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ISLAMIC FINANCE: AN EFFICIENT & EQUITABLE OPTION

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ABSTRACT¹

Islamic finance starts from one basic concept that is to avoid trading directly present for future money. Finance is provided in the form of money in return for either equity or rights to share proportionately in future business profits. It is also provided in the form of goods and services delivered in return for commitment to repay their value at a future date. This is an obvious option in addition to the conventional practices of interest-based finance. This paper addresses itself to four questions: (1) Why all the fuss about the rate of interest? (2) Is Islamic finance, as an alternative to *interest based* debt finance viable and efficient? (3) What Islamic finance implies for the whole economy? (4) Given that Islamic finance is really viable, why it has not been adopted at a larger scale?

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ISLAMIC FINANCE: A CONCISE DESCRIPTION

Islamic finance starts from one basic concept that is to avoid trading directly present for future money. Finance is provided in the form of money in return for either equity or rights to share proportionately in future business profits. It is also provided in the form of goods and services delivered in return for commitment to repay their value at a future date². This is an obvious option in addition to the conventional practices of interest-based finance through which people borrow money and pay it back in the future in addition to interest. The reader may ask:

- ◆ Why all the fuss about the rate of interest?
- ◆ Is Islamic finance, as an alternative to *interest based* debt finance, viable and efficient?
- ◆ What does Islamic finance imply for the whole economy?
- ◆ Given that Islamic finance is really viable, why is the world not looking forward to adopt it at a much larger scale?

As we describe the main features of Islamic finance, the reader will find answers to the above questions.

I. THE RATE OF INTEREST:

During the last three hundred years the Western World has evolved the current system of finance whose cornerstone is the rate of interest. Huge amounts of debt are being traded in national and international financial markets every working hour, exceeding the gross domestic products of many countries. Since then, lending at a rate of interest has become a household practice all over the world. As to developing countries, they have played little role in establishing the current financial system. They have either adopted the current practice or inherited it from their former colonial masters.

Until the middle of the twentieth century, it seemed to everyone that no wrong could be found with the system. That is when economics has matured as a scientific discipline that commanded both intellectual as well as political influence. Economists, staying within the boundaries of “positive analysis” that purports avoidance of moral judgment, considered the rate of interest as a price: it is the relative price of present money to future money. You could rarely find an economist who would call for a zero price for anything, as prices serve as important tools in

² The reverse, that is to provide cash against the future delivery of goods would also be permissible under certain conditions.

resource allocation.

However, in search for optimal monetary policies economists stumbled on the relationship between the level of the rate of interest and the optimality of resource allocation. Monetary economists found that a zero nominal interest rate is a necessary condition for the optimal allocation of resources (Friedman, 1969). The reason is simple. After switching from metallic to fiat money, adding one marginal unit of real balances costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transactions costs. They would therefore use some real resources instead of money. 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. When this matter was investigated within general equilibrium models, it was found that a zero interest rate is both necessary and sufficient for allocative efficiency (Cole and Kocherlakota, 1998; Wilson, 1979). Though these theoretical results are dependent on some simplifying assumptions, they are robust in a variety of models (Correia and Teles, 1997). They 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. It is amazing to see such religious teaching stay valid after so many centuries.

In Milton Friedman's words, "***Our final rule for the optimum quantity of money is that it will be attained by a rate of price deflation that makes the rate of interest equal to zero.***"³ Friedman goes further to suggest steadily contracting the money supply at a rate equal to the representative household time preference (Friedman, 1969, p. 34 quoted by Ireland, 2000).

Accordingly, economists are expected to search for the set of monetary policies that would bring the rate of interest to zero, in order to reach an optimal allocation of resources. They depend on the relationship known as the *Fisher hypothesis*, which decomposes (in the terms used by St-Amant, 1996) the nominal interest rates as the sum of expected inflation and ex ante real interest rates:

$$i_t = r_t + E(\pi)_t, \quad (1)$$

where i_t is the nominal interest rate at time t , r_t is the *ex ante* real

³ We have brought this quotation in order to show that what is intended is not to impose a zero rate of interest on the national economy, by to reach the desired level through the process of deflation.

interest rate, or as defined by Cole and Kocherlakota (1998), the rate of return on real (physical) capital net of depreciation or the rental rate on capital goods, and $E(\pi)_t$ is the expected inflation rate at time t for a specified future period.

Setting i_t equal to zero implies that the real rate of interest r is equal to the rate of deflation. Therefore, it appears that deflating the economy at a rate equal to the real rate of interest would automatically set the (nominal) rate of interest to zero. This would be the optimal monetary policy rule that insures that financial resources are allocated efficiently.

Such policy rule clearly implies that the optimal rate of inflation is negative. However, Central bankers would never seriously advocate a long-run policy of deflation (Wolman, 1997).

Deflating the economy would bring with it several problems both conceptually and practically. Conceptually, economists would naturally worry about the existence of a liquidity trap when the rate of interest is zero (Uhlig, Harald, 2000). Several economists point out that deflationary policies have to be exercised only asymptotically in order to apply the Friedman's Rule (Cole and Kocherlakota, 1998). Even if the asymptotic conditions are not fulfilled, short-term constraints on monetary policy can do the job (Ireland, 2000). Others may worry that when the rate of interest becomes very low, monetary authorities have less leeway with adjusting it downwards in the face of recession. Meanwhile, some economists respond by proposing alternative ways to overcome the zero-bound on interest rate policy (Goodfriend, 2000). Another conceptual problem is that deflation has efficiency problems parallel to those of inflation, even at very low interest rates (Lucas, 1994). However, the welfare cost of implementing a zero rate of interest has been found negligible (Wolman, 1997).

Consensus among economists appears to be that practical and conceptual problems involved with zero interest rates are all surmountable. Nonetheless, monetary authorities are not yet impressed. No monetary authority has so far come forward to adopt the optimal monetary policy rule⁴.

II. THE ISLAMIC OPTION

It is obvious that *interest-free* loans cannot be used on a large scale to finance investment. Such loans would appear to be philanthropic rather than enterprising actions⁵. In other words, the Friedman's Rule is to

⁴ Economists also recommended the application of 100 percent required reserve ratio. However, policy-makers have not been impressed, despite the obvious benefits.

⁵ Muslims are encouraged by their religion to give 'Qard Hassan' or interest-free loans to the poor

satiate money holders with cash for *transactions* purposes. However, when it comes to financing investment, another institutional arrangement must be found to provide finance independently from philanthropic incentives and at the same time do not involve payment of interest on loans. Towards this end, Islamic finance provides finance modes that avoid lending at interest⁶. Hence, there would be no rate of interest to try to reduce to zero. In his way, the problem of efficient allocation of resources is automatically resolved.

The option of Islamic finance encompasses an institutional set up that could be applied at the level of individual enterprises, namely banks or financial institutions. Each bank and/or financial institution can apply Islamic modes of finance either to all its operations or to a window extended to those interested in benefiting from such rules. Its financial product would carry the distinctive quality of being *Islamic*⁷. It can also be applied at a system-wide scale, where the whole banking and financial system operates according to the rules of Islamic finance.

The system of Islamic finance is strongly enforced by a group of moral values that abhor selling future for present money to which Muslims devoutly adhere. Such values are also shared by the followers of the other two revealed religions, Judaism and Christianity. This gives additional strength to the system and enforces its modes of transactions.

Some may think that Islamic finance is just “interest-free” finance enforcing a zero interest rate on the economy and running contrary to market rules. Nothing can be farther from reality. The logic of keeping a zero rate of interest has been formed for a fiat-money market economy, with an integrated debt market where future money is traded against present money. The Islamic economic system, while based on market rules, has no integrated debt market and future money cannot be traded against present money. That makes the “*Islamic modes of finance*” the central institutional setup that replaces *both* the rate of interest and the integrated debt market.

