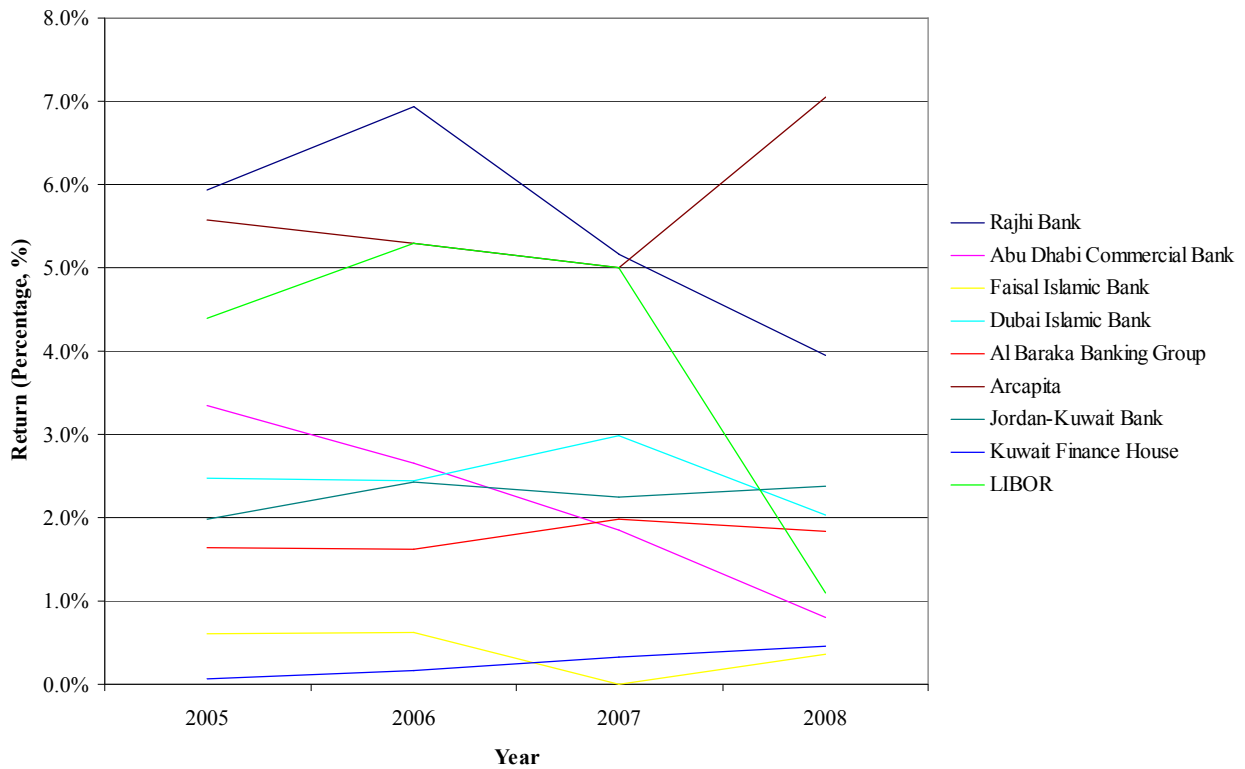


This graph shows that conventional banks were clearly out-performed by the IBF institutions during this period. The aggregate income of the IBF institutions is increasing at a quicker pace than the conventional banks; whereas they made up 78.9 percent of the total net income in 2005, they made up 87.6 percent of it in 2008. Conversely, the conventional banks' share decreased from 21.1 percent to 12.4 percent. This shows that the surveyed IBF institutions are increasing their market share in relation to conventional banking, led largely by the small- to medium-sized institutions like DIB and Arcapita. In the aggregate, this supports the idea that IBF is a sustainable industry. However, there still remains a large degree of diversity between IBF institutions. For instance, FIB performed poorly and went from \$143 million (5.7 percent) in 2005 net income to \$85 million (2.9 percent) in 2008. This shows that although most Islamic banks are performing well in contemporary financial markets, not all can be characterized as becoming more efficient or profitable. Creating a competitive advantage between banks by

offering different types of financial products is necessary for Islamic banks to compete with conventional banking and amongst themselves. The incorporation of *murābahah* deposits is a good example of how KFH(M) has been able to attract more customers' deposits through economic creativity. Additionally, the higher returns for IBF deposits in comparison with conventional banks will help to support IBF growth. However, even firms with long and rich histories like FIB continually need to innovate and improve their lending practices in order to earn profits today and meet the demands of tomorrow.

