

FIRST DRAFT – Amanah

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**Challenges facing Islamic Finance:
Research Areas***Sayyid Tahir**

Recorded history of Islamic banking and finance goes back to intellectual breakthroughs in the mid-1950s with the publication of “An Outline of Interest-less Banking” by Uzair Ahmad. Islamic banking made a modest beginning with the establishment of Dubai Islamic Bank in 1975. As of now, consider the following indices:

1. The number of Islamic banks, Islamic investment funds, takaful companies and other Islamic financial institutions
2. The size of funds handled by the above institutions
3. The geographical coverage—virtually all the Muslim countries, several Western countries and some other non-Muslim countries with significant Muslim minorities
4. Islamic securities markets or Islamic inter-bank money markets, offshore Islamic banking and international Islamic money market
5. An international Islamic Development Bank
6. An international Islamic Financial Services Board
7. National Shari’ah Boards in several Muslims countries and countless Shari’ah Boards at the level of individual Islamic financial institutions

Islamic finance has reached colossal proportions. Has this growth been systematic and planned? Do the fiqhi positions taken on the different

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matters fit together? Or, are many of the positions incongruent? Is the practice of Islamic banking and finance distinguishable from that of interest-based banking and finance? Or, is it moving toward convergence with the latter, excepting the name? These are only some of the questions that have come to surface over the past few years.

The problem is that Islamic banking did not start with a well-developed model covering fine details of the various banking matters. It developed with (1) initiative by resourceful and influential individuals, (2) intellectual leads by Islamic economists, (3) helping hand from professional bankers trained in interest-based banking and (4) guidance by the Shari’ah scholars in the routine banking matters. These four groups of individuals indeed share a common concern about riba but they do not have shared interests. Consequently, Islamic banking is rapidly shaping into something that perhaps nobody might like to be accountable for.

It is quite intriguing that most of the financial innovation in Islamic finance took place in the 21st century. Lack of progress in the preceding 50 years and astronomical growth in a matter of few years in this century raise several questions. Most of the financial products lately introduced, such as Tawarruq and the sukuks, are result of financial engineering based on convenient fusion of various Islamic transaction modes with no allowance for the fundamentals of those transaction modes (*see section 2.4, for example*).

The case for Islamic finance rests on Shari’ah-compliance. It is, therefore, natural that the Shari’ah factor dominates the research agenda in Islamic finance. In this paper, we propose to look at:

- ▣ the need for revising the methodology of the fiqh especially for matters related to business and finance, and
- ▣ identify the potential for work in some areas of contemporary concern.

These two issues are addressed in sections 1 and 2, respectively. The purpose here is to light the flame. Allah SWT willing, points can be picked up and developed into practical solutions for meeting the contemporary needs in Islamic banking and finance.

1. The Methodological Issues

1.1 The Existing Methodology of the Fiqh

The foundation of the fiqh, both the old and the new, is the following Hadith given in Sunan Abu Dawood, also reported by Al-Tirmizee, Ahmad and Al-Darnee:

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[(3119)

Verily, when the Prophet SAAWS sent Mo'az b. Jabal to Yemen, He SAAWS asked him: How would you judge a matter that comes to you for judgment? Mo'az replied: I will decide by the Book of Allah (SWT). The Prophet SAAWS then asked him: If you do not find it in the Book of Allah (SWT), what will you do? Mo'az replied: (I will decide) By the Sunnah of the Prophet (SAAWS) of Allah (SWT). The Prophet SAAWS then asked: If you do not find it either in the Sunnah of the Prophet (SAAWS) of Allah (SWT) or in the Book of Allah (SWT), then? Mo'az replied: I will try to form my own opinion and spare no effort (in that regard).¹ The Prophet SAAWS patted at the chest of Mo'az (in appreciation) and said: All the praises are for Allah (SWT) who helped the envoy of the Prophet (SAAWS) of Allah (SWT) with what satisfies the Prophet (SAAWS) of Allah (SWT).