To explain the Islamic option, we start with a short description of how Islamic banks and financial institutions work and then explain the finance modes used by them.

as an act of charity.

⁶ Needless to say, extending interest-free loans to the needy remains a laudable philanthropic activity in Islam.

⁷ One cannot help but notice that the word “Islamic” in this context could have two meanings. The first refers to the quality of the financial product, viz., that it satisfies the Islamic requirements for lawful contracts. The second is that it satisfies ethical standards as defined by religion. In this sense, Islamic finance is equally Christian, Jewish and Hindu.

A. ISLAMIC BANKING AND FINANCE

1. ISLAMIC BANKS

Islamic banks operate in ways that differ from their conventional counterparts. Nonetheless, they provide fund owners as well as fund users, profitable opportunities. On the liability side, they provide *owners of funds* opportunities to place their financial resources profitably, as they become implicit partners of those firms that finance their activities through the banking system in return for a share in their net profit. Meanwhile, owners of funds carry a proportionate share of the risk born by firms. On the asset side, they provide finance to enterprises through either sharing directly in the net results of their activities or financing their purchases of assets, goods, and services.

We can therefore expect Islamic banks to hold equity in corporations and sit on their boards of directors. They use the information obtained from their vantage point to reduce risk from information asymmetry and to fine-tune their finance directed to the same corporations. In addition, they can trade in goods and services, provide Islamic insurance, and operate in financial markets. In other words, they operate like *universal* rather than commercial banks.

2. ISLAMIC NON-BANKING FINANCIAL INSTITUTIONS

There can be a variety of non-banking financial institutions that collect funds without taking deposits and use Islamic finance modes to provide finance to entrepreneurs. They mobilize funds through selling stocks, mutual shares, and a variety of instruments (*Sukuk*) with a wide choice of risk sharing and maturities.

Non-banking financial institutions have even greater flexibility to deal with equity and partnership than universal banks, as they are not encumbered with guaranteed demand deposits. The advantages of financing working capital requirements to enterprises in which they hold equity can therefore be more pronounced than in universal banking.

More light can be shed on how Islamic banking and financial institutions operate when we explain the Islamic modes of finance.

B. ISLAMIC MODES OF FINANCE

Islamic modes of finance can be grouped into two categories: (i) equity and profit sharing, (ii) commodity finance.

1. EQUITY & PROFIT SHARING

Equity finance as popularly known implies that savers would provide funds to enterprises in return for a share in prospective net returns as well as a share in management. Meanwhile, **profit sharing** finance implies that finance providers would provide finance, not for the whole life of the financed enterprise, as in case of equity, but for shorter period, as in the case of providing working capital finance. Profit sharing finance may be provided with and without sharing in management.

To give more details, we can find the group of equity and profit-sharing modes to include four specific modes: partnership (Musharaka), diminishing partnership (Musharaka Mutanaqisa), unrestricted profit sharing (unrestricted Mudaraba) and restricted profit sharing (restricted Mudaraba). All those modes have one joint characteristic, namely that the bank providing the finance gets a share in profit or loss. However, there are some differences in fine details.

Equity finance implies provision of finance in return for two things: profit sharing as well as sharing in management. In the case of joint stock companies, this mode is equivalent to holding an interest in the company and participation in its management. This would entitle the bank to enjoy distributed profits as well as capital appreciation. Exit would be possible through finding someone to purchase the bank-held shares or offering them for sale in the stock market.

Diminishing partnership implies that the financing bank would be able to retrieve the principal over an agreed period of time, as the company uses a part of its profit every year to extinguish a portion of the finance principal.

Mudaraba finance means that the bank provides financing in return for a share in the profit, without sharing in management. This implies that the bank authorizes the investor to invest the money advanced without the bank directly interfering in conducting the business. Finance is therefore provided for a specific period, as in the case of providing working capital to business enterprises.

Mudaraba can be restricted or unrestricted. Unrestricted Mudaraba entails that the bank provides finance to be invested without preconditions. Restricted Mudaraba implies that finance is provided on the condition that the investor uses it within certain limitations. Such limitations could be positive, like providing a list of permissible actions, e.g., investing in a certain field or through certain modes. Limitations can also be negative, as providing a list of actions not permissible, like trading in financial markets.

Mudaraba requires that the investor must operate with a high degree of transparency, in order to enable the bank to continuously monitor his actions, and regularly assure itself of how things are going. As investors usually prefer not to expose the details of what they are doing,

monitoring would be rather costly, causing Islamic banks to seek other modes of finance.

To cross such hurdle, the bank can provide finance in a mixture of equity and Mudaraba. This means that the bank becomes a shareholder and qualifies to participate in management, thereby becoming entitled to obtain all necessary information automatically and periodically. In light of such information, the bank can present further finance on terms of restricted or unrestricted Mudaraba. Equity finance would therefore reduce the cost of monitoring necessary for successful Mudaraba finance. It is not customary for conventional banks to take equity in business enterprises and participate in their management, while providing extra advances as needed. The majority of conventional banks are *commercial banks* meaning that their operations are limited to mere intermediation between lenders and borrowers. In few countries that include Germany and Japan, there are universal banks which provide both equity and other types of finance simultaneously. This would be dealt with later.

2. COMMODITY FINANCE

In commodity finance, the bank finances the acquisition of goods, which are generally assets or consumers' durables or their usufruct. It has four basic modes: Murabaha, forward sale (Bai' Bithaman Alajil), Istisna', Salam, and Ijarah. The first two modes imply **Credit purchase**, i.e., the financing institution provides goods and services for spot delivery in return for a debt instrument that promises payment of their value at a specified future date. In the case of **Murabaha**, the goods and services may not be in possession of the bank at the beginning. The customer comes forward to the bank and promises to purchase the commodity in question at a price equal to the cost paid by the bank plus a markup. The bank acquires the commodity and sells it to the customer at the agreed cost plus markup. The customer pays at a later date either in installments or in lump sum. Murabaha is characterized by a high degree of transparency, as the customer knows the price at which the bank acquires the commodity. In the case of forward sale (**Bai' Bithaman Alajil**), the bank possess the commodities and have them ready for inspection in stores or showrooms. The customer purchases directly at the price set by the bank and similarly pays at a later date.

The debt instrument is not negotiable. In case of temporary insolvency the debtor is granted an extension with no increase in maturity value. Only delinquent debtors with no valid excuses can be subjected to penalty. Alternatively, the financing institution can pay the value of the goods and services spot and get them delivered at some specified time in the future. In this case, the debt instrument would be written in terms of goods and services.

Some may think that this type of *sales finance* is no different from interest. They may say that trading present against future money involves explicit interest, while trading goods against future money may involve *implicit interest*. While both interest and markup reflect time preference, the latter is far from similar to the former. Several differences can be cited in this regard⁸. First, the nominal value of the debt involved in sales finance cannot grow by itself. The value of debt is set at the time of sale and cannot be increased. In contrast, interest is set as a compound rate per unit of time, allowing the nominal value of debt to grow until it has been repaid. Second, finance is provided in conjunction with acquiring and subsequently using a commodity. This has serious implications with regard to the relationship between the real and the financial sectors, which will be taken up further below.

