East African Scholars Journal of Economics, Business and Management
Abbreviated Key Title: East African Scholars J Econ Bus Manag
ISSN 2617-4464 (Print) | ISSN 2617-7269 (Online) |
Published By East African Scholars Publisher, Kenya

OPEN ACCESS

DOI: 10.36349/easjebm.2019.v02i01.003 Volume-2 | Issue-1 | January-2019 |

Review Article

Fundamentals and Practices of Islamic Financing Techniques

Khaled Ahmed Elmadani
Phd student, Belgrade Banking Academy, Belgrade, Serbia

*Corresponding Author
Khaled Ahmed Elmadani

Abstract: Islamic banking and finance can be described as a system through which finance is provided in the form of money in return for either equity or rights to share in future business profits, or in the form of goods and services delivered in return for a commitment to repay their value at a future date. By now, a good deal of intellectual effort has been undertaken by a number of specialists in Islamic economics to explore different aspects of Islamic banking and finance. Even some conventional economists, intentionally or unintentionally, have dealt with the subjects, which may be considered closely akin to it. Islamic finance is an industry which in many ways tries to "reinvent the wheel," producing successive approximations of western financial practices. However, it is an industry that is likely to survive in the medium term, due to continued existence of customers who value Islamic jurist approval of its modes of operation. To the extent that Islamism in all its forms is on the rise, the industry is likely to continue to grow.
Keywords: Islamic banking and finance, Shari'ah , Risk-sharing , Banking Theory , Monetary and Macro Theory

1. Introduction*:*

Islamic banking and finance can be described as a system through which finance is provided in the form of money in return for either equity or rights to share in future business profits, or in the form of goods and services delivered in return for a commitment to repay their value at a future date. By now, a good deal of intellectual effort has been undertaken by a number of specialists in Islamic economics to explore different aspects of Islamic banking and finance. Even some conventional economists, intentionally or unintentionally, have dealt with the subjects, which may be considered closely akin to it. It is an undeniable fact that Islamic financial institutions have had only a marginal existence during the last 300 years. They did not get the same chance as western financial institutions to gradually evolve their institutional structure, tools and modus operandi to their full potential.

Therefore, such evolutionary process of Islamic banking and finance must be done through serious intellectual work by economists rather than observing institutions at work.

However, Islamic banking and finance has now been in the arena for more than a quarter of a century. It has taken a contemporary shape. Whether it has sufficiently approached the Islamic paradigm par excellence or not, is a different question. The philosophy of Islamic banking and finance is a set of theories and ideas related to its understanding.[1]

In this regard, I shall start with the rules of Islamic Shari^ah from which the very idea of Islamic banking has been drawn. Second, monetary and macro theory is required to explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of such practice. Third, banking theory itself would be necessary to figure out the behavior of Islamic banking and finance as well as to assess its comparative performance.

1.1 Shari'ah

Islamic teachings in the fields of mu'amalat, or transactions, prohibit selling a certain quantity of any present goods or service for a different (presumably larger) quantity of the same good or/and service delivered in the future. This is understood to apply to

[1] El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", *Fordham International Law Review*, December 2003

Quick Response Code

Journal homepage:
http://www.easpublisher.com/easjebm/

Article History
Received: 11.01.2019
Accepted: 20.01.2019
Published: 28.01.2019

money as well as to all other goods and services. As a result, any amount of present money cannot be exchanged for a larger amount of money in future. In addition, there are other rules of transactions that must be applied to insure fairness of dealing to both the contracting parties concerned. Mainly al- ghabn[2] and al-gharar[3] are strictly prohibited.

1.2 Monetary and Macro Theory

Until the middle of the twentieth century, most economists found no fault with the fact that the present banking and financial system is interestbased. In the mid sixties of the last century, some economists noticed that the current macroeconomic theory is devoid of any satisfactory and acceptable rationale for holding money. As a result of this realization, attempts were made to introduce money explicitly into theory, while building the microfoundations of macroeconomics. During such process, it was natural to look into the issue of optimal monetary policies. Only then, they stumbled on the Friedman's monetary rule that a zero nominal interest rate is a necessary and sufficient condition for optimal allocative efficiency.[4] In a fiat-money world, adding one marginal unit of real balances costs no real resources to the community. Imposing a positive price on the use of money would lead traders to economize on its use, by using real resources. However, when the rate of interest is zero, traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment. These results imply that the long forgotten Christian and Jewish teachings as well as those of Islam and Hinduism that prohibit the charge of interest on loans are not an aberration. In a conventional market economy the rate of interest can be brought down to zero only through deflating the economy at a rate equal to the real rate of interest, which can be attained by steadily contracting the money supply at a rate equal to the representative household time preference.[5] Such policy rule clearly implies that central bankers should implement a long-run policy of deflation, something that they would never accept.[6] With deflating the economy, some economists would worry about the existence of a liquidity trap when the rate of interest is zero.[7] Other economists advise to exercise deflationary policies only asymptotically in order to apply the Friedman's Rule.[8] Others point out that monetary authorities would have less leeway with adjusting the interest rate downwards in the face of recession if the rate of interest is very low. Certainly, deflation has efficiency problems parallel to those of inflation, even at very low interest rates.[9] While many economists believe that problems involved with zero interest rates are all surmountable, monetary authorities are not yet impressed.

The fact that Islamic banking and finance avoids the use of interest-based lending has significant implications to monetary policy. In managing the money supply, the monetary authority would monitor the real rate of growth and set the rate of monetary expansion to the level consistent with price stability and expected real growth. Some Islamic economists propose a 100 per cent required reserve ratio in order to give the authorities absolute control of the money supply and to appropriate all seigniorage resulting from monetary expansion to the government instead of banks' shareholders.[10] The fact that the economy is as close as possible to price stability implies that the rate of monetary growth is optimal, and there is no need to divert real resources to monetary use. Therefore, Pareto optimality is assured without problematic deflationary policies. Meanwhile, people can use their cash balances to carry out spot purchases. Those with insufficient cash balances for their current purchases of assets and/or commodities can revert to finance. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources. In case of profit sharing modes of Islamic finance, focus would be on the profitability and rate of return of the concerned investment. Financial resources would be directed to the most productive investments. This would increase the efficiency of the financing process and also reinforce efficiency in the real sectors. In credit-purchase and leasing modes of Islamic finance, money is not given outright, but rather commodities are given in return for debt obligations. Credit expansion in the face of increasing credit-purchase of assets and commodities would be tied directly to higher demand for assets and commodities, which would have a direct bearing on aggregate supply.