The pioneer fuqaha—namely, Imam Abu Hanifa, Imam Malik, Imam Ja'fer, Imam Shafi'e, Imam Malik and their able students—acted on this Hadith literally. The meaning of matter being “in the Book of Allah” was taken to mean that the case be covered by name in the Qur'an. The same was the approach in respect of the Sunnah.—Of course, there was no unanimity in this regard due to the different Ahadith which sometimes

¹ The words of Mo'az b. Jabal can also be interpreted as: “I shall do ijtehad and spare no pains for that purpose”.

these learned scholars drew upon. With the matter perceived in this way, in the days after the Prophet SAAWS and his illustrious companions virtually most issues came to be regarded as cases fit for “ijtehad”. The tools of Ijma', Qiyas, Istehsan and Maslahah Mursalah, Istis'hab, 'Urf, Qaol Al-Sahabi, Sadd Al-Zari'ah, Shara' Mann Qablona were developed in order to facilitate the process of ijtehad for arriving at the necessary conclusions.—The refinement of Maqasid Al-Shari'ah came into the picture several centuries later.

At the level of later generations of fuqaha, another addition was made. In order to develop answers for issues of their age, these fuqaha also started to look for precedence in the rulings of their predecessors. Thus the search for answers to the then contemporary issues was done not only in the Qur'an and the Sunnah but also in the fiqhi positions that evolved in the past. This unconsciously created a situation that largely went unnoticed. No doubt the pioneer fuqaha made an honest effort to the best of their ability in their own time. But they were human—not infallible. Their rulings could not be given the same status as that associated with the rulings in the Qur'an and the Sunnah for the Shari'ah matters. Unfortunately, their judgments assumed a binding status among their followers. That is, like the Qur'an and the Sunnah, their judgments also came to be regarded as sources of the Shari'ah for the later generations of fuqaha. The present is a continuation of this paradigm shift that took place over a thousand years ago.

In the present age, Qiyas, Istehsan, etc., are still regarded as “tools” of the fiqh. But, as noted above, in practice these tools are used with reference to the Qur'an, the Sunnah and the rulings of the earlier fuqaha. In addition to this, in the modern age research in Shari'ah matters has two distinguishing features:

1. The literalist approach to the interpretation of the Qur'an and the Hadith has been taken to new heights with judicious reliance on the legal maxims in the fiqh, such as “everything is permissible unless pointedly prohibited in the Qur'an and the Sunnah”. This explains the Malaysian reliance on Bai' Eenah. The fuqaha elsewhere do a similar thing in their financial engineering

through a judicious reliance on the concept of w'ad or "unilateral promise" for fusion of the otherwise incompatible contracts.

2. A "democratic" process of selection has come to work in the name of "collective ijtehad". Such ijtehad is exercised at the level of different fiqhi academies in the Muslim countries and the Shari'ah Boards of the various Islamic banks and financial institutions. In this process, the input comes from the notable fuqaha belonging to different schools of fiqh, and solutions to contemporary problems are made by consensus at the respective academy or board meetings. Of course, the choice from amongst different fiqhi positions held by the various schools is made mostly on grounds of practicability in the modern age.

The above approach is inspired by several factors. For example, the enormity and the complexity of modern issues are viewed as something beyond the handling capacity of an individual Islamic jurist. But, more importantly, it stems from the recognition of the pressing need for a common fiqh in this age of globalization.

Whereas we shall come to examples of modern ijtehad and the unresolved issues associated with it, it is appropriate to see what the other options available for the fiqh were and still are.

1.2 A Suggested Methodology for the Fiqh

This methodology is already present in the Hadith of Sayyidena Mo'az b. Jabal. It has been missed due to a literal interpretation of his Hadith.

Mo'az b. Jabal was one of the four Sahabah to whom the Prophet SAAWS referred the others for learning the Qur'an—the other three were Abdullah b. Mas'ud, Salem Baola Abi Huzaifah and Obai b. K'ab. His Hadith needs to be read as follows:

1. When Mo'az said that he would first check the matter in the Qur'an and follow the ruling therein, he meant that the first priority must be given to checking the matter in the Qur'an because that is the immediate source of the Will of Allah SWT. And, his statement of following a ruling therein meant that there could be no room for one's

personal opinion if a matter is directly established by the Qur'an. An example of this is the Ahkam for qisas.