Istisna' literally means to order the manufacture of something. It is often used to finance the production of new assets, as in the case when an agent requires building a construction, a ship, or a plane according to certain specifications. It can also be used to finance the production of other goods. The bank would collect necessary information about producers and related conditions. Then, it enters into Istisna' contract with the customer stipulating the manufacture of the required goods with certain specifications, delivery date, and payment schedule. The bank then signs a parallel Istisna' contract with a manufacturer for producing the same goods. Naturally, specifications and delivery date would be the same as in the initial Istisna' contract. It is important that the Istisna' contract should not be made conditional on the parallel Istisna' contract.

Salam literally means the purchase of goods for which payment is done instantly and their delivery is done in the future. It can be used when a customer requires financing for the manufacturing processes of his products. A manufacturer can offer the bank to purchase some of his products to be delivered in the future in return for spot payment. In this way, the customer can use the instant cash to finance production inputs. The bank can sell the same goods for future delivery to another agent against spot payment through a parallel Salam contract. The bank profit would be equal to the different between the price in the parallel Salam and the price in the Salam contracts. In this fashion an Islamic bank would have helped finance the production process and at the same time provided for the future requirements of some customers.

Ijarah or leasing (operational lease⁹) finance implies that the financing

⁸ I am indebted for this explanation to one of the two anonymous referees who have contributed to improving this paper.

⁹ This is called operational lease in contrast to financial lease. In the former, the leaser bears all

institution purchases a durable asset and leases it to a customer in return for regular payments reflecting the cost of holding, maintaining the asset in addition to transferring the property of the asset from the financing institution to finance recipients.

C. DEPOSITS WITH ISLAMIC BANKS

In addition to demand deposits, which are guaranteed but earn no return, Islamic banks also take investment deposits for specific maturities. Investment deposits are either general or restricted. The former are grouped with bank equity in one pool and invested in several ways. Each earns a proportional share of the net profit of the pool. The latter are placed in specific investments chosen by respective depositors and earn a proportional share of the profit on their investment.

In all cases, Islamic banks use the deposits they obtain to provide finance in the modes outlined above and get a proportion of the profit or a commission as a fee.

Islamic banks get a proportion of the profit in compensation for their efforts; the profit-sharing ratio between each bank and depositors must be therefore set at the outset. However, the actual rate of return eventually paid out on Investment deposits is not predetermined. It is closely linked to the performance of the real economy, as finance modes are generally directed to finance trade in goods and services as well as the actual production processes. It also depends upon the performance of individual banks in relation to the choice and management of investment.

D. ISLAMIC FINANCIAL INSTRUMENTS¹⁰

Financial instruments play an important role in reducing transactions costs for both savers and investors. As they can be tailored to the tastes and requirements of both parties, they can drastically reduce the cost of negotiating terms related to size, maturity, profit-sharing formula and other relevant conditions.

Financial instruments increase the *reach* of financial institutions to fund suppliers and users, enabling institutions to deal with large numbers of customers and thus realize significant economies of scale. This *reach factor* manifests itself through the ability of trading instruments in primary and secondary markets. In this regard, we can find two advantages of Islamic financial instruments over their traditional

risk attached to the asset until its title is transferred to the lessee, while in the latter, the lessee assumes all risks from the very beginning.

¹⁰ Al-Jarhi, 1998.

counterparts.

First, in pricing their services, the issuers of Islamic financial instruments have *wider latitude*. When dealing with savers and investors, they negotiate a profit share between zero and 100. Conventional security issuers, meanwhile, are bound to negotiate a small cut within the much narrower differential between the borrowing and lending rates. Wider latitude enables financial intermediaries to be more effective in mobilizing resources on the one hand and attracting investors on the other.

In a conventional economy, when intermediaries raise the rate of interest to mobilize more savings, they have to charge investors correspondingly higher rates of interest. In Islamic finance, intermediaries can mobilize more savings by offering higher rates of profit sharing to savers; the profit here would be obtained from investment net of all costs including finance costs. Meanwhile, they can entice more investment by offering investors higher profit share, that would implicitly mean lower finance costs. In other words, attracting more saving does not conflict with enticing more investment in Islamic finance. Islamic finance can therefore be said to have *consistency of purpose* that is missing in conventional finance.

It is rather interesting to conclude that financial intermediation in the non-banking sector would imply lower transactions costs and mobilize both savings and investment more effectively than conventional finance.

ADVANTAGES OF ISLAMIC FINANCE

This section examines Islamic finance from several sides, including efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability.

I. EFFICIENCY

At the macroeconomic level, Islamic finance avoids the use of interest-based lending. 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.

Conventional finance allocates financial resources with paramount regard for borrower's ability to repay loan principal and interest. In modes of Islamic finance that are based on equity and profit sharing, focus would be on the profitability and rate of return of the concerned investment. This type of finance has the potential of directing financial resources to the most productive investments. This would increase the efficiency of the financing process and reinforce efficiency in the real sectors.

Modes of Islamic finance that are based on mark-up finance the acquisition of goods and services, including productive assets. When conducted in an open market with sufficient competition, the cost of finance, or mark-up, will depend on the relative value in use of each commodity, whether in consumption or production. Resource allocation would again be optimal.

II. STABILITY

A conventional bank has on the one hand liabilities that include demand, time and saving deposits, which the bank guarantees. On the other hand, it has assets that are mostly composed of debt instruments each of which has quality that depends on the ability of the corresponding debtor to repay. Default on the asset side, if it happens in significant proportion, would imply inability to meet the bank's obligations on the liability side. Such default can be expected at times of crises, be it of macroeconomic nature or caused by circumstances specific to the bank.

A bank operating according to Islamic rules of finance has liabilities of different nature. Only demand deposits are guaranteed. Meanwhile, investment deposits are placed on profit-and-loss-sharing basis. When such bank faces macroeconomic or bank-specific crises, investment

depositors automatically share the risk. The bank is less likely to fail and a bank run is less probable. It can therefore be said that an Islamic banking system is relatively more stable when compared to conventional banking (Khan, 1986).

In conventional finance, present money is traded in an integrated debt market against future money, which takes the shape of commitments to pay specified amounts at specified future dates, or bonds. Bonds are supposed to be easily traded financial instruments, many of which are listed in international financial markets. Hundreds of billions of dollars of debt are traded daily in those markets. Bonds markets provide an easy and automatic mechanism through which short-term funds flow at will from one country to another. Much of those flows follow factors that are only nebulously related to economic fundamentals. They bring an important element of instability into national economies. They 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.”

The integrated debt market has grown immense in size as well as in scale of integration that now encompasses the whole world economy. Many experiences, as lately manifested in the Southeast Asian economies, have shown that integrated debt markets are sources of both domestic financial instability and contagion. Some economists have come forward with proposals to place restrictions on capital movements in contrary with what has been considered in economics as received doctrine.

In contrast, debt is created in Islamic finance through selling goods and services on credit. Resulting debt instruments are 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 a mark-up rate. Such credit markets would be fully segmented, while the debt instruments themselves are traded only for nominal values at maturity¹¹. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion through the debt market would therefore be remote and the justifications to choke capital movements with restrictions become unnecessary.

Examination of daily records of trading in financial markets vividly shows that institutional participants carry out huge speculative transactions. More often than not, such transactions are sources of instabilities. In contrast, Islamic financial institutions are automatically prevented from

¹¹ At maturity both countervalues, *viz.*, debt and its nominal value would be spot and equal in amount, thereby fulfilling the necessary conditions for trading money in Islam. Meanwhile, debt can be swapped against tangible goods or services (according to Imam Malik and Ibn Taymiah, but not for cash).

carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

We have noted above that Islamic finance never provides present money in return for future money. All Islamic modes of finance involve money on the one end and goods and services on the other. Monetary flows through Islamic financial modes would have to be tied directly with commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obviously, this leaves little room for excessive credit expansion, as the finance extended is automatically earmarked for specific uses.