The return on total assets is a classical ratio used to compare the lending practices and efficiencies of banks across all sizes. It is calculated by taking the net income for a year and dividing it by the total assets of the firm. In this way, returns can be expressed as a function of earnings per dollar. The graph on the next page illustrates the return on total assets by bank with the one month LIBOR rate included as a benchmark:

Graph 6
Return on Total Assets, by Institution



Once again, RB performed well in this category and is consistently above the weighted average rate of return (WARR) on total assets of 2.8 percent for the period. Even with its size, it still compares well to the other banks in terms of efficiency. The only bank that is comparable to RB in size is ADCB, whose returns on total assets experienced a steady decline from 3.3 percent in 2005 to 0.8 percent in 2008. RB outperformed ADCB by at least 2.6 percent for every year over the 2005-2008 period. The only financial institution that has better ratios than RB is Arcapita which has maintained its strong returns even with large infusions of cash from investors. On the other hand, KFH(M) has a lower WARR because its rapid growth has not been met with enough investing avenues to allocate the new funds. It is difficult to amalgamate rapid expansion with efficient capital allocation. But even so, its net income has increased from \$0.1 million in 2005

to \$13 million in 2008, which suggests that its ratios will soon improve once the fresh influx of capital is efficiently allocated.

Once more, the conventional JKB performed worse by this economic indicator than RB, DIB, and Arcapita. The ratio of its net income to total assets varied little given that a majority of its income originated from interest-bearing activities; therefore, it is unlikely that its WARR on total assets will appreciate to any large degree in the future. So long as interest rates are kept at reasonable levels, conventional banks like JKB and ADCB will be stuck with glass ceilings of returns ratios in comparison to IBF institutions. This being said, the two banks did out-perform FIB, KFH(M), and Al Baraka for the period. For KFH(M), this is expected because of the large increases in total assets that the firm has experienced. For FIB and Al Baraka, it is not surprising that JKB had better returns given that the net incomes of the former two were relatively low between 2005 and 2008. Islamic investments allow for great fluctuation in the returns they produce given that ventures are not directly tied to interest rates. Some institutions such as RB and Arcapita are well above the WARR on total assets whereas others such as FIB, KFH(M), and Al Baraka are well below it.

Strong returns on total assets are necessary for the long term sustainability of IBF because banks must remain profitable in order to stay in business. Banks like FIB need to improve their ratios because they cannot survive with returns of less than one percent of total assets. Once the petrodollars dry up and banks are forced to conduct business in a weaker economy, it will only be the most efficient ones that are able to endure. But these returns are hardly regular and Graph 3 shows a large degree of fluctuation for IBF returns over the four year period. Even the returns of large banks like RB vary from 6.9 percent in 2006 to 4.0 percent in 2008. Much of these variations are related to the items on the banks' balance sheets. Not

surprisingly, changes in the types of financing instruments have an impact on the bank's overall return. Therefore, this discussion now turns to an economic analysis of the classes of financing tools used in IBF with particular attention paid to the additional costs that each has. Afterwards, these costs will be put to the test by an in-depth analysis of DIB's balance sheets in order to understand what there exists so much fluctuation and what investments are the most popular.

Historically, debt-like financial instruments dominated the investment tools of IBF institutions because of the ease of monitoring those transactions.¹⁸⁴ With mark-up pricing and rental agreements, the bank does not need to closely monitor the affairs of the debtor because its return is not based on the venture's performance. Rather, the bank only has to ensure that payments are made on time and in full. Providing incentives for customers to repay debt-like financings on time is more costly for IBF institutions because they cannot charge additional interest or principle on delinquent loans as a conventional bank would, unless in the case of deliberate procrastination on behalf of the debtor.¹⁸⁵ This represents a credit risk to banks because their assets could be tied up in nonproductive activity for an extended period of time.¹⁸⁶ Additionally, there is a risk to the bank of contractual infringements if the supplier of the financed asset does not provide the product at the right time or requisite quality.¹⁸⁷ All of these risks add additional transaction costs to the bank that must be accounted for. Usually, the Islamic institutions choose to add *ex ante* collateral and pledges to the contracts in order to hedge against the risks.¹⁸⁸ However, neither of these are perfect solutions and Islamic banks are exposed to more credit risks than their conventional counterparts.