Consequently, credit finance under Islamic finance would be less inflationary in comparison to conventional banking and finance.

1.3 Behaviour of Credit Markets

An important part of macro theory relates to the behaviour of credit markets. In conventional finance, present money is traded against future money either in integrated debt or in bond markets, where huge sums of debt are traded daily. Debt markets act as an

[2] *Al-ghabn* in transactions implies deception and misrepresentation or cheating.
[3] *Al-gharar* in transactions implies uncertainty
[4] Friedman (1969); Cole and Kocherlakota (1998); and Wilson (1979). This result is robust in a variety of models, see Correia and Teles, 1997.
[5] Friedman (1969), p. 34 quoted by Ireland (2000).
[6] Wolman (1997).
[7] Uhlig, Harald (2000)
[8] Cole and Kocherlakota (1998); and Ireland (2000).
[9] Lucas (1994). For an assessment of the welfare cost of implementing a zero rate of interest, see Wolman (1997).
[10] Fohlin (2000); Barth, Caprio and Levine's (2000); and Gorton and Schmidt (1996).

easy conduit to move short-term funds at will from one country to another, more often than not, in reaction to factors that are only nebulously related to economic fundamentals. Such flows threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call "contagion."

In contrast, debt is created in Islamic finance through selling goods and services on credit, which by itself is not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines an equilibrium mark-up rate. Such credit markets would be fully segmented. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion would therefore be remote and there would be no pressing need to choke capital movements with restrictions. Institutional participants in conventional credit markets carry out huge speculative transactions which most often turn out to a major source of instability. In contrast, Islamic banking and financial institutions are strictly prevented from carrying out such gambling activities. Thus, it seems reasonable to deduce that destabilizing speculative activity would significantly be curtailed in Islamic financial markets. Speculative activities related to interest rate expectations would become out of place. Change in spending would be reflected directly on change in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces.

1.4 Risk-sharing

Another important aspect of micro theory is that of risk-sharing. Conventional finance can be likened to a spectator's game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic finance, meanwhile, is similar to participatory sports, where everyone is playing and no one is mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of everyone's mind. Risk is known to be one of the most important ingredients of making investment. In Islamic finance, those who finance investment share a good part of the risk with those who carry out actual investment activities.

Conventional finance leaves risk to be borne by specialists and traded among them. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves shielded from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only. Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it will be. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions. The banks and financial institutions can also share the decision-making process as their representatives sit on the boards of directors of firms receiving funds. It, therefore, may be noticed that risk as well as the responsibility for decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for involvement of a wider section of entrepreneur and investors in economic activities, so that people will eventually feel they are partners rather than spectators. The benefit of wider involvement goes beyond the feeling of involvement. It adds to the stability of banks. Investment depositors share risk indirectly with firms, while relying on banks for monitoring. Having the proxy vote of depositors and other investors, Islamic banks, would be capable of influencing the corporate governance of firms in a way that reduces the risks of failure and promotes profits. In other words, the stability of the banking system will reinforce and be reinforced by the stability of the real sector. The main results of this would be a higher integrity of the whole economic system.[11]

1.5 Equity Considerations

An important aspect of macro theory is equity. Islamic financial system is basically viewed as private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they might contribute to the efforts taken by the whole society in that direction. Zakah proceeds are known to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of working and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor enough productive assets, to make them more productive, which in turn contributes to economic development.

Islamic banks can help by acting as custodians of and participants in the disbursement of the zakah proceeds. Government and nongovernmental organizations (NGOs) collecting zakah can deposit part of the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they may also add a proportion of zakah due on their shareholders' equity.[12] They might even accept direct payments of zakah and other donations on behalf of

[11] El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", *Fordham International Law Review*, December 2003.

[12] Understandably, there may be other expenditure items which would be financed from *zakah* proceeds. That is why only a proportion of them would be handed to banks. Such proportion can be determined by society and could change from year to year.

zakah payer individuals and philanthropic institutions. As to income maintenance, Islamic banks can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturely liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial institutions in project financing should come in handy in reducing poverty and increasing equity through proper use of zakah proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profitsharing basis would be more concerned with profitability and rate of return than with collateral and guarantees. In an Islamic financial system those who are not wealthy, but have worthy investment projects, may also have appropriate access to finance.

1.6 Banking Theory

In the Islamic world, Islamic banks can only accept fiduciary deposits, for which they cannot pay interest, since interest would be considered usury/riba once the principal is guaranteed. On the other hand, they are allowed to accept "investment account" funds, which they may invest on behalf of the account holders, and share profits and losses thereof. This clearly gives rise to a moral hazard problem, and a regulatory issue regarding protection of investment account holders who are neither protected as creditors (first claimants), nor as stock-holders with representation on boards of directors. Islamic banking and finance relates to banking theory in two aspects.

First, Islamic banks perform the function of intermediation between fund owners and firms. Banking theory can justify this role in fashion similar to the role of commercial banking, which intermediates between borrowers and lenders. As monitoring is costly, models containing a costly state-verification problem, (CSV- a special purpose vehicle owned by the Islamic financiers, they are protected from the risks associated with the ownership of the assets), conclude that an efficient solution to the monitoring problem can be obtained when an agent pools deposits to finance investment projects.[13]

Second, Islamic banks are supposed to practice equity finance simultaneously with credit purchase and leasing finance. This implies that they are some kind of kin of universal rather than of commercial banks. Banking theory comes again to show that such a role brings extra advantages to Islamic banking.

Models that provide rationale for relationship banking postulate a positive relationship between the severity of asymmetric information between banks and fund users on the one hand and informational distance on the other. When conclusions of such models are applied to Islamic banks, if unencumbered with constricting regulations, they would tend to build relationships in their core markets. Such retrenchment permits them to fend off the competitive threat to their captive market.