2. The ranking of the Sunnah after the Qur'an as the source for judgment was quite logical because Allah SWT has Himself ordered that the Prophet SAAWS be obeyed and his judgments be respected unconditionally. This covers all matters of details of the Ahkam in the Qur'an as well as all those matters which are not pointedly addressed in the Qur'an. An example is that the Qur'an gives the husband the right to divorce. What if the wife wants so? There is example in the Sunnah whereby the Prophet SAAWS enforced the request of a Sahabiah for divorce while her husband was reluctant to do so. The Prophet SAAWS's action implies that no doubt the letter and intent of the Qur'an gives man the right/freedom to divorce, but men and women are equal in seeking separation. Therefore, if need be, the husband has to complete the procedural formality prescribed in the Qur'an.
3. As to the third point in the Hadith, the meanings have been grossly misunderstood. As mentioned above, Mo'az was one of the four Sahabah to whom the Prophet SAAWS referred the people for understanding the Qur'an. How he could be thought of going beyond the Qur'an and the Sunnah while the Qur'an repeatedly states:

(27)

[27 :]

We have put forth for men, in this Qur'an every kind of parable, in order that they may receive admonition. [Az-Zumr 39: 27; emphasis added]

[54 :] (54)

We have explained in detail in this Qur'an, for the benefit of mankind, every kind of similitude: but man is, in most things, contentious. [Al-Kahf 18: 54; emphasis added]

[89 :] (89)

And We have explained to man, in this Qur'an, every kind of similitude: yet the greater part of men refuse (to receive it) except with ingratitude! [Al-Asraa' 17: 89; emphasis added]

If one takes a pause, and weighs the size of the Qur'an versus virtually the infinite possibilities in the domain of transactions among human beings since the time of the Revelation of the Qur'an till the Day of Judgment, the following point comes to light.

Allah SWT has given the Ahkam for the various cases in the form of general principles that govern all conceivable primary transactions at the individual level in a do/don't format.

That is, the basic Ahkam in the Qur'an and the Sunnah are about what an individual may/may not do in the primary cases (like trading, loaning, etc.). All other conceivable transactions are extensions of these basic cases. Sometimes they involve several exchanges among the same two parties, and sometime one or more exchanges among several individuals. The Ahkam for all such cases automatically stem from the basic Ahkam in the Qur'an and the Sunnah. It is a matter of recognizing them.

The above point was certainly not lost to Sayyidena Mo'az b. Jabal. Therefore, when he said that he would exercise ijtehad, it did not mean that he would go for personal reasoning in the narrow sense. In fact, it meant that he would decide the matter in the light of the principles—whether explicit or implicit—in the Qur'an and the Sunnah for all the matters. This interpretation is also supported by the following Ayah:

[] (59)

O ye who believe! obey Allah, and obey the Messenger, and those charged with authority among you. If ye differ in anything among yourselves, refer it to Allah and His Messenger, if ye do believe in Allah and the Last Day: that is best, and most suitable for final determination. [An-Nisaa' 4: 59]

The reference to “refer it to Allah and His Messenger” in this Ayah merits serious attention. Practically, it implies that “don't think outside the Qur'an and the Sunnah”. This, in turn, means that one ought to exercise

any reasoning in the light of the general principles for mu'amalat (transactions) and everything else enunciated in the Qur'an and the Sunnah. Of course, the question that begs answer is: what are the principles for permissible forms of transactions in the Qur'an and the Sunnah? This issue did not receive its much-deserving attention from the fuqaha in the past, and it remains elusive till this day.

The foregoing discussion leads to the following methodological conclusions:

- ★ Let us work out the principles for permissible forms of transactions in the Qur'an and the Hadith.
- ★ For any given case, we may check the goal or purpose of the various stakeholders and the permissibility or otherwise of that goal.
- ★ If the goal at hand is recognized in the Shari'ah, we may work out the practical arrangement in the light of the principles mentioned above.