¹⁸⁴ See Ramachandran (1989), Nomani (1994), or Iqbal (2002 and 2005).

¹⁸⁵ Ferry, "Scuppered by Sukūk," 91.

¹⁸⁶ Greuning and Iqbal, *Risk Analysis for Islamic Banks*, 126-7.

¹⁸⁷ *Ibid.*

¹⁸⁸ *Ibid.*

Like debt-like financings, equity-like financial instruments also come with the credit risks and their associated transaction costs. However, the instruments also carry a great deal of asymmetric information that translates into even higher transaction costs for the firm. As Rajesh Aggarwal and Tarik Yousef note, moral hazard problems and adverse selection promote debt-like instruments because the monitoring costs for equity-like instruments make them less profitable for a bank to engage in.¹⁸⁹ Given the nature of profit-and-loss sharing agreements, the banks take on an inordinate amount of risk at all stages of the venture. Before the venture is approved, there exists asymmetric information between the applicant and bank because the applicant knows more about the viability of the project than the bank. And once the project is underway, there exists an economic incentive for the applicant to under-report his earnings so that he can have a greater personal income. As a result, Islamic banks are forced to require high projected earnings, regular auditing, and even higher collateral amounts to resolve these problems. Also, most equity-like financings are long-term in nature and reduce the liquidity of banks because funds are tied up in those investments. On the other hand, debt-like instruments are typically short-term and provide regular streams of usufruct or installment payments. Because of the additional transaction costs and long-term nature of equity-like financing, debt-like instruments have historically been preferred to the former. In the past, debt-like investments have made up over 90 percent of Islamic banks' balance sheets.¹⁹⁰ However, this trend is starting to change as the study of DIB will show.

On the next page is a table that shows the total amount of assets invested in each type of financial instrument:

¹⁸⁹ Aggarwal and Yousef, "Islamic Banks and Investment Financing," 94-6.

¹⁹⁰ Ibid., 100.

Table 6
Total Investment by Financial Instrument, Dubai Islamic Bank,
2005-2008 (USD million)

Financial Instrument	Classification	2005	2006	2007	2008
Murābahah	Debt-like	4,425	5,524	6,407	6,338
Istisna'ā	Debt-like	834	1,361	2,197	2,229
Ijārah	Debt-like	1,629	1,846	2,090	2,708
Islamic Credit Cards	Debt-like	0	49	75	84
Total Debt-like		6,888	8,781	10,770	11,430
Percentage Debt-like		69.6%	70.8%	65.8%	58.9%
Mudārabah	Equity-like	664	934	1,731	1,963
Mushārahah	Equity-like	1,842	866	1,329	2,736
Sukūk	Equity-like	449	1,762	2,489	3,057
Wakalat ¹⁹¹	Equity-like	49	57	55	230
Total Equity-like		3,004	3,619	5,604	7,986
Percentage Equity-like		30.4%	29.2%	34.2%	41.1%
Qarḍ Al-ḥasan	Qarḍ	4.0	2.4	2.3	2.2
Total		9,896	12,402	16,376	19,418

Note: All dollar values have been equalized to 2008 values via the CPI deflator method.

This table shows a clear trend towards equity-like financing in recent years due in large part to an increase in *sukūk* investing. *Mudārabah* and *mushārahah* investments are also substantial and comparable to investments in *istisna'ā* and *ijārah*, respectively. Whereas equity-like assets made up only 30.4 percent of DIB's total investments in 2005, they grew to 41.1 percent in 2008 and continue to grow in the present. This is due in large part to the development of secondary markets such as the Dow Jones Islamic Market (DJIM) Indexes in 1999 that have allowed Islamic bonds and other equity-like assets to be traded by investors. All companies listed on the DJIM must be screened for *shari'ah*-compliance; if approved, they can subsequently be listed on one of the 69 country-level benchmark indexes.¹⁹² The screening is performed by five Muslim

¹⁹¹ *Wakalat* investments consist of the bank providing funds to an agent who invests it according to conditions in the contract in return for a fee. This fee can either be a lump sum or percentage of the returns. Usually, the bank opts for the latter; therefore, it is classified as an equity-like instrument.