Outside their core segment, they offer credit-purchase and leasing finance, which bear some similarity to transactional loans. In equilibrium, both forms of relationship and transactional finance compete with each other but Islamic banks would be expected to specialize in a core market with relationship or universal banking.[14]

Islamic banks should, therefore, function as universal banks, which are …"large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters…"[15]

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

Obviously, adverse selection can be avoided by careful screening of finance seekers. When a bank provides equity and debt finance simultaneously, it will have more access to information than in a situation when only debt finance is provided. It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking. Reducing possibilities of moral hazard requires monitoring of the firm obtaining finance.[16] Equity finance provides the bank with access to information necessary to practice continuous monitoring. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt

[13] Hauswald and Marquez (2000).

[14] Da Rin, Marco and Thomas Hellmann (2001).

[15] Cole, Harold L. and Narayana Kocherlakota (1998), "Zero Nominal Interest Rates: Why they're good and how to get them", *Federal Reserve Bank of Minneapolis Quarterly Review*, 22 (Spring 1998): 2-10.

[16] Dewenter, Kathryn L. and Alan C. Hess (1998), "An International Comparison of Bank's Equity Returns", Journal of Money Credit and Banking, Vol. 30, No. 3, (August, Part 2), 472-92.

finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment.

In summary, banking theory indicates that Islamic banks should operate as universal banks, and when they do, they would be exposed to lower levels of moral hazard and adverse selection. Universal banking has recently attracted much writings from both proponents and antagonists. [17] Meanwhile, the arguments levelled against it created much discussion in the beginning but proved unfounded at the end. It has been credited with encouraging industrialization in pre-war Belgium, Germany, Italy and Japan.

Da Rin and Hellmann (2001) have introduced financial intermediation into the big push model which has two Pareto[18]-rankable equilibria. They showed that universal banks can induce an economy to move from low to high equilibrium if they are sufficiently large to invest in a critical mass of firms.

The costs of mobilizing the critical mass are reduced, if banks are allowed to own equity that allows them a share in the value they help create by mobilizing the critical mass. This means that universal banks will find it easier to promote investments in new industries.

While providing a sophisticated analytical framework for the behaviour of universal banking, Da Rin and Hellmann's model is a good step towards building a macro theory of banking.

Universal banks have been accused of altering the corporate capital structure in favour of debt and against equity, inefficiently combining banking with trade, of concentration to a degree that produces anti-competitive behaviour (what came to be known as the organ bank hypothesis). They have also been accused of benefiting from the inside information about the firms they lend while exercising monopolistic power over access to external finance, leading to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights. None of such accusations was found credible.[19]

2. Modes of operation in Islam finance

There are many contract and institutional forms used within the industry collectively known as Islamic finance. Specifics vary across countries and sectors. In this paper, I will concentrate on some of the basic and central modes of financing that are most popular in Islamic finance today.

2.1 Consumer and Business Loan Alternatives

The juristic-based understanding of forbidden riba/usury suggested that Islamic finance has to be "asset-based", in the sense that one cannot collect or pay interest on rented money, as one does in conventional banking. Therefore, the easiest transactions to Islamize were secured lending operations, e.g., to finance the purchase of real estate, vehicles, business equipment, etc.

Three main tools are utilized for this type of retail financing:

a) Buy-sell-back arrangements given the classical Arabic name: murabaha.

Under this transaction, the bank obtains a promise that its customer will purchase the property on credit at an agreed-upon mark-up (interest alternative), then proceeds to buy the property and subsequently sell it to the customer. These are analogous to the Federal Reserve's use of "matched-sale purchases." Depending on the jurisdiction and the object of financing, this may or may not impose additional sales taxes, license fees, etc. In the U.K., a recent regulatory ruling allowed Islamic financiers (HSBC) to practice double-sale financing without being subject to double-duty taxation. In 1999, at the request of United Bank of Kuwait (UBK), which at the time offered an Islamic home financing program in the U.S. (called Manzil USA, the program was terminated shortly thereafter), the Office of the Comptroller of the Currency issued an interpretive letter declaring Murabaha financing to be "functionally equivalent to or a natural outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking". The mark-up in Murabaha financing is benchmarked (i.e., made to track) conventional interest rates.[20]

b) Lease-to-purchase or diminishing partnership arrangements under the Arabic names: Ijara or Musharaka Mutanaqisa.

A typical structure requires the bank to create a special purpose vehicle (SPV) to purchase and hold title to the financed property. The SPV then leases the property to the customer, who makes monthly payments that are part-rent and part-principal. Rents are calculated based on market interest rates, allowing monthly payments to follow a conventional amortization table. The juristic justification of this

[17] Diamond, D. (1984), "Financial Intermediation and Delegated Monitoring", Review of Economic Studies, 51, 393-414.

[18] A technique used for decision making based on the Pareto Principle, known as the 80/20 rule. It is a decision-making technique that statistically separates a limited number of input factors as having the greatest impact on an outcome, either desirable or undesirable. Pareto analysis is based on the idea that 80% of a project's benefit can be achieved by doing 20% of the work or conversely 80% of problems are traced to 20% of the causes.

[19] Gorton, Gary and Frank A. Schmidt (1996), "Universal Banking and the Performance of German Firms", Working Paper No. 5453, NBER, February.

[20] El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", *Fordham International Law Review*, December 2003

practice is that principal parts of monthly payments increase the customer's ownership in the property, and allow him to pay less rent (on the part ostensibly owned by the bank through the SPV) over time, thus replicating a conventional amortization table. Again, at the request of UBK, the Office of the Comptroller of the Currency examined the typical structure of Islamic lease-to-own (Ijara) transactions, and reasoned as follows:

…"Today, banks structure leases so that they are equivalent to lending secured by private property ... a lease that has the economic attributes of a loan is within the business of banking... Here it is clear that UBK's net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender...". [21]

An added advantage to lease financing is that Islamic jurists allow the SPV to issue certificates securitizing the lease (ostensibly, the certificates represent ownership of the underlying asset, and thus allow their holders to collect rent). In recent years, this has given rise to a booming securitization industry in Islamic Finance, as we shall discuss within the context of bond-alternatives. Here in the U.S., both Fannie Mae [22] and Freddie Mac [23] have purchased and guaranteed Ijara-based mortgages, subject to their note requirements (which required overcoming some legal and juristic hurdles). Those Islamic mortgage-backed securities are currently being marketed as fixed-income investment alternatives for Muslims.

c)Recently, banks in Gulf Cooperation Council (GCC) countries have been offering consumer finance through a three-party contract known by the Arabic name Tawarruq
(literally: monetization of some commodity).