The significance of this methodology for developing Shari'ah-compliant alternatives in the modern age is as follows:

- i. It will help replace the “passive approach” whereby Islamic jurists focus on permissibility or non-permissibility of any given arrangement. And, it will divert all energies toward the required Shari'ah solutions for contemporary problems.
- ii. It will help us avoid inconsistencies in the approach adopted in different cases. For example, the fuqaha rely upon qiyas in interpreting the Ahadith on riba. The 'illah (effective cause) is traced to the nature of the things—gold, silver, wheat, barley, dates and salt—directly mentioned in the Hadith. But such an approach is ignored when it comes to the case of bai' arboun. The modern applications of bai' 'arboun in Islamic finance are independent of any consideration about the cases to the Ahadith originally applied.
- iii. It will greatly minimize the personality factor that stood in the way of the way of unification of the fiqhi positions across the different schools of fiqh in the past, and still carries weight.

Of course, the success of the above methodology also requires a new methodology for interpretation of the Qur'an and the Ahadith. For example, rather than relying on an individual Ayah or an individual Hadith, the goals may be better served by an integrated look at all the Ayat and all the Ahadith related to a subject. And, not only that the Qur'an should be interpreted in the light of the Sunnah or the Hadith, but the Ahadith too should be interpreted in the light of the leads available in the Qur'an on the given subject.

2. Potential Research Areas

Islamic banking, as noted earlier, started in the 1970s with personal initiative of the concerned Muslims to address the problem for riba. The pioneers included committed and resourceful individuals, professional bankers, Islamic economists and Shari'ah scholars. There was no initial working model to act upon. The journey of Islamic banking over the years is marked by experimentation with the ideas. The initial enthusiasm about profit-and-loss sharing being "the" basis for Islamic banking has given way to more pragmatic solutions. Now, despite all the advances on the theoretical and the practical planes, the situation is moving in another direction.

With every passing day, the difference in the working of the Islamic and the interest-based banks is becoming thin. The existing Islamic banking model runs the risk of being called "banking for the Muslims with the sanction of the Shari'ah scholars". Further drift in this direction can be avoided only by urgent research effort. Some potential areas for research are identified hereunder.

2.1 General Principles for Permissible Forms of Transactions

As noted in section 1.2, if we can work out all the Shari'ah principles for permissible forms of transactions, then it would become fairly straightforward to work out a Shari'ah-compliant arrangement for all conceivable purposes admissible in the Shari'ah. Some such principles traceable directly to the Qur'an and the Sunnah are as follows:

1. Primacy of the Will of Allah SWT
2. Admissibility of Goal or Purpose
3. Permissibility of the Subject Matter
4. No Transaction of *Ghaeb*
5. 1st and 2nd Fundamental Principles for All Exchanges
 - 1st Fundamental Principle: Shari'ah-compliance
 - 2nd Fundamental Principle: Full willing consent
6. No Gharar—A procedure: Complete information disclosure.
7. No Qimar/Maesir
8. No Riba
9. No Role for a Third-Party in Bilateral Matters
10. Explicit but Non-binding Clauses in Contracts
11. Implicit but Binding Clauses in Contracts
12. The personal nature of all rights and obligations
13. Protection of Self-Interest
14. The rules for exceptions from the basic Ahkam
21. 1st and 2nd Principles for Group Level Transactions
 - 1st: Whatever is haram or non-permissible for an individual, that is also haram for group entities.
 - 2nd: A halal or permissible for an individual is also permissible at the group level only if it does not conflict with some other Hukm of the Shari'ah

Given these and any other principles not listed here, one can take any case and work out a Shari'ah-compliant arrangement. For example, take the case of universal life insurance. An individual policyholder seeks economic security of his heirs and capital accumulation. Thus, two goals are involved at the individual level both of which are recognized in the Shari'ah. A practical insurance model based on the Shari'ah concepts of 'aaqilah and modarabah can be worked out. Given the model, one can then work out how an insurance company might fit in the picture.²

² The existing takaful model presumes the existence of a company, and searches for the arrangement that can attract the prospective policyholders. It problems need separate discussion.