¹⁹² "Dow Jones Islamic Market (DJIM) Indexes," CME Group Index Services, LLC, 2010, <http://www.djindexes.com/Islamic/index.cfm?go=overview>.

scholars on the DJIM Index *Shari'ah* Supervisory Board and is important because it reduces the transaction costs for potential Muslim investors who must ensure that their ventures are *shari'ah*-compliant. Once the equities become certified by the Muslim scholars, investors no longer need to determine the *shari'ah*-compliance of the business and can instead focus on relevant economic ratios such as the price/earnings and dividend payout ratios. And by trading the equities in the open market, investors also face less asymmetric information risk because the trading prices provide additional data about the grade of the equities that might otherwise be unavailable or prohibitively-costly to ascertain. Therefore, equity-like financing has witness expansive growth since 1999 and DIB is a good example of this.¹⁹³

However, there must be a word of caution in interpreting the results of DIB. The shift from debt-like to equity-like financing is largely a result of the appreciation of *sukūk* investing from \$449 million in 2005 to \$3.1 billion in 2008. *Sukūk* bonds are financial certificates similar to conventional bonds that can be traded in secondary markets.¹⁹⁴ But unlike conventional bonds, they are not interest bearing and involve the ownership of an underlying asset of the issuing bank or company by the certificate holder. In order to issue a Islamic bond, the issuer must first create a special purpose vehicle (SPV) that is bankruptcy remote and allows for the pooling of investor funds and ensuing purchase of a one or many of the issuing company's assets. After the underlying asset is purchased, the issuer then pays a predetermined rent to the SPV that subsequently transfers the payments to the certificate holders as returns.¹⁹⁵ In particular, this type of Islamic bond is sub-classified as *ijārah sukūk*. And once the Islamic bond matures, the issuer repurchases the asset from the SPV and the principle is returned to the certificate holders.

¹⁹³ Ibid.

¹⁹⁴ El-Gamal, *Islamic Finance*, 5-7, 97-114.

¹⁹⁵ Ibid., 6.

While this description of Islamic bonds might appear fairly straightforward, their performance in contemporary financial markets is not so streamlined. While some bonds like DIB's have witnessed strong returns, others such as Nakheel issued by the parent company Dubai World (DW) have not been so fortunate. In late 2009, DW nearly defaulted on \$4.1 billion of Nakheel debt and the government of Abu Dhabi was forced to bail out the firm with a transfer of \$10 billion to the institution's coffers.¹⁹⁶ This was a large transfer given the difficult economic times in the United Arab Emirates; however, the more important issues that the Nakheel case brought up were the legal uncertainties that surround Islamic bonds when default is imminent.¹⁹⁷ First, lawyers and businesspersons were unsure who retained ownership of the underlying asset if the issuer defaulted.¹⁹⁸ Indeed if there was a legal, material transfer of ownership of the asset to the SPV when the Islamic bond was issued, then the certificate holders would have possession of it.¹⁹⁹ However, some such as Badlsyah Abdul Ghani, chief executive of the Islamic investment bank CIMB Islamic, argued that the asset should remain in possession of the issuer because it was not technically a source of security to the bondholders.²⁰⁰ Luckily, this issue did not have to go to the bankruptcy courts to be decided.

But this then brought up the second issue of the lack of a tested legal framework to adjudicate on bankruptcy claims from Islamic bond defaults.²⁰¹ Because of their youth, neither the legal nature of Islamic bonds has not been tested in judiciary system nor have they gone through restructuring procedures to refinance their debts.²⁰² Furthermore, it is unknown how these legal issues would be resolved and enforced across international boundaries where the rules

¹⁹⁶ John Ferry, "Scuppered by Sukūk," *Risk* 23, no. 1 (2010): 90.

¹⁹⁷ *Ibid.*, 90-2.

¹⁹⁸ *Ibid.*, 91.

¹⁹⁹ Heather Timmons, "Dubai Debt Tests Laws of Islamic Financing," *New York Times*, December 1, 2009.