This is a practice that Islamic banks have used with more sophisticated business clients for a number of years, but only recently introduced for consumer financing. For example, a customer wants to borrow $1000 using an Islamic Juristic-compliant mechanism.

GCC[24] Islamic jurists, relying on an opinion within the Hanbali school of jurisprudence, which is dominant in that region, allow the bank to buy $1,000-worth of commodities (e.g., wheat), and sell them to the customer on credit at a mark-up (equal to the interest rate they would have charged on a loan, perhaps plus compensation for the transaction costs associated with multiple sales). The customer may then turn around and sell the commodity to a third party (oftentimes the same party that sold it to the bank), collecting the desired cash immediately, with a deferred debt equal to principal plus interest. In 2004, at least one other bank in a GCC country announced a new Tawarruq facility. Since this type of financing can easily replace lending for any purpose (consumer loans, unsecured loans, etc.), it has allowed a number of conventional banks to announce that they will "Islamize" all of their operations. The most significant such announcement was that made by Saudi Arabia's National Commercial Bank, stating that it planned to Islamize all of its lending practices by 2005.

2.2 Corporate and Government Bond Alternatives

In its early stages of development in the 1980s and 90s, a number of bond alternatives were tried with very limited success. Some were based on profit and loss sharing (e.g., in Sudan and Pakistan), while others guaranteed the principal but did not guarantee a fixed rate of return (e.g., in Malaysia). Once the securitization of leases became fully understood, a significant number of corporate and government bonds were structured as lease-backed securities (under the Arabic name Sukuk al-Ijara).[25] In 2004, the largest issuance was by the Department of Civil Aviation of the United Arab Emirates for $750 million. The second largest was by the Bahrain Monetary Agency for $250 million. The latter was led by Citigroup, with heavy involvement of the Norton Rose law firm to structure the deal. A third interesting government issuance was by the German Federal State of Saxony-Anhalt for €100 million, which is heavily marketed in the Arab countries of the GCC as the first western-government issued Islamic bond. The two largest corporate Islamic bond issuances in the first half of 2004 were those of the National Central Cooling Company (of U.A.E.) for $100 million and Hanco Rent a Car in Saudi Arabia for $26.13 million.

Corporate bond issuances in the early part of 2006 totaled $10.2 billion, the most notable being the Dubai Ports issuance of the largest sukuk to date, a 2 year convertible $3.5 billion bond (profit and loss sharing). In 2005, an estimated $11.4 billion in corporate sukuks were issued, up from $5.5 billion and $4.6 billion in 2004 and 2003 respectively. Sovereign issuances in 2006 total $2.7 billion thus far, up from $706 million in 2005, $1.5 million in 2004 and $1.2 million in 2003.11 An additional $6.7 billion in sovereigns is slated to be issued for the remainder of 2006. A number of those issuances were made by SPVs, which buy some properties from the respective governments or corporations using bond-sale proceeds, and then lease the properties back, passing principal and

[21] Samuelson and Nordhaus (1985), p. 898; Dornbusch and Fischer (1987), p. 125.

[22] The Federal National Mortgage Association (FNMA), commonly known as Fannie Mae, was founded in 1938 during the Great Depression as part of the New Deal. It is agovernment-sponsored enterprise (GSE), though it has been a publicly traded company since 1968

23 The Federal Home Loan Mortgage Corporation (FHLMC), known as Freddie Mac, is a public government-sponsored enterprise (GSE),

[24] Gulf Cooperation Council (GCC), political and economic alliance of six Middle Eastern countries—Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman.

[25] *Ijarah Sukuk*- Tradable forward instruments against rentable assets.

interest back to bond-holders in the form of rent. A number of different U.S. and European investment banks are involved in the securitization process (e.g., Citigroup for the Bahraini and German state bonds, Credit Suisse First Boston for the UAE cooling company, and Barclays Bank with the Dubai Islamic Bank for the Dubai Ports Co.). Lease-backed bonds are long-term securities, for which underlying physical assets allow secondary markets to exist. Shorter-term (Treasury bill-like) bonds are also issued on occasion by governments of countries with significant Islamic banking operations (e.g., Bahrain). Those are typically based on forward sales of some commodities, using the Arabic name salam, and adhering to the classical juristic ruling that price must be paid in-full at the inception of a salam-sale. By utilizing what is called a "parallel salam", the bond-issuer can match a forward-purchase with a purchase-sale for the same commodities and the same delivery date, but initiated at different times. Thus, corn deliverable in six months can be sold forward today for $1 million, and then bought forward in three months (using a separate contract with a different counterparty) for $1.01 million. While residual credit, commodity and delivery risks may exist in this structure, issuers typically guarantee the contract so that the bond buyers would – in our example – be guaranteed 1% in 3 months. Since the underlying assets for this type of bond are debts, Islamic jurists ruled that they cannot be traded on secondary markets (except at face value, which defeats the purpose).

Thus, they were originally envisioned as vehicles primarily for Islamic banks to hold to maturity. Recently, however, Bahrain has introduced some innovative repo (repurchase) facilities, to allow Islamic banks to use those bills more effectively for liquidity management.

2.3 Investment Vehicle Alternatives (e.g., Mutual Fund, Private Equity)

For investment in corporate equity, it was easy to see why Islamic investors should shy away from companies that produced products that are forbidden to Muslims (e.g., beer, pork products, etc.), as well as some others that Islamic jurists decided to forbid (e.g., weapons producers, cutting-edge genetic research, etc.). The issue of interest was much more difficult: Most companies either have excess liquidity – in which case they earn interest, or use leverage – in which case they pay interest. Islamic jurists decided to invoke the rule of necessity (the universe of equity securities to choose from would be too small if they exclude all companies that either pay or receive interest). They decided to impose three financial screens: (i) exclude companies for which accounts receivables constituted a major share of their assets; (ii) exclude companies that had too much debt; and (iii) exclude companies that received too much interest. After experimentation with different cutoff marks for financial ratios, the set of rules selected by the Dow Jones Islamic indices became globally accepted: (i) exclude companies whose receivables accounted for more than 45% of assets; and (ii) exclude companies whose debt to moving average of market capitalization exceed 33%. Many add a third rule related to the first: (iii) exclude companies whose interest income exceeds 5% (or, for some, 10%) of total income.