Speculative activities related to interest rate expectations would become out of place. Changes in spending would automatically be reflected on changes in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. In other words, markets are more likely to operate efficiently and smoothly. It is therefore interesting to note that Islamic finance, though non-conventional, supports market forces and mechanisms more than does conventional finance.

III. MORAL HAZARD AND ADVERSE SELECTION

As mentioned above, Islamic banks can be likened to universal banks, especially as they carry out both investment and commercial banking activities. However, not all conclusions related to universal banks would automatically hold to Islamic banks. Differences may arise due mostly to external factors, like the existence of organized and active equity markets that would compete with investment banking in providing external finance. The whole regulatory and supervisory environment can be critical in influencing the ultimate characteristics of both universal and Islamic banking. In addition, conventions and cultural elements may also interfere as external factors.

We must note as examples of the external factors that universal banking performance and practices in Japan would differ in many respects from those in Germany, for several external factors that would include culture and conventions. While universal banking is not prohibited by regulations in Britain, practices of investment banking should differ from those in Germany as the stock market is much more developed in the former than in the latter.

The main characteristic that concerns us in relation to moral hazard and adverse selection is that Islamic banks, like universal banks can hold equity in the business enterprises they finance. In this respect, they bear resemblance to universal banks and can be thought to handle the problems of moral hazard and adverse selection better than conventional

banks.

However, some reservations have lately been levied against universal banking. This section deals with two main questions. First, how both universal and Islamic banks can better handle moral hazard and adverse selection. Second, some of the controversies around universal banking are briefly exposed to show the reader that most of them have not made much dent, at least as yet, in the greater ability of universal banking to handle moral hazard and adverse selection.

A. OPERATING AS UNIVERSAL BANKS

We have mentioned above that Islamic banks hold equity and trade in goods and services as they operate as universal rather than commercial banks. Universal banks are defined as “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, “(Calomiris, 2000).

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 applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. We can therefore conclude that screening would be more effective and adverse selection less probable with universal banking.

Reducing the possibilities of moral hazard requires monitoring the firm that obtains finance. All three kinds of ex ante, interim and ex post monitoring must be exercised to be effective (Aoki, Masahiko, 1994). Equity finance provides the bank with access to information necessary to practice monitoring at all intervals. That explains why the research of Dewenter and Hess (1997) supports the idea that relationship (universal) banks are more effective monitors than transactional (commercial) banks.

Equity finance also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt 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 universal banking would be

exposed to lower levels of moral hazard and adverse selection. In addition, by sitting on the firms' board of directors, banks could influence corporate governance in the whole productive sector, leading to improvements in economic performance.

Empirically, it has been found that using a combination of debt and equity finance by banks seems to carry several advantages to both banks and firms, confirming theoretical findings. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns. Applied research has found that universal banks face lower risk than commercial banks during both upturns and downturns. In addition, the risk differential between universal and commercial banks gets wider and more significant during downturns (Dewenter and Hess, 1998).

B. DOUBTS ABOUT UNIVERSAL BANKING

The following doubts, in relation to universal banks ability to deal with moral hazard and adverse selection, have been levied against universal banking:

1. Alteration of Corporate Capital Structure In Favor Of Debt and Against Equity

Universal banks are seen as institutions that facilitate access to information about firms. German universal banks are described as financial supermarkets providing commercial banking, securities underwriting, and brokerage, holding positions on the supervisory boards of joint-stock companies, voting equity shares in proxy for customers, and sometimes taking short-term stakes in companies (Fohlin, 2000b). Theoretically, the presence of universal banking and the resulting bank attachments with corporations, could therefore give some firms more access to external finance thereby motivating them to change their preferences regarding debt finance.

Fohlin (2000b) found that, universal banking is not associated with different leverage nor debt maturity structure. While older firms continue to have lower leverage and short-term debt, bank attachment is not associated with earlier than average reductions in leverage as firms mature or with alterations in the predictors of short-term debt use. The findings offer little support for the idea that formal bank-firm relationships altered the financing options or choices of German industrial firms.

2. Universal Banking Inefficiently Combines Banking with Trade

Barth, Caprio and Levine's (2000) empirical study highlights the negative implications of imposing regulatory restrictions on the activities of commercial banks. Specifically, regulations that restrict the ability of

banks to (a) engage in securities activities and (b) own non-financial firms are closely associated with greater banking sector instability. Their analyses, moreover, suggest no countervailing positive benefits from restricting the mixing of banking and commerce or from restricting the activities of banks in the areas of investment banking, insurance, and real estate.

3. Bank Relationship and Firm Profitability

Under universal banking, firms deal with one bank which is also one of its shareholders. Some economists suspect that such single firm-bank relationship could be less profitable.

Degryse, Hans and Steven Ongena (2000) empirical work suggests that the profitability of Norwegian publicly listed firms with bilateral bank relationships is higher than the profitability of firms with multilateral relationships. This result is quite robust. It holds controlling for firm age, size, debt, asset intangibility, and Tobin's Q and in a variety of specifications. The result seems conform an implication of Yosha (1995) and von Rheinbaben and Ruckes (1998). If firms disclose proprietary information to creditors, firms using bilateral financing achieve higher sales profitability than those using multilateral financing.

4. The Organ Bank Hypothesis

Universal banking opens the door to banks to establish special relationships with the companies in which they hold stock and finance simultaneously. Such relationship could reflect negatively on the efficiency and stability of the banking system. This "Organ Bank Hypothesis" was advanced first by the Japanese Economist T. Kato and tested recently by Okazaki and Yokoyama (2001). They have found that in prewar Japan that interlocking directorship and auditing between banks and non-banking companies to be very pervasive and more so in large size banks. They also found that interlocking had negative influence on banks liquidity performance and profitability which played a roll in increasing bank closures during the Showa Financial Crises of 1927.

In contrast, when studying the German universal banking system in the pre-World War I period, in comparison with the banking system prevailing in the UK and the USA, Fohlin (2000a) finds a different perspective. Her results indicate that universality does not lead to appreciable market power. They imply that concentration in the German banking industry does not in itself produce anti-competitive behavior.

We can therefore conclude that other reasons may explain the Japanese case, and the Organ Bank Hypothesis is by no means generally valid.

5. The Conflict Of Interest Hypothesis

Gorton and Schmidt (1996) consider universal banking to be an alternative mechanism to stock market for risk sharing that could provide information to guide investment. In Germany, the stock market has been historically small. Universal banks hold equity as well as proxy voting rights over their customers' stock holdings. They lend to firms and sit on their corporate boards simultaneously. If German banks were acting as substitutes to the stock market, their behavior would improve corporate performance. Alternatively, banks could benefit from the inside information they gather about the firms they lend while exercising monopolistic power over access to external finance. This would lead to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights.

Gorton and Schmidt (1996) test the conflict-of-interest hypothesis between German banks during the 1970s and 1980s. They find that German banks improved the performance of firms they finance to the extent of their equity holdings. No evidence was found on the conflict of interest concerning the use of proxy votes. This was the case in their sample of 1974. In 1985, German security markets became more developed. While banks continued to affect corporate performance, their influence could not be distinguished from that of non-bank shareholders. The study of Gorton and Schmidt appears to cast substantial doubt on the conflict-of-interest hypothesis.

Gorton and Schmidt (1996) investigate the potential conflict of interest in the issuance of public securities when the underwriting of the initial offering is done by an investment bank that holds equity in the concerned firm. The underwriter would be similar to a universal bank. The evidence in their study suggests that the conflict of interest does exist, in the sense that the underwriting bank is able to utilize the superior information it obtains through its affiliation with the firm. Yet, the effects of the conflict of interest are fully discounted, as they are fully anticipated by all market participants. In this regard, Gorton and Schmidt find that initial public offering underwritten for a firm by its affiliated investment bank performs as well or better than issues of firms in which no investment bank holds a prior equity position.