²⁰⁰ *Ibid.*

²⁰¹ *Ibid.*

²⁰² *Ibid.*, 91-2.

for property rights transfers and bankruptcy arbitration are not constant.²⁰³ Without being legally tested for bankruptcy proceedings and restructuring procedures, Islamic bonds are very vulnerable to high legal costs and potential economic problems in the future. And if governments continue to bail out Islamic bond issuers without requiring that the ownership issues be resolved beforehand, Islamic bonds could become the next economic bubble to burst in the Middle East and cause a domino effect throughout the industry due to the resultant mistrust amongst Muslim investors. Therefore, even though Islamic bonds have benefited IBF institutions like DIB by attracting more investments, they still must be tested by the legal and political frameworks of different nations. The process of legally testing Islamic bonds adds additional costs to the investments in addition to the costs of creating the SPV and structuring the bond issuance, but they are necessary in order to ensure that they are sustainable additions to IBF balance sheets.²⁰⁴

Besides the legal issues and costs of certain IBF investment vehicles, the DIB balance sheet also brings up the topic of *qarḍ al-ḥasan* loans that have dropped to near-zero levels since their high of 10.5 percent in 1984. In 2005, they amounted to only \$4.0 million (0.040 percent) of DIB's investments and have witnessed a steady decline to \$2.2 million (0.011 percent) in 2008. This trend is common amongst contemporary Islamic banks and reflects the increased pressures that the banks are facing to become more competitive amongst conventional banks.²⁰⁵ Because any *qarḍ al-ḥasan* loan has a negative net present value (NPV), the bank is more profitable the less *qarḍ al-ḥasan* loans it grants. Therefore, there is an economic incentive to decrease *qarḍ al-ḥasan* lending. But this is problematic because part of the ethical standing of IBF is based on these types of transactions. Without such activities, IBF cannot be said to be operating according to the ethical tenets of Islam.

²⁰³ Ibid.

²⁰⁴ El-Gamal, *Islamic Finance*, 8.

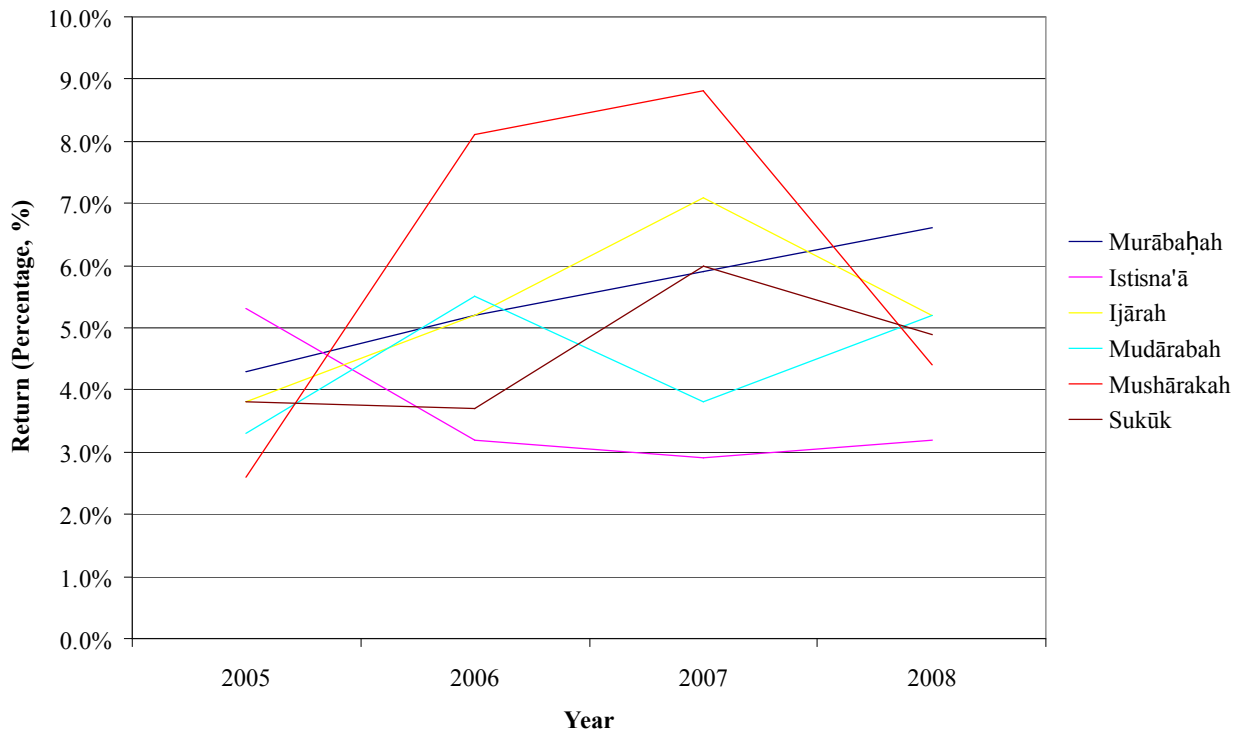
²⁰⁵ Aggarwal and Yousef, "Islamic Banks and Investment Financing," 103.