Dow Jones, and later Financial Times, launched their Islamic indices in the late 1990s, and continue to add various other Islamic indices paralleling their other conventional indices, with the smaller universe of equity securities. Mutual fund companies either mimic their screening rules, or obtain licenses from one of the indices, which they use as a benchmark. These types of mutual funds are usually dubbed "Islamic" or "Shari`a-compliant." While sales of mutual funds in general have done well in Saudi Arabia and GCC markets, Islamic mutual funds seem to have only a limited marketing advantage over conventional ones. In one study done by National Commercial Bank in Saudi Arabia, investors indicated that all other things equal, they would prefer an "Islamic" fund to a conventional one. However, if other things are not equal, they would prefer a conventional fund with better returns, or offered by a more reputable provider, to ones that are "Islamic" but inferior along those dimensions. Consequently, the total funds under management by Islamic mutual funds have – to date – fallen substantially short of initial expectations. [26]

On the other hand, growing unanimity over the general screens used by Islamic mutual funds has enabled Islamic private equity and investment banking boutiques to thrive.

Those institutions typically collect investor funds in GCC countries (investors from Saudi Arabia, Kuwait, and U.A.E. being primary sources of funds). Through local subsidiaries or partners in the west (U.S.A. and U.K. being primary destinations for investment funds), collected funds are used to acquire real estate and small companies that pass the above mentioned screens, or whose debt can be restructured to pass them (oftentimes through lease-based leveraged buy-outs, a popular western mergers and acquisitions tool of the 1980s and 1990s). There are 134 registered equity funds, six hybrid funds, six sukuk funds, two Takaful funds (insurance), five leasing funds and eight real estate funds.

2.4 Insurance Alternatives

[26] Hussein Hamid Hassan, "Flexibility of Shari'ah Principles of Finance and Resource Mobilization Needs of Government", in Ahmad, Ausaf and Khan, Tariqullah, (ed.) *Islamic Financial Instruments for Public Sector Resource Mobilization*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1997, pp. 27-60.

The vast majority of Islamic jurists declared the use of, and investment in, insurance companies to be impermissible under Islamic jurisprudence. This prohibition is based on two considerations: the first consideration is that "safety" or "insurance" is not itself viewed as an object of sale in classical Islamic jurisprudence. Thus, Islamic jurists argued, the insured-insurer relationship is viewed to be one akin to gambling, wherein the insured as buyer pays periodic premia as price, but may or may not receive the object of sale (compensation in case of loss), depending on chance.

The second consideration that prompted Islamic jurists to forbid insurance is the fact that insurance companies tend to concentrate their assets in interest-based instruments such as government bonds and mortgage-backed securities. The alternative they proposed is marketed under the Arabic name Takaful, which has recently begun making inroads in Islamic countries, after years of slow growth.

The main idea behind Takaful is similar to mutual insurance, wherein there is no commutative financial contract that allows one to interpret premium payments as prices and insurance claim fulfillment as an object of sale. Rather, policy holders are viewed as contributors to a pool of money, which they agree voluntarily to share in cases of loss to any of them. Early Takaful companies were in fact structured as stock insurance companies, but the language of "voluntary contribution" to insurance claimants was used to argue that the contract was not a commutative one. Inroads have recently been made by Bank Al-Jazira of Saudi Arabia by modifying its insurance to better approximate western-style mutual insurance, and the model appears to be boosting its underwriting success. Regardless of structure, both types of Takaful companies do not invest in conventional government bonds and fixed income securities. However, as seen elsewhere in this section, Islamized analogues of those securities have become increasingly available in recent years, further contributing to the industry's growth. Despite the industry's growth, it has not yet reached a critical size that would support the equivalent of re-insurance, or "re- Takaful", companies to emerge. [27]

Consequently, Islamic jurists have invoked the rule of necessity to allow Takaful companies to sell their risks to conventional re-insurance companies, with the provision that they should work to develop a re - Takaful company as soon as possible.

2.5 Bank Deposit and Fixed Income Security Alternatives

In the Islamic world, Islamic banks can only accept fiduciary deposits, for which they cannot pay interest, since interest would be considered usury/riba once the principal is guaranteed. On the other hand, they are allowed to accept "investment account" funds, which they may invest on behalf of the account holders, and share profits and losses thereof. This clearly gives rise to a moral hazard problem, and a regulatory issue regarding protection of investment account holders who are neither protected as creditors (first claimants), nor as stock-holders with representation on boards of directors. Attempts by significant juristic bodies to justify interest-bearing bank deposits have been strongly rejected by most Islamic jurists, especially the ones to whom Islamic bank customers look for guidance.[28]

In the U.S., a number of attempts took place in the U.S. to license an Islamic bank, a number of conventional banks are offering Islamic financing products, and working towards offering FDIC-insured variable-interest (tied to rate of return on portfolio of Islamic mortgage, auto-financing, etc.) Interpretation of such services as "deposits" is controversial, and their appeal to target clientele is uncertain. In particular, and in analogy to the limited appeal of Islamic mutual funds, it may be the case that potential Islamic bank customers who are sufficiently sophisticated to accept deposit insurance will also be sufficiently sophisticated to seek the best combinations of returns and offering institution-size. On the other hand, the novelty of "Islamic banking" availability, coupled with the possibility of obtaining FDIC insurance of the principal, may prove to be sufficiently attractive for a group of Muslims who have so-far shied away from depositing their funds in savings or money market accounts, as well as others who have such accounts but prefer to buy the "Islamic" brand-name.[29]

In the meantime, market-based fixed-income alternatives have been available for quite some time based on securitization. Thus, Islamic finance clients can buy Islamic mortgage-based securities, or invest directly in pools of securitized fixed-return Islamic financial products. In this regard, while securitized Murabaha (cost-plus credit sale receivable) portfolios are deemed non-tradable except on face value, Islamic jurists have allowed trading mixed portfolios of sale-based and lease-based receivables, provided that the latter constitute at least 51%. If the market for Islamic-finance assets continues to grow, the ability to offer all types of fixed-income instruments, including bank

[27] Hussein Hamid Hassan, "Flexibility of Shari'ah Principles of Finance and Resource Mobilization Needs of Government", in Ahmad, Ausaf and Khan, Tariqullah, (ed.) *Islamic Financial Instruments for Public Sector Resource Mobilization*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1997, pp. 27-60.