6. Bank Concentration and Concentration in the Industrial Sector

In the European experience, concentration in universal banking was often associated with concentration in the industrial sector. Da Rin and Hellmann (2001) consider in their big-push model the issue of concentration¹². They theorize that universal banks start

¹² For other models on the ills of market power in financial markets, see Hart (1983) or Aghion, Dewatripont and Rey (1997).

with financing *pioneers* in their own industries. Then, they continue to finance incumbents. They conclude that large and powerful banks have a vested interest in preserving industrial monopolies. However, universal banks need to be powerful and large to succeed in limiting entry into the financial market. They also need either the outright support of government translated into regulations or at least their acquiescence.

7. Corporate Governance

The fact that universal banks sit on boards of firms they finance and have power that may exceed what would be commensurate with their own equity holdings could create problems of corporate governance. First, to internalize the privileges usually accorded to board members, universal banks management would tend to appoint representatives to boards from within the narrowest circle of top management. Sooner or later, the few members of top management find themselves overloaded the job of monitoring the performance of too many firms. That would make monitoring much less effective.

Second, members of universal banks top management may not have the necessary knowledge and skills to exercise monitoring effectively. Third, as they are top management members, their reporting on the board meetings they attend may turn to be too brief and non-technical for technicians whose job is limited to desk-type follow-up to draw the right conclusions at the right time.

All the above problems would be easily avoided by regulations and supervision. Simple rules setting the proper qualifications of banks representatives on the boards, putting a ceiling on the number of board membership and perhaps prohibiting top management from taking board membership outside their banks would certainly ameliorate the situation.

IV. FINANCE AND DEVELOPMENT

Some economists believe that universal banking that combines all phases of finance can be credited in part for industrial development and economic growth in Germany and Japan. Universal banking, is thought to have yielded economies of scope and greater efficiency that provided more finance at lower costs, thereby promoting industrial investment.¹³

In particular, German banks have been perceived to have maintained close, long-term relationships with industrial firms, which influenced

¹³ For a theoretical analysis of the relationship between finance and growth, see, e. g., Greenwood and Smith (1997).

banks attitudes towards multiperiod optimization (Fohlin, 1998). This opinion is supported by Terrin (1998), but opposed by Fohlin (1998) as well as Miwa and Ramseyer (2000).

Given the characteristics of Islamic finance mentioned above, particularly the fact that Islamic banks operate according to the rules of universal rather than commercial banking, we can ask which system gives better support to economic development. In this regard, we can intuitively conclude that the practice of universal banking by Islamic banks put their financing activities right in the center of the development process. Bankers in this case become both partners and financiers of entrepreneurial efforts to develop the economy. Empirical findings seem to confirm such intuition.

Calomiris (2000), through his study of pre-World-War I Germany, has found that universal banking served to reduce the cost of financing industrialization in Germany relative to its corresponding level in other countries where commercial banking is prevalent. He also found that the financial sector reached a higher level of allocative efficiency in Prewar Germany than in the latter countries. We can therefore rest assured that banks operating as universal banks give better support to development efforts.

It is widely accepted that economic development requires mobilization of vast financial resources both internally and externally. Any financial resources left hoarded would imply unrealized potential for economic development. As Islamic teachings emphatically prohibit trading present for future money at a rate of interest, many Muslims hold their funds outside the banking and financial sector, thereby missing an opportunity to apply those funds to the development process. Islamic finance opens the door to the effective use of much needed financial resources within many Islamic countries that would be otherwise kept idle. In addition, it provides Muslims with a way through which they can participate in the development process without exceeding their religious beliefs. Muslim minorities in other countries, whose banking systems do not provide Islamic financial products, suffer from *cultural exclusion*. Some of those Muslims may have to keep their savings outside the financial system thereby contributing to idle financial resources in their countries.

V. INTEGRITY

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 concerned with mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of mind of everyone.

Risk is known to be one of the most important ingredients of making investment. Those who finance investment share a good part of the risk involved with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves apart 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 would 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 and allows banks and financial institutions a share in the decision-making process, by sitting on the boards of directors of firms receiving funds.

We can therefore notice that risk as well as 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 wider involvement in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the mere feeling of involvement. It adds to the stability of banks. Holders of investment deposits with banks share in both the profits and losses. When a bank faced the unlikely event of an overall loss over the placement of its investment pool, its depositors shoulder their proportional share of the loss. Individual banks as well as the banking system as a whole would therefore be less likely to break down.

The economic system itself becomes more compact with wider involvement. The real and financial sector, banks and savers, investors and fund owners are all strongly glued to each other. This finally leads to an economic system with a high degree of integrity that can withstand shocks.

VI. EQUITY

Islamic financial institutions must be viewed as basically 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 can contribute to the efforts taken by the whole society in that regard.

Islam prescribes a tax-subsidy approach to reducing poverty. A levy called *Zakah* is paid out by the wealthy (those whose wealth exceeds a certain minimum level) in proportion to their property.

Zakah proceeds are 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 work and *wealth maintenance* is provided to the rest of the poor. The latter policy entails giving the poor productive assets, which they can use to produce goods and services and sell them for profit. This method of poverty reduction can be closely intertwined with that of economic development, as redistribution is mostly directed towards making the poor more productive, which in turn contributes to economic development.

Income maintenance would involve regular (monthly) payments to the needy. Wealth maintenance, meanwhile, involves transferring to the poor a combination of productive resources, which would be capable of generating sufficient income to maintain at least one household.

Zakah collection would be expected to be carried out mostly by nongovernmental and sometimes by governmental organizations. Islamic banks can help by acting as custodians and in the disbursement of the proceeds. In addition, non-banking financial institutions can also take part in collecting Zakah, using Islamic banks as depositories, and invest the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they would also add a proportion of Zakah due on their shareholders equity¹⁴. They can even accept direct payments of Zakah and other donations on behalf of philanthropic institutions.

As to income maintenance, Islamic banks and financial institutions 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, the 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 eradicating poverty and increasing equity through proper use of Zakah proceeds.

Another point related to equity is the relative shares of finance going to the poor compared to the rich under Islamic and conventional finance. Under conventional lending, banks give their utmost attention to the ability to repay loans. To ascertain such ability, they depend overwhelmingly on the provisions of collaterals and guarantees. Thus, those already rich would have most access to finance. In contrast, Islamic finance could provide the poor

¹⁴ Understandably, there may be other expenditures items which would be financed from zakah proceeds. That is why only a proportion of them would be handed to collectors. Such proportion can be determined by society and could change from year to year.

through sale finance (Murabaha, Bai' Bithaman Alajil, Ijarah and Ijarah Muntahia Bittamleek) with consumers durables as well as assets for installment payments that fall within their income. In such case, the consumers' durables as well as the assets finance will in themselves serve as guarantees as they are mortgaged to the bank until payments are all effected. The poor will need only to verify his income through proper documentation or depositing his receivables or salary with the bank. In addition, providing funds on equity or profit-sharing basis would be more concerned with profitability and rates of return and less concerned about collateral as the primary consideration. In both cases, those who are not wealthy, but have worthy investment projects, would have relatively more access to finance.