However, analysis of DIB's balance sheets also show that its *zakāt* contributions have increased from \$12.5 million (0.09% of total assets) in 2005 to \$39.0 million (0.17% of total assets) in 2008. This is supportive of the Islamic mandates for IBF because *zakāt* is obligatory for IBF institutions and the relative increase in its payment shows that steps are being taken to ensure that IBF maintains its ethical standing. By combining the total *qarḍ al-ḥasan* and *zakāt* amounts, the total funds contributed to altruistic acts amounts to \$16.5 million in 2005 and \$41.2 million in 2008. This corresponds to 0.12 percent and 0.18 percent of DIB's total assets, respectively. Therefore, the aggregate amount of altruistic lending and charitable donations has increased relative to the growth in DIB's total assets. This is helpful in ensuring the future ethical validity of IBF.

However, debt-like instruments still remain the most popular form of investment with *mudārabah* alone accounting for \$6.3 billion (32.6 percent) of DIB's investments. This is in part due to the return on assets that each type of investment provides. On the next page is a graph that illustrates the return on assets by financial instrument for DIB:²⁰⁶

²⁰⁶ Income from Islamic credit cards not listed on DIB Annual Reports 2006-2008. Consequently, they cannot be assigned a return. By nature, *qarḍ ḥasan* loans do not produce any income; therefore, they are excluded as well. Returns from Wakalat investments are also excluded because they vary from 7.7 percent in 2008 to 125 percent in 2006. In the aggregated, their weighted average rate of return is 31 percent.

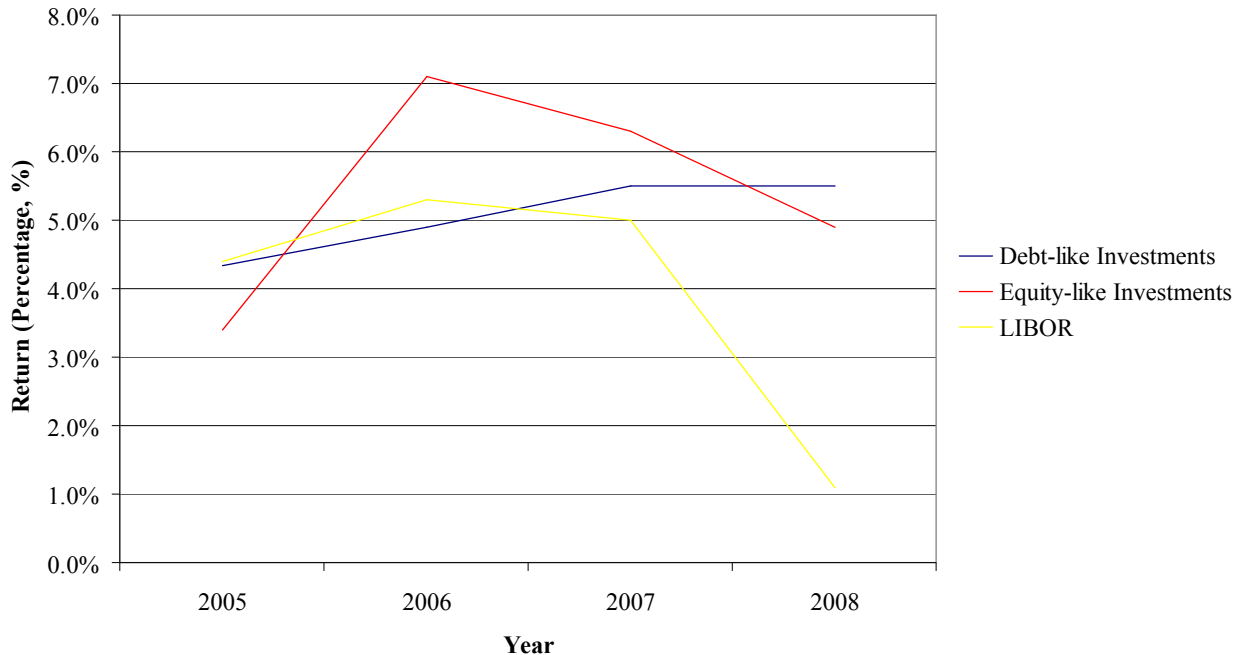
Graph 7
Return on Assets, by Financial Instrument (DIB)