[28] El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", *Fordham International Law Review*, December 2003

[29] Mannan, M. A., (ed.) (1996), *Financing Development in Islam*, Jeddah: Islamic Research and Training Institute, Islamic Development Bank.

savings accounts, should become more common in the West. It may take time for Middle-Eastern and Asian clients to accept this notion, given the vigor with which they have constantly argued against interest-based transactions as the forbidden Riba.

3. GeographicDistribution of Islamic Finance

Intensive efforts have been spent in recent years to harmonize Islamic financial practices, from creating accounting standards for Islamic financial products (through the Accounting and Auditing Organization for Islamic Financial Institutions, AAOIFI), to integration of those standards with global corporate and risk management standards (i.e., Basel Accords I and II) through the recently created Islamic Financial Services Board (IFSB). Those efforts are motivated by two objectives: (1) to create a worldwide network of financial markets, including the offshore markets in Labuan (off the Malaysian coast), Bahrain, and Dubai, thus enhancing depth and liquidity of markets for industry securities; and (2) to integrate the industry more effectively with the international financial system. However, country and region-specific features have not faded away. We list some of the defining features of Islamic finance in the various relevant sub-regions in this section.

4. Gulf Cooperation Council (GCC) Countries

Not surprisingly, the rise of Islamic finance in the late 1970s coincided with the two oil shocks of that decade, which created an immense amount of wealth. The earliest private Islamic banks of the modern era were Dubai Islamic Bank, Faisal Islamic Bank Egypt, and Faisal Islamic Bank Sudan, the latter two being sponsored by Prince Muhammad Al-Faisal, son of the late King Faisal of Saudi Arabia. Other early entrants in the industry were the various financial arms of Saudi Sheikh Saleh Kamel’s Dallah Al-Baraka groups, and Kuwait Finance House, among others.[30]

In its early stages, most governments in the GCC region, and the Arab world more generally, were either hostile to, or at best ambivalent about, Islamic finance. Indeed, to most people’s surprise, the latest country to allow Islamic banking in the region is Saudi Arabia, where the Saudi Arabian Monetary Authority has always been concerned about and averse to introducing non-standard banking practices.

However, demand for financial products allowed a number of local and western financial practitioners to create a small industry, using investment funds from the Gulf region, especially Saudi Arabia. Over the past decade, Bahrain has pursued Islamic finance as a significant niche that could allow it to build on its strong banking sector, perhaps to become a regional financial center. Local investment banking talent also emerged in Bahrain (e.g., First Islamic Investment Bank) and Kuwait (e.g., The International Investor) to capitalize on the growing industry, which had earlier centered in London and Geneva.

Not to be out-maneuvered, a number of multinational financial institutions (e.g., Citigroup, HSBC, and UBS) set-up Islamic financial arms in the region (mainly in Bahrain and U.A.E.) to cater to commercial as well as investment banking needs within the Islamic finance niche.

Islamic finance arms of multinational banks, with their superior resources, later helped indigenous Islamic finance companies to establish the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and most recently initiate the drive to get Central Banks, as well as the IMF and World Bank, to establish the Islamic Financial Services Board in Kuala Lumpur, Malaysia. We have already seen the primary role played by multinational investment banks in the most recent wave of Islamic bond issuances, both by sovereign states in the region (Bahrain and Qatar), as well as corporations.[31]

5. Southeast, South and Central Asia

Malaysia developed one of the earliest mature Islamic finance markets in the mid-1980s. Initiatives to integrate ethnic Malays in the country’s formal financial sector culminated in converting a pilgrimage savings plan into a full-fledged Islamic bank: Bank Islam Malaysia Berhad. Over the next two decades, conventional Malaysian banks were allowed to offer Islamic financial products through “Islamic windows”. Malaysia’s central bank, Bank Negara, began supervision of Islamic banking practices at its inception. Special bonds called Government Investment Certificates were issued to facilitate open market and inter-bank operations. Those bonds guaranteed the principal, but gave interest only as an unanticipated gift based on profitability of government investments. Malaysian Islamic money markets were successful early on, and attracted some investment capital from GCC investors eager to invest some of their capital in Islamic countries.

However, as advanced as the Malaysian Islamic financial sector was relative to its Arab counterparts, it suffered a fundamental drawback. Much of the development of that sector relied on a juristic opinion held by Malaysian Islamic jurists, who allowed trading debts and pure-debt instruments. That allowed Malaysia to evolve a highly efficient parallel Islamic financial system. However, Islamic jurists of other regions did not approve of this debt-trading practice. As the Arab market grew, and Malaysia feared that Bahrain would replace London as the sole center of global Islamic

[30] Ahmad, Ausaf (1993), “Contemporary Practices of Islamic Financing Techniques”, Research Paper Number 20, First Edition, Jeddah: IRTI.

[31] Hassan, M. Kabir and Adnan Q. Al-Dayel (1998/1999), “Stability of Money Demand Under Interest-Free Versus Interest-Based Banking System”, *Humanomics*, 14(4) and 15(1).

finance, Malaysians strove to harmonize their Islamic financial markets with Islamic financial practices elsewhere in the world. To emphasize its leading role in this industry, the Malaysian central bank led the creation of the Islamic Financial Services Board, which is now housed in Kuala Lumpur and relies on Malaysian contributions for running expenses. In the meantime, Malaysians continue to allow more innovation for their own domestic Islamic financial market, allowing conventional futures trading, debt trading, etc., and recently creating a deposit insurance mechanism for Islamic banking. Other countries in Southeast Asia, e.g., Indonesia, Singapore, etc. have relatively small Islamic financial sectors, which are likely to evolve as a hybrid between the Malaysian and the more conservative Arab and Pakistani models.[32]

Pakistan is another interesting case to consider. General Zia-ul-Haqq, in his many efforts to use Islamic fervor for his regime's legitimacy, declared full-fledged Islamization of the financial sector in the 1980s. However, bankers merely continued their conventional banking practices, replacing the term "profit" with "interest". The Pakistani Shari`a Appellate Court repeatedly issued ultimatum orders to Islamize the system for real at various dates, but that proved impossible. A new Islamic banking initiative was started in 2004: there are four Islamic banks, two are in the pipeline and 15 conventional banks have Islamic branches. The State Bank of Pakistan (the Central Bank) appointed its own 5-member Shari'a board (Islamic juristic authority) composed of an Islamic jurist, accountant, lawyer, banker, and central bank representative and has posted a list of permissible Islamic banking contract forms on its website. This may be a prelude to more general imposition of Islamic banking practices in Pakistan.