VII. SUSTAINABILITY

Conventional debt has certain characteristics that could place debtors in difficulties if circumstances do not allow them to repay in time. Interest is usually calculated on the outstanding balance of debt, usually compounded annually and sometimes at shorter intervals. Delinquent debtors are often subjected to penalty rates of interest, which are higher than regular rates. It is not uncommon to find borrowers who end up paying debt service that is many folds the original principal they borrowed. This is particularly symptomatic of developing countries debt, as they continue to face debt problems that sometimes reach crisis levels. Creditor countries and institutions have often sought to find ways and mechanisms to provide debt relief to debtor countries. Despite continuous efforts, the debt problems faced by developing countries seem to be ever-present.

We can therefore conclude that interest based financing lacks a great deal of sustainability. Creditors have to stop every few years to give debtors relief in terms of rescheduling and forgiveness. Sometimes this also includes floating low quality debt at lower market value and swapping it with equity. The system has demonstrated unsustainability several times.

Unconventional debt created through Islamic finance has characteristics with which debt crises are less likely to rise. Particularly, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be repaid in installments, without increase in its total value, as there is no compounded interest to pay on outstanding balance.

When debtors face unavoidable circumstances that would make them temporarily insolvent, they are often granted grace periods to help them bring their finances back to order. No penalty fees can be levied in this case. In other words, debt rescheduling, when justifiable, would be

granted at no extra cost to borrowers. Therefore, we can conclude that Islamic finance is sustainable and less liable in itself to cause undue hardship to debtors.

Quite often, conventional debt cannot be repaid because it was not used for its prescribed purpose. Under the rules of conventional finance, creditors assume that the use of the loans they extend would strengthen the ability of debtors to meet their future obligations. However, conventional loans are usually offered without ways or mechanisms to assure their use for certain purposes¹⁵. In contrast, Islamic debt is created through the finance of acquiring goods and services on credit. In other words, the loan is used from the very beginning for its prescribed purpose. Default resulting from improper use of borrowed funds would therefore be most unlikely.

As Islamic finance provided to finance investment is asset-based, i.e., it is used to acquire real assets; it is much less likely to lead to debt crises. Such type of asset-based finance, directly contributes to the ability of the economy to meet its internal and external financial obligations. This is certainly a welcome effect.

¹⁵ In cases where a loan is earmarked for the purchase of commodities, a conventional bank would find it cheaper to enforce earmarking through a sale-finance contract.

ACCEPTANCE OF ISLAMIC FINANCE

Islamic finance has achieved a great deal of progress especially in the areas of financial innovation, central banking operations, establishing money markets, accounting, disclosure, regulation, and rating standards. The relationships between Islamic and conventional banking and financial institutions have been cooperative and mutually beneficial. Nonetheless Islamic finance has not expanded to its full potential. We will take these issues in this section.

Islamic finance has been practiced for more than a quarter of a century. It has gained acceptance and succeeded in making inroads into the financial industry, providing services to Muslims and non-Muslims alike. The size of the assets managed by the Islamic finance industry is estimated to go beyond \$500 billion. The industry witnessed growth of 20 percent during 2004 and is still growing strong (Box and Asaria, 2005). A large number of Islamic banks and financial institutions have been established in both Muslim and non-Muslim countries. At least four countries have been competing for becoming an international Islamic finance center, namely Bahrain, Emirates, Malaysia, and Qatar. So far, the the Islamic banking sector in the UAE is the largest and the fastest growing among those four countries. Some Muslim countries, notably Iran and Sudan have opted for a full-fledged Islamic monetary and financial system. Others, e.g., Bahrain, Indonesia, Malaysia and Pakistan have sought to develop a significant Islamic financial sector with modern capabilities. Many conventional banks, both national and international have entered the field of Islamic finance through opening windows and branches.

Islamic banking has already entered Europe from the British gate, with the establishment of the first Islamic bank in Britain. Several international conventional banks are increasingly providing Islamic finance products, windows and branches.

The record of Islamic banking and financial institutions indicates that Islamic finance started as an innovative non-conventional way of doing business and quickly gained success, popularity, and acceptance. That may indicate that it is useful both to individuals and societies. We elaborate below some of its accomplishments.

I. ACCOMPLISHMENTS OF ISLAMIC FINANCE

Some of the most recent accomplishments of Islamic finance are noted below.

A. DEVELOPMENT FINANCE¹⁶

Islamic finance is not only practiced at the domestic level in the form of retail and wholesale banking, but also extends to the area of development finance at the international level.

The Islamic Development Bank Group (IDB Group) is a multilateral development finance institution comprising four entities: the Islamic Development Bank, IDB (55 member countries), the Islamic Research and Training Institute (IRTI), the Islamic Corporation for the Development of the Private Sector, ICD (44 member countries), and the Islamic Corporation for the Insurance of Investment and Export Credit, ICIEC (34 member countries). These entities, with IDB as the flagship, were established at different times in the history of the Group, each with its objectives and operational modalities but sharing common vision and mission. The IDB works in close cooperation with the World Bank, the IMF and regional financial institutions.

The IDB Group is a unique multilateral financing institution. It uses financing modes that are Shari'ah-compatible for its operations. Its membership comprises only the developing countries. Accordingly, the resources from the relatively better off member countries are used to assist those that are less well off. Each member country benefits from the IDB resources in proportion to its developmental need rather than its capital subscription. This makes the IDB Group a model institution for South-South cooperation.

The major achievements of the IDB Group since its inception are several. Membership in the IDB has grown from 22 to 55 countries. ICD membership has grown from 25 to 44 countries plus the IDB itself and 5 financial institutions. ICIEC membership has grown from 13 to 34 countries plus IDB. Membership of the flagship entity (IDB) is global, spreading over Africa, Asia, Middle East, Europe, and South America.

The IDB has registered substantial growth in capital. Authorized capital in Islamic Dinars¹⁷ (ID) now stands at ID15 billion (around \$22 billion), and its paid-in capital has increased to ID 2.72 billion (about \$4 billion)

During its first 25 years of operations that ended in March 2001, the IDB provided project financing and technical assistance exceeding ID5.5 billion (\$8.0 billion) and trade financing of around ID12.2 billion (\$17.8 billion). Out of project financing, 28.2 percent went to public utilities, 21 percent to public sector, 16.7 percent to transport and communication,

¹⁶ This part has been summarized from the IDB website: <http://www.isdb.org/>

¹⁷ One Islamic Dinar is equivalent to one Special Drawing Right (SDR), which stood at \$1.45698 on September 23, 2005.

13.8 percent to agriculture, 13 percent to industry and mining and 6.7 percent to financial services and other sectors. In total, ID 3.1 billion (\$4.5 billion) went to project financing in IDB least developed member countries, which amounts to 56.4 percent of total project finance.

The IDB has also seen substantial growth in operations/sectoral financing. Net approval of IDB Group (excluding ICIEC operations) from inception up to the end-1425H (9 February 2005) amounted to ID28.8 billion (\$38.3 billion) for 4,754 operations in all sectors of member countries' economies, of which ID20.4 billion (\$27.2 billion) has been disbursed. The IDB has earned highest ratings (AAA/A1+) with a stable outlook assigned to it in 2002 and reaffirmed in 2004 by Standard and Poor's. Classification of IDB as a zero-risk weighted multilateral development bank under the new Basel Capital Accord was issued by the Bank for International Settlement in June 2004.

B. ASSET SECURITIZATION:

Financial instruments in Islamic finance must be asset based. Naturally stocks would be acceptable as Islamic financial instruments. However, bonds would not be acceptable as they are purely monetary assets. Other Islamic financial instruments, Sukuk, must be issued against a collection of real assets. Examples include a collection of real estate that whose rent would be distributed over Sukuk holders, and a share in the assets of a firm whose profit share is passed to Sukuk holders.