Returns from *murābaḥah* investments increased from 2005-2008 at a fairly constant rate of 0.7 percent per year. The fact that the rate of return on these investments oscillated very little in relation to the others is attractive to IBF institutions because they are more predictable on a year-by-year basis. The returns of the other debt-like instruments averaged between four and five percent overall with a low of 2.9 percent for *istisna'ā* in 2007 and a high of 7.1 percent for *ijārah* in the same year. On the other hand, *mushāarakah* and *mudārabah* investments had large annual differences in their rates of return with *mushāarakah* varying from 2.6 percent in 2005 to 8.8 percent in 2007 and *mudārabah* fluctuating from 3.3 percent in 2005 to 5.5 percent in 2006. This is due to the variable returns that equity-like assets produce given their profit-and-loss sharing nature compared to debt-like financings that are either rental or mark-up pricing. At first, this might seem to make the rates of return difficult to compare between debt-like and equity-like

investments. However, the graph below accomplishes this through looking at the weighted average return for each investment class. The one month LIBOR is also included as a benchmark rate:

Graph 8
Weighted Average Return on Investment Classes (DIB)



Taken in the aggregate for the 2005-2008 period, equity-like investments averaged a 5.5 WARR whereas debt-like financings averaged 5.1 percent. In the long run, it is expected that the equity-like instruments will garner greater returns than their debt-like counterparts because they carry more investment risks such as adverse selection and moral hazard on behalf of the debtor. The WARR also fluctuates more because the returns of the underlying equity-like investments also vary more than debt-like financings. This is explicitly shown in the graph above with the WARR of equity-like investments fluctuating from 3.4 percent in 2005 to 7.1 percent only one year later. Conversely, the WARR of debt-like investments saw little movement during the period with returns of 4.3 percent in 2005 and 5.5 percent in 2007 and 2008. From 2005 to 2007,

the WARR for debt-like instruments was very close to the one month LIBOR interest rate but was slow to react to the sharp decrease in the benchmark from 5.0 percent in 2007 to 1.1 percent one year later. So for DIB, the choice of investments comes down to how much risk the bank wants to bear on a year-by-year basis. For the long-term, equity-financing will provide the best returns but will vary considerably in the short-run. Debt-like instruments provide regular income in the short-term but do not appreciate to any high levels in the long-run. Therefore, both of these types of investments will find their places on the balance sheets of Islamic banks because of the economic needs they satisfy. Equity-like instruments will provide strong returns in the aggregate but will fluctuate considerably from year to year. Debt-like instruments are necessary to meet the immediate cash needs of a bank and provide liquidity but will not be the most profitable forms of investment in the long-run. In the meantime, Islamic banks must diversify their asset portfolios between debt-like and equity-like instruments in order to have the most efficient allocation of capital.

From an economics standpoint, IBF has made great strides in recent years to become more profitable, competitive, and sustainable in contemporary financial markets. Customers' deposits are rising and firms are shifting towards more equity-like investments in order to diversify their balance sheets. The return to consumers' deposits is also substantial and banks are earning considerable returns on their investments. Even though there still remains a spectrum of Islamic firms from RB down to FIB, almost all of the surveyed IBF firms outpaced the conventional JKB and ADCB in the economic indicators that this paper explored. Therefore, it can be concluded that IBF has become a competitive financial industry within socially responsible investing (SRI) and will remain a viable economic alternative to conventional funds even without the global movement towards SRI funds. So long as IBF continues to outpace

conventional firms like JKB and ADCB in the Middle East and elsewhere, it will have a strong future in financial markets. However, the banks must also adhere to their ethical injunctions and act according to the relevant Islamic mandates. With only Arabic names and no true Islamic character, IBF would devolve into a mere shadow of conventional banking.