2.2 The Theory of Islamic Banking

There is no theory of Islamic banking at present. The different ideas put forth so far are the individuals' responses to emerging situation. A theory of Islamic banking is needed to explain, among other things, the following.

1. The rationale for Islamic banks
2. The role function and the nature of Islamic banks
3. The financial instruments for Islamic banking operations
4. The working of Islamic banks on both the deposit mobilization and the financing sides
5. The main differences between Islamic banking and interest-based banking both at the micro and the macro levels
6. The special requirements for success of Islamic banking in the present age

Last but not the least, such a theory should also provide a platform for further advances in the area of Islamic finance.

2.3 Financial Instruments for Routine Banking Operations

While work on the theory of Islamic banking is the need of the hour, urgent attention is needed for developing Shari'ah-compliant financial instruments for routine banking operations. The existing financing instruments, such as Bai' Bithaman Ajil in Malaysia or Murabahah elsewhere, are not what their names stand for. In both the cases, Islamic banks are buying and selling but that takes place between the bank and the client. As originally expected the banks are not buying from the producers/suppliers and selling to the client. Of course, the debate is side-tracked by the bankers by introducing in the debate terms such as "asset-backed financing", "commodity remaining at the risk of the bank", etc. But the exact details of the transaction—such as those available in Murabahah Financing Instrument on the website of the State Bank of Pakistan—raise several very serious unanswered questions. The idea of "penalty for charitable purposes" and the way in which its rate is determined have made the murabahah financing identically the same as

interest-based financing. The only difference that now remains is that on paper the client and the Islamic bank complete the formality of exchanging offer and acceptance vows for purchase by the client and sale by the bank. There is no guarantee that the client actually purchased the thing, albeit on the bank's behalf, while all this is taking place. This only increased transaction costs for Islamic banks while making no substantial difference from interest-based financing.

The ijarah financing, mostly popular for vehicles financing, again clubs acts of leasing and sale in the same transaction. Moreover, according to the specification of the rental, it is not only variable but also at the mercy of market forces. This is at odds with the Shari'ah requirement that in lease contracts the rental must be precisely stated in advance.

These are only some of the problems. Modarabah and musharakah financing have hardly gone beyond getting some lip-service. Are the causes only limited to the moral fabric of the "Islamic" clients? Or, is something else that is being missed? These issues have not drawn the much needed attention.

2.4 Divisible and Tradable Financial Instruments

Some developments have taken place in the domain of sukuks since the year 2000. There are now salam sukuks and ijarah sukuks. Virtually all major players in Islamic finance— Malaysia, Bahrain, Dubai, Qatar and Pakistan—have come up with their ijarah sukuks. But the following basic questions are being conveniently ignored:

1. These sukuks are based on the notion of leasing of assets. This is not an instrument for mobilization of funds.
2. The sale to SPV contradicts the basic fiqh in several respects, such as:
 - (i) The government sells an asset to an SPV which is created by the government itself. This conflicts with the principle of independence of the buyer and seller—'Hurriyyah Al-'Aaqidayn.
 - (ii) The sale to SPV is not a valid sale because:

- (a) It does not involve full transfer of ownership to the SPV.—The latter is required to reimburse all the proceeds from the sale of the sukuk to the government.
 - (b) The SPV pays token money at the time of sale of the asset to it. The price is actually the targeted proceeds. The addition of green shoe option in some cases leaves that imprecise.
 - (iii) The government's promise to buy back the asset at the same value at which it is sold to the buyers of the sukuk, through the SPV, is a contingent sale. It is, in fact, a buy-back transaction or *bai' al-eeenah*.
3. On the side of leasing back of the sukuk, the stated rental—often in terms of LIBOR plus some basis points—is variable, not fixed as required by the Shari'ah for lease contracts.

If the actual aim is revenue generation, the government should lease its assets for a long time, and *sukuk al-intifa'* be used in order to involve the maximum number of investors.—See *IIIE's Blueprint of the Islamic Financial System*, Chapter 5, for the details.