Iran also declared the Islamization of its banking sector shortly after the Islamic revolution. However, since most banks were either national or nationalized, interest payments between those banks were seen to cancel out in the consolidated balance sheet, and were therefore permitted. For dealings with the public, some banks did not guarantee interest rates, but in practice paid rates equal to the interest rates determined elsewhere in the system. Hence, Iranian banking has not changed significantly before and after the revolution. Finally, a small number of boutique Islamic financial shops started in the various "stans" (especially Kazakhstan) in recent years, but there are no signs of an Islamic financial industry evolving in central Asia at this time.[33]

6. Arab World excluding GCC

Faisal Islamic Banks in Egypt and Sudan were among the very first Islamic banks. Faisal Islamic Bank Egypt was established by special decree, and Islamic banking in Egypt remains extremely limited, although some state banks are allowed to offer Islamic transactions to fulfill the market demand. Official and public perceptions of Islamic banking in Egypt were severely damaged in the aftermath of massive failures of Islamist "fund mobilization companies" that apparently attracted remittances of many Egyptians working in GCC countries, ostensibly to invest in trading real assets, but in fact constituted pyramid schemes.

In contrast, Sudan Islamized its entire banking sector. A very conservative (and hence relatively inefficient) version of Islamic finance is followed in Sudan, for instance with government bonds based on profit-and-loss sharing partnerships. There are indications currently that banks in the Southern part of Sudan will be allowed to operate conventionally or Islamically as they please, while banks in the north will remain purely Islamic.

Elsewhere in the Arab and Islamic world, a number of GCC-based banks have had Islamic operations for a number of years. The general rise in Islamic sentiments in the region is accompanied with high levels of adherence to classical law in all matters ranging from dress-codes to finance. Consequently, countries that originally resisted Islamic banking are currently inviting it to satisfy their nascent demand. Recently, for instance, Lebanon increased substantially its Islamic banking profile with Saudi-based Al-Baraka, and Syria licensed its first Islamic bank, which is jointly Qatar-Syrian owned. One can expect private Islamic finance to continue to grow substantially all around the Arab and Islamic world. Depending on political environment, some governments may even opt for Islamization of some state-owned banks as a measure to limit capital flight and appease Islamist elements within their borders.

7. North America and Western Europe

Islamic finance has arisen in the West primarily as a result of the popularity of U.S., and to a lesser extent U.K. and German, financial assets among GCC investors, who are the primary financiers of Islamic finance. Whether we consider Islamic mutual funds that select among stocks on the NYSE and NASDAQ[34], commercial real estate investment, or acquisition target corporations, those investors favor the legal transparency and lower risk associated with mature western markets.

[32] Hassan, M. Kabir and Tariq Hossain (1992), "Performance Evaluation of Private Sector Commercial Banks", *The Indian Journal of Economics*, LXXIII, Part II, 289, 159-180.

[33] Islami Bank Bangladesh (1995), *Islami Bank: An Era of Progress*, July, Dhaka: Islami Bank Bangladesh Limited.

[34] The NASDAQ Stock Market commonly known as the NASDAQ, is an American stock exchange. *NASDAQ* stands for National Association of Securities Dealers Automated Quotations. It is the second-largest stock exchange in the world by market capitalization, after the New York Stock Exchange.

For the past three decades, Islamic finance practitioners have also attempted to tap the relatively educated and professional Muslim populations in the west (again, primarily the U.S. and U.K.). Arab banks have tried repeatedly, with mixed success, to engage in home and auto financing in the U.S. and U.K. (Al-Baraka was one of the earliest, United Bank of Kuwait coming later and utilizing some of its models). Most recently, Islamic Bank of Britain, Plc. (in part pioneered by Abu Dhabi Islamic Bank) was licensed in the U.K. in August, 2004. Western home-grown boutique financial institutions, structured as co-ops, savings and loans, and investment companies, also started in the late 1970s and 1980s, but remained very small in size. Recently, the securitization successes through participation of Fannie Mae and Freddie Mac have allowed the market for Islamic home financing to grow significantly in the U.S., with some providers seeking to sell hundreds of millions worth of GSE[35]-guaranteed mortgage backed securities in GCC countries, as cheaper alternatives to investment banking and boutique private equity financial instruments. Participants in this industry, home-grown and foreign, have recently had a number of regulatory successes, including the above cited OCC[36] letters, and potential FDIC[37] approval of various depositary products in the U.S., as well as licensing of the first full-fledged Islamic bank and elimination of double-duty taxation for HSBC Islamic home financing in U.K. Islamic finance is likely to continue to grow in the U.S. and western Europe, but not to the extent expected by market participants who hope that a significant proportion of Muslims in those countries will participate in this industry. For instance, while Islamic mutual funds are widely accessible, they have only attracted a very small percentage of savings of Muslims in those countries.

Conclusions

Islamic finance is an industry which in many ways tries to "reinvent the wheel," producing successive approximations of western financial practices.

However, it is an industry that is likely to survive in the medium term, due to continued existence of customers who value Islamic jurist approval of its modes of operation. To the extent that Islamism in all its forms is on the rise, the industry is likely to continue to grow, but I believe its growth prospects are limited. Its absolute size has already reached levels that require monitoring the sector, and ensuring the development of appropriate prudential regulations therein as well as harmonious development within the international financial system. Islamic finance may have already succeeded in integrating some part of the global Muslim population (those who had decided not to deal with conventional finance) in the formal international financial system. In the process, Islamic jurists were forced to analyze classical Islamic jurisprudence in light of contemporary legal, regulatory, economic and financial systems. This gave rise to a continuing process of growth in Islamic jurisprudence, which ultimately may further produce an efficient integration of Muslims who had previously shunned the conventional financial sector. Moreover, recall that the primary market for Islamic finance is in developing countries - which may have formally borrowed modern legal, regulatory, and financial standards from advanced countries, but fall significantly short of those standards in practice. In this regard, one may recall that provisions in laws of contracts under classical Islamic jurisprudence were, in essence, prudential regulations of that time. To the extent that those provisions are respected in Islamic financial practice (which is not necessarily the case), Islamic finance may in fact be a catalyst for improving financial practices in those countries.