What will be important in the coming years is for the banks to collaborate and learn from each other in order to isolate the most profitable investment vehicles while still staying true to the ethical injunctions of Islam. The respective *shari'ah* boards will be critical in this effort because the compliance of any new investment vehicles will be ultimately their decision. The boards must also be wary about the *zakāt* provisions of their respective banks and ensure that the institutions are adhering to the Islamic mandate of charitable acts. In the past, scholars have pointed out a disconnect between experts of Islam and experts of economics.²⁰⁷ However, the recent developments of Islamic credit cards, *murābaḥah* deposits, and others are encouraging signs that there is now more expertise in the area of Islamic financial engineering and more creativity will follow. Even Islamic hedge funds are now being explored by IBF institutions such as the Saudi Economic and Development Company (SEDCO).²⁰⁸ But as the Islamic bond example highlights, this financial creativity must also be teemed with the development of the necessary legal and political frameworks to make them sustainable.

The Future of IBF

Given the recent developments in IBF, the industry does not appear to a bubble with any immediate chance of bursting. The emergence and maturation of secondary markets like the DJIM Indexes was critical in promoting equity-like investments and making them more

²⁰⁷ See Iqbal (2005) or Sulaiman and Galadanci (2003).

²⁰⁸ El-Gamal, *Islamic Finance*, 40-61.

profitable and liquid. And the creativity of Islamic businesspersons in developing Islamic bonds and credit cards is a critical component for the future competitiveness and viability of IBF. In the meantime, the emergence of secondary markets will necessitate the streamlining of accounting standards across Islamic ventures that wish to be part of any index. This streamlining will have the direct effect of encouraging even more investment because information will be made more accessible and relatable between firms. In the past, this has been a problem because of the use of many similar but disparate terms on different Islamic banks' balance sheets.²⁰⁹ With universal accounting standards, the secondary markets will expand in volume and reduce transaction costs and asymmetric information for investors. These will make equity-like instruments more liquid and spur increased investment into them because they are generally more profitable on a long-term basis. But debt-like instruments will remain because of the regular income they provide to banks.

This now begs the question, how close will Islamic banks come to competing directly with conventional banks in the mainstream financial market? Although numerous scholars have labeled IBF as a niche market in the past, what could the implications of high returns on assets, rapid growth, and large pools of un-invested Muslim funds have on this classification? Surely, it will take a long time before Islamic banks are able to rival conventional banks in terms of size or scope. For instance, the largest bank surveyed (RB) would only rank at 36 amongst the top-50 US bank holding companies.²¹⁰ Additionally, even with the high-end estimate of the top-100 IBF institutions' total assets at \$2.26 trillion, it is still only slightly larger than the total assets of Bank

²⁰⁹ Munawar Iqbal and David Llewellyn, *Islamic Banking and Finance* (Northampton: Edward Elgar Publishing, Ltd., 2002), 93.

²¹⁰ National Information Center, "Top 50 Bank Holding Companies," United States Federal Reserve System, <http://ffiec.gov/nicpubweb/nicweb/Top50form.aspx>.

of America at \$2.22 trillion.²¹¹ Even so, the growth in deposits and strong ratios show that IBF institutions are doing well in their markets while banks such as JKB and ADCB are stalling. For Islamic banks to expand outside of niche markets, they must make themselves accessible to outside investors. This will be primarily accomplished through secondary markets and institutional developments that allow outsiders to research the investments and economic performance of Islamic banks and the geopolitical markets they are a part of. Any efforts to minimize the risks of investment by decreasing the asymmetric information and unresolved legal issues involved in the transactions will improve IBF and make it more competitive with conventional banking and sustainable.

Conclusion

IBF is the economic expression of Islamic principles and ideals in a form that is both ethical and competitive in contemporary financial markets. While it was only an academic study and religious ideal fifty years ago, it is now a functioning system that is becoming more efficient and popular amongst Muslim and non-Muslim populations. This paper shows that contemporary Islamic banking is succeeding in accomplishing its goals of ethical investing with competitive financial returns. But its greatest test will come in the near future as it must refine and develop its practices while staying true to the moral tenets that underlie them. Through refined practices, ethical investing, and competitive returns, IBF will be sustainable even without the large infusions of petrodollars. If it can succeed and compete with conventional banking in the mainstream financial markets, IBF will be a living testament to how religious ideals can be practiced in the world and improve upon secular systems that are commonly perceived as being the most efficient.

²¹¹ Ibid.

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