2.5 Shari'ah-compliant Models for Deposit Mobilization

At present, Islamic banks are doing the following:

1. They accept deposits of different types (demand deposits, term deposits and general savings deposits) for different maturities (nil withdrawal restriction on demand and general savings deposits and 3-month, 6-months, 9-months, 1-year, etc., in the case of term deposits). They put all funds into one pool for investment purposes.
2. They charge all their overhead expenses to the investment operations made out of the term and the general savings deposits mobilized on the principle of *modarabah*.
3. A depositor can place his deposit in any one of the financial products offered by a bank at any time, and exit accordingly.

4. In term deposit matures during the course of a financial year, the depositor is paid his principal and some profits. The profits thus paid are added to operating costs of the banks.

Each one of the above practices conflicts with the basic theory of *modarabah* or *musharakah* enunciated by the Islamic jurists. There is no Shari'ah explanation for the ongoing practices. Islamic banks only cite a nod by their respective Shari'ah Boards.

2.6 Pricing Formulas for Islamic Financial Products

Islamic banking is managed by bankers trained in interest-based banking. The last 30 years have seen debates on various modes of financing. But the available literature hardly gives a clue to the formulas that are relevant for Islamic financing instruments. How is it possible that the instruments used by Islamic banks are claimed to be different from those used by interest-based banks, but the pricing methods are still the same? To see the importance this point further, recall that in the case of *musharakah* financing, a bank is supposed to contract with the client on the basis of a profit-sharing ratio, of course, toward some desired rate of return. But how the profit-sharing would be determined? What is the formula for such a purpose? Such things are only in the black boxes of Islamic bankers.

2.7 Shari'ah-compliant Covers for Bank Financing

Right now, Islamic banks have introduced the concept of penalty in *murabahah* financing to create leverage on the clients against any payment default. Do the theory and the practice meet the standards set in the Qur'an? Unfortunately, no.

There has been no research in the area of *Al-Rahn* and guarantees during the last 30 years.³ A systematic study of the Qur'an and the Hadith can yield not only better insights in these regards but also bring to fore alternative possibilities as well.

2.8 Shari'ah-compliant Accounting

³ Bank Islam Malaysia Berhad has moved in a strange direction, and come up with the idea of *Al-Rahn* financing.

The issue can be best explained by observing that although Islamic banking is claimed to be distinct from interest-based banking, yet the accounting practices followed by Islamic banks in lieu of various financing products and for different deposit products are the same as those used by their interest-based cousins. There is something definitely not right, if not wrong.

2.9 Legal Framework for Efficient Islamic Banking

Quite surprisingly, Islamic banking has arrived in style in several Muslim countries. Many of these countries have also provided legal cover for Islamic banking activities. But serious effort has not gone into clarifying how Islamic banks can be

2.10 Zakah and Islamic Banking

The Prophet SAAWS directed that at the time of zakah assessment, separate maal (wealth or assets) should not be clubbed, and mixed (or, joint) maal should not be separated. If one goes by this dictum, the burden of zakah on modarabah- and musharakah-based accounts should be shared by not only the depositors but also the Islamic banks.

What about financing side? If one goes by the existing fiqhi views on the zakah on debts, how would the proceeds of murabahah financing be affected?

The above are a few issues. The whole issue needs in-depth analysis in view of the seriousness of the matter of zakah in the Shari'ah.

3. A Summing Up

The above are only some of the issues. The actual agenda for research in Islamic finance is very large. In every area, there is the need to identify Shari'ah-based solutions. All the advances on the practical plane in the last 50 years might have endorsement from some Shari'ah-scholar. But does the Shari'ah, the Will of Allah SWT embodied in the Qur'an and the Sunnah, also support them? This issue cannot be ducked for very long. Unfortunately, the recent convergence between Islamic and interest-based banking implies that something is being missed. If this is what was

to be done, why could it not be done several decades ago? May be, some time interest-based banks will stand up and claim that they have all along been Islamic, though they did/do not using the Islamic vocabulary.