For instance, the focus on secured rather than unsecured lending (albeit being abandoned with the growth of Tawarruq financing), coupled with proper marking-to-market of asset values, can improve collateralization practices that have been non-existent or poorly implemented in some majority-Muslim countries, leading to catastrophic bad loan volumes that threaten their banking systems. On the other hand, one cannot but conclude that the modus operandi of Islamic finance, including the evolving opinions of its professional Islamic jurists, is a prolonged reinvention of the financial wheel. One needs only to observe the evolution of standards from original practices of Murabaha, to more advanced Murabaha with agency provisions, and finally Tawarruq practices, to notice how competition and better understanding of banking practices brings Islamic financial practice closer to its conventional counterpart.

However, the industry's survival to-date has relied on its captive market of pious Muslims, who may abandon it if full convergence is obtained. Moreover, just as some manufacturers may delay the introduction of their latest products to smooth demand over time, Islamic financial providers prefer to introduce "innovations" (better approximations of conventional financial practice) gradually, to extract the most rents, and gently prepare their clientele. This implies that some level of inefficiency is intrinsic to this industry, taking the forms of transactions costs, additional legal

[35] Government-sponsored enterprises

[36] The Comptroller of the Currency (OCC) - a national banks is required to submit an application or notice and obtain OCC approval or "no objection" prior to establishing, acquiring, or investing in an operating or financial subsidiary, or performing a new activity in an existing
operating or financial subsidiary. Banks must generally file a notice with the OCC to make an investment in a bank service company or a noncontrolling equity investment in an entity that performs bank permissible activities.

[37] Federal Deposit Insurance Corporation – FDIC-The U.S. corporation insuring deposits in the U.S. against bank failure. The FDIC was created in 1933 to maintain public confidence and encourage stability in the financial system through the promotion of sound banking practices.

costs, and fees for Islamic jurists. The industry by its very nature has a longer lag in "chasing past returns." Due to catering to a captive clientele, the industry has been able to survive and continue its growth despite this continued inefficiency.

With time, competition is likely to reduce inefficiency in the industry (though it cannot be eliminated if the industry were to maintain its Islamic character). To attain higher levels of efficiency, Islamic jurists will have to continue their process of understanding modern financial practices, and developing an Islamic jurisprudence that is appropriate for today's legal, regulatory, and financial realities.

In this regard, while some developments facilitate Islamic finance (e.g., the English elimination of double duty taxation on HSBC Islamic financial structures involving double-sale for financing purposes), one should not encourage regulatory adjustments to accommodate Islamic financial practices. Islamic finance has shown its ability to adapt to existing regulatory frameworks. I have also argued that this adaptation eventually changes the very Islamic jurisprudence upon which the industry is built. Toward that end, regulators' primary concern should continue to be protection of consumers of financial services, as well as safety, stability, and fairness of the overall financial system.

To the extent that current Islamic jurisprudence has not yet reached a level of maturity that allows it to coexist harmoniously within the best legal and regulatory standards, it would be unwise to push market participants toward standardizing their financial and religious-legal standards at this time.

Premature standardization of the current inefficient practices may become tantamount to irreversible codification of what can be considered an anachronistic financial model.

REFERENCES

1. Ahmad, Ausaf (1993), "Contemporary Practices of Islamic Financing Techniques", Research Paper Number 20, First Edition, Jeddah: IRTI.
2. Cole, Harold L. and Narayana Kocherlakota (1998), "Zero Nominal Interest Rates: Why they're good and how to get them", Federal Reserve Bank of Minneapolis Quarterly Review, 22 (Spring 1998): 2-10.
3. Dewenter, Kathryn L. and Alan C. Hess (1998), "An International Comparison of Bank's Equity Returns", Journal of Money Credit and Banking, Vol. 30, No. 3, (August, Part 2), 472-92.
4. Diamond, D. (1984), "Financial Intermediation and Delegated Monitoring", Review of Economic Studies, 51, 393-414.
5. El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", Fordham International Law Review, December 2003.
6. El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", Fordham International Law Review, December 2003
7. El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", Fordham International Law Review, December 2003
8. Fohlin (2000); Barth, Caprio and Levine's (2000); and Gorton and Schmidt (1996).
9. Friedman (1969), p. 34 quoted by Ireland (2000).
10. Friedman (1969); Cole and Kocherlakota (1998); and Wilson (1979). This result is robust in a variety of models, see Correia and Teles, 1997.
11. Gorton, Gary and Frank A. Schmidt (1996), "Universal Banking and the Performance of German Firms", Working Paper No. 5453, NBER, February.
12. Hassan, M. Kabir and Adnan Q. Al-Dayel (1998/1999), "Stability of Money Demand Under Interest-Free Versus Interest-Based Banking System", Humanomics, 14(4) and 15(1).
13. Hassan, M. Kabir and Tariq Hossain (1992), "Performance Evaluation of Private Sector Commercial Banks", The Indian Journal of Economics, LXXIII, Part II, 289, 159-180.
14. Hauswald and Marquez (2000). Da Rin, Marco and Thomas Hellmann (2001).
15. Hussein Hamid Hassan, "Flexibility of Shari'ah Principles of Finance and Resource Mobilization Needs of Government", in Ahmad, Ausaf and Khan, Tariqullah, (ed.) Islamic Financial Instruments for Public Sector Resource Mobilization, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1997, pp. 27-60.
16. Islami Bank Bangladesh (1995), Islami Bank: An Era of Progress, July, Dhaka: Islami Bank Bangladesh Limited.
17. Lucas (1994). For an assessment of the welfare cost of implementing a zero rate of interest, see Wolman (1997).
18. Mannan, M. A., (ed.) (1996), Financing Development in Islam, Jeddah: Islamic Research and Training Institute, Islamic Development Bank.
19. Samuelson and Nordhaus (1985), p. 898; Dornbusch and Fischer (1987), p. 125.