The Sukuk market is rather new, but it is quickly approaching a definite shape, thanks to growth in issues. The total value of Sukuk issued stood at \$6.7 billion at the end of 2004. Sovereign Sukuk have been issued by Malaysia, Bahrain and lately by the German state of Saxony-Anhalt as well as the World Bank (Al-Jarhi, 2005).

Sukuk announcements between January and August 2005 have reached \$3250 million and Sukuk issues \$6365 million. This does not include the instruments issued by Malaysian institutions which have been estimated at \$3 billion during the first half of 2005.

A good part of government debt in Sudan is issued as Sukuk issued by Sudan Financial Services Company limited. The company organizes auctions of buying and selling Central Bank Musharaka Certificates (CMCs), Government Musharaka Certificates (GMCs) and Government Investment Certificates (GICs). The total value of outstanding Sukuk of all three kinds reached \$532 million in 2003¹⁸.

The Bahrain Monetary Agency has rolling program of monthly issuance of short-term commodity-backed securities, Sukuk Al-Salam, since June

¹⁸ Bank of Sudan, <http://www.bankofsudan.org/>

2001. It complements the regular issuance of asset-backed Ijarah Sukuk of medium and long-term tenor that started since September 2001. Last year, the BMA issued the longest tenor Ijarah Sukuk, with a BD40 million (US\$106 million) carrying with 10-year maturity. So far, the BMA has offered 11 issues of Ijarah Sukuk, worth a total of US\$1.21 billion, of which US\$1.14 billion is currently outstanding. The BMA now has a full complement of Ijarah Sukuk of short, medium, and long tenors issued on behalf of the Government of Bahrain (Al-Jarhi, 2005).

One of the examples of success has been in the area of identifying a collection of government-owned income-earning assets of high quality and issuing financial instruments backed by them. Such instruments are readily tradable in the market and can be used to carry out open market operations. Similar examples of leasing- and *Salam*- based instruments are found. Such instruments would reduce the government need for deficit finance and help in developing an Islamic financial market.

The IDB contributed significantly towards the establishment of an Islamic financial market. It issued AAA-rated Sukuk, totaling \$400 million during 2004. In addition it implemented a short-term resource-mobilization scheme through Reverse Murabaha. In this manner, the IDB tapped, for the first time, international capital markets to fund its operations and thus releasing member countries of further equity financing obligations.

Based on the IDB's Five-year Strategic Plan, which covers the period from 1426H to 1430H, resource requirements have been identified at ID3 billion (approximately \$4.7 billion). Consequently, the Bank is in the process of launching its second Sukuk issue under the Euro Medium-term Note (EMTN) program for \$1 billion with a "benchmark issue" or the first tranche of \$500 million. The program is expected to be completed by the end of second quarter of 2005. Subsequently, smaller tranches will be offered depending on the financing and/or liquidity requirements of the Bank. The EMTN is expected to achieve a wide distribution, with emphasis on investors outside the IDB member countries, so as to add depth to the Sukuk market.

In addition, the IDB has developed the *Islamic Banks Portfolio* and the *Unit Investment Fund*. Both represent securities held by Islamic financial institutions and backed by assets, which they manage. The IDB has also established the *Infrastructure Fund* and the *Awqaf Properties Fund* to invest in specialized areas.

In addition to Sudan and Bahrain, the IDB and the World Bank, we find that Brunei, Indonesia, Malaysia, the United Arab Emirates, Egypt, and Iran have had successful issue of new and innovative Islamic financial instruments for financing both private and public sectors operations. Judging by Sukuk growth during 2005, we can safely say that the Sukuk

is quiet vibrant and could mature in few years in depth, breadth, and maturity structure.

C. CENTRAL BANKING OPERATIONS:

Sudan has succeeded in developing fully-fledged central banking operations that are in line with Islamic principles to serve its banking system and to regain control of monetary and credit aggregates. Malaysia has developed its central banking operations to deal with a mixed system that combines both conventional and Islamic finance. Indonesia is following the same footsteps with a more ambitious plan to promote Islamic banking. Lately it has become interested in expanding the size of the Islamic banking sector and is taking the necessary steps towards that goal. Pakistan has attempted to evolve central banking operations similar to those in Sudan, to suit transforming its banking and financial system to an Islamic system. However, such step faltered due to lack of political will. Instead, Pakistan started to follow the Malaysian model of a mixed banking system and opening the door for foreign Islamic banks.

Bahrain, vying to become an international center for Islamic finance, has developed sophisticated regulatory and supervisory system for Islamic banks. Qatar, with the same ambitions, has taken similar steps. A well-integrated central banking system for Islamic finance is not an easy task. Such system involves designing regulatory and supervisory rules specially tailored for Islamic banking, centralized *Shari'ah committee* in the central bank to insure compliance, product quality as well as homogeneity of products. They also involve setting up rules for an inter-bank market that avoids the use of the rate of interest.

D. INTERNATIONAL ISLAMIC FINANCIAL INFRASTRUCTURE:

One of the most obvious signs of maturity of the Islamic finance industry is that at the international level, its institutional infrastructure is complete. The necessary institutions have been established and some have taken advanced steps towards fulfilling their roles. Others have made a good start and require some time in order to make an impact. The following gives a quick review of the infrastructure.

- ◆ **The Islamic Financial Services Board (IFSB):** The IFSB was established in 2002. The IFSB serves as an international standard-setting body for regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry (banking, capital market, and insurance). It promotes the development of prudent and transparent Islamic financial service industry through

introducing new, or adapting existing international standards consistent with Islamic Shari`ah principles. The IFSB complements the work of the Basel Committee on Banking Supervision, International Organization of Securities Commissions, and the International Association of Insurance Supervisors. On 15 March 2005, the IFSB issued an Exposure Draft on prudential standards Risk Management and another on Capital Adequacy. It expects to issue an Exposure Draft on Corporate Governance by the end of 2005. In addition, it started preparing a standard on Supervisory Review Process and another one on Transparency and Market Discipline.

- ◆ **The Accounting and Auditing Organization for Islamic financial Institutions, AAOIFI:** AAOIFI was established in accordance with the Agreement of Association which signed by Islamic financial institutions in February 1990 in Algiers. It was then registered in March 1991 in Bahrain. AAOIFI aims to develop accounting, auditing, governance, and ethical standards relating to the activities of Islamic financial institutions, taking into consideration the international standards and practices which comply with Islamic Shari'a rules. Its membership now stands at 115 members representing 27 countries. So far, AAOIFI has issued 56 standards on accounting, auditing, governance, ethical, and Shari'a standards, including a statement on capital adequacy. AAOIFI's are either mandatory or used as guidelines by the regulators in jurisdictions such as Bahrain, Sudan, Jordan, Malaysia, Qatar, Saudi Arabia, Dubai and Lebanon and Syria.
- ◆ **The General Council of Islamic Banks and Financial Institutions, GCIBFI:** It is an international autonomous non-profit body that represents Islamic banks and financial institutions and the Islamic financial industry globally. The GCIBFI has been incorporated in the Kingdom of Bahrain in the year 2001. It aims at promoting the Islamic financial industry in theory and practice, improving multilateral understanding between Islamic banks, their customers and the public at large, and providing information related to Islamic banks and financial institutions and related Islamic organization.
- ◆ **The International Islamic Financial Market, IIFM:** The IIFM was established in April 2002 through the collective efforts of five countries: Bahrain, Brunei, Indonesia, Malaysia, Sudan and one multilateral institution: the Islamic Development Bank (IDB). It is located in Kuala Lumpur, Malaysia. The IIFM was initially conceived to establish a more structured global financial market that is based on Shari`ah principles and to develop the

cooperative framework among Islamic countries and financial institutions . Later on, the IIFM started to develop into a vital infrastructure institution for the expansion of Islamic money and capital markets and subsequently create a secondary market for Islamic financial-market instruments. The IIFM will also focus on and play a vital role in the advancement and standardization of Islamic financial instrument structures and contracts, infrastructure and product development, issuance of guidelines and enhancing the cooperative framework among Islamic Financial Institutions .

- ◆ **The International Islamic Center for Reconciliation and Commercial Arbitration (IICRC):** The Center was established in 2005 by the Islamic Development Bank and the Government of Dubai to provide out-of-court settlements to disputes related to Islamic finance.
- ◆ **The Liquidity Management Center, LMC:** The Center (LMC) was established in Bahrain in May 2003 with the aim to increase the quantity and improve the quality of financial assets for Islamic financial industry. It is part of a larger project to create an International Islamic Financial Market. The Center focuses on providing Shari`ah-compliant short- and medium-term liquid investment products for both Islamic and conventional banks and financial institutions. The LMC will create a pool of assets in which Islamic financial institutions can invest surplus liquidity. Part of its activities will be to create an Islamic inter-bank money market, allowing Islamic institutions to effectively manage their assets and liabilities. LMC shareholders are the Islamic Development Bank (IDB), Kuwait Finance House, Dubai Islamic Bank, and Bahrain Islamic Bank (BIB).
- ◆ **The Islamic International Rating Agency, IIRA:** The IIRA was launched in October 2002 in Bahrain. It aims at rating and evaluating Islamic banks, financial institutions and instruments, as well as providing an independent assessment and opinion on the likelihood of a future loss of the rated entity or financial instrument. It provides an independent assessment of compliance by the entity or instrument with Shari`ah principles. It attempts to introduce standards for greater disclosure and appropriate governance within the global Islamic banking industry.

II. RELATIONS BETWEEN ISLAMIC AND CONVENTIONAL FINANCIAL INSTITUTIONS

The relationships between Islamic and conventional banking and financial institutions have proven fruitful in many aspects. The market mechanism has enabled both kinds of institutions to interact and develop working relationships and alliances.

A. LESSONS ISLAMIC AND CONVENTIONAL BANKS CAN LEARN FROM EACH OTHER.

Islamic financial institutions share with their conventional counterparts similar specializations and business interests. Differences that exist between their modes of operations afford them excellent opportunities to cooperate and collaborate. Areas like joint financing and financial market operations can be the stage of daily collaboration. As conventional financial institutions have been first in the field, they can be a valuable source for professional techniques and standards. In other words, Islamic financial institutions have a lot to learn from conventional financial institutions in this regard.

Islamic financial institutions, being aware of their innovative methods, have toiled to develop the new financial products. That included a lot of work to formulate new contractual arrangements on both their asset and liability sides. In addition, they have been able to acquire a niche that conventional financial institutions do not have. Nevertheless, the latter can participate and make use of such new and innovative techniques that would help them better serve their customers.

As would be expected, Islamic financial institutions depend sometimes on their conventional counterparts in working with financial markets. They often collaborate to design new products, which they can jointly market and manage. This includes funds, securities, and the like.

Many of the funds created and marketed by Islamic financial institutions involve financial instruments traded in international financial centers as well as financial centers in emerging markets. Trading in those instruments would have to be done through conventional financial institutions, which are geographically proximate to those markets. The management of such funds may also require the assistance of financial services institutions, which are closely located and may even have trading privileges in those markets.

B. CAN CONVENTIONAL BANKS LEGITIMATELY OFFER ISLAMIC FACILITIES?

One of the ultimate indicators of the success of Islamic finance is that its modes of operations appear sufficiently attractive to conventional financial institutions so that they ultimately enter the market of Islamic finance as partners or even as competitors to Islamic financial

institutions. This is an important area where collaboration can introduce a wider variety of financial products into the market. Competition would also improve efficiency and benefit both savers and investors.

Through cooperation with Islamic financial institutions, conventional institutions can ascertain the quality of their Islamic financial products. If conventional financial institutions wish to compete in the market of Islamic financial products, they must make sure that their products have the proper qualities that the market of Islamic finance requires. Otherwise, the market could end up being cluttered with products that meet little interest on the customers' side. In particular, compliance of Islamic rules of finance must not be compromised, if financial products are to be marketed as *Islamic*.

Given that conventional producers of Islamic financial services are strictly observing the quality requirements of such products, we can safely say that Islamic finance will increasingly gain universal acceptance. This will demonstrate that Islamic finance is not just for Muslims alone. It is rather for everybody.

III. EQUAL OPPORTUNITY FOR ISLAMIC FINANCE

Now we come to the final question we raised with regard to Islamic finance. Theoretically and empirically, it is not difficult for specialists in economics and finance to find Islamic finance not only viable and acceptable, but also efficient and significantly effective. It is not therefore surprising to see large multinational financial institutions providing Islamic financial services and products to their customers in significant amounts. As an innovation, Islamic finance has been practiced for more than a quarter of a century. Some people might think that it should have received wider acceptance worldwide. There are several reasons why this has not happened.

First, Islamic finance seems quite different from conventional practices, as it is not based on borrowing and lending. Conventional banking is based on mobilizing financial resources through borrowing and providing the resources to their users through lending. Meanwhile, Islamic finance is based on mobilizing financial resources through profit sharing and making them available to resource users through the modes of Islamic finance that we outlined above. Therefore, conversion from conventional to Islamic finance requires total change in both perception and mechanisms. Human minds usually take time before accepting changes in perception. Practices which have been established for some time do not easily give way to new mechanisms.

However, we must emphasize that the continued efforts of specialists to write explaining the idea of Islamic finance, its meaning and rationale, has helped a great deal in formulating the correct perception of this innovative idea. With continued efforts, the

financial mentality that has been trained in a conventional environment will eventually be able to have the right perception of Islamic finance.

Second, Islamic financial institutions, like their conventional counterparts, can operate more effectively when the proper legal and institutional environment is provided, something that is yet to happen at a large scale in a significant number of countries. The well-known fiscal prejudice against profit and in favor of interest is just an example, where interest payments are partially or fully tax exempt, and profit gets no such advantage. However, such bias is declining in some places, which would indicate more hopeful prospects for better understanding of Islamic finance.

Third, the present capital markets are not adequately equipped to process the information required by Islamic finance. This requires a careful blend of laws and ethics, the latter playing more important role than the former. Islamic finance would thus require a certain set of ethics in the market. Scholars elaborate on the details of the required ethics based on Islamic principles. It may take some time before Islamic ethics are introduced appropriately in the capital market. Needless to say, the required ethics make sense irrespective of religious beliefs. Religion, however, provides commitment to abide by those ethics in letter and spirit.

Fourth, Islamic banks and financial institutions working in mixed systems that allow for both conventional and Islamic practices have been able to approach but have not yet reached their ideal model. Islamic financial institutions are expected to provide equity/profit sharing and debt finance while giving higher weight to the former. Yet, when they operate in mixed environment, their asset structure tilts towards debt finance. The reason for this is two-fold. On the one hand, dealing with equity and profit-sharing finance requires supporting environment and institutions. On the environment side, entities obtaining this type of finance need to have orderly bookkeeping, audited financial statements, and suitable corporate governance. In most countries where Islamic banking is practiced, those elements are hard to come by. It would also make things a lot easier if banking laws, rules enforcing obligation fulfillment and credit (or investment) rating is available.

They are also expected to provide debt and equity finance simultaneously to the same customers, as universal banks should do. However, such pattern of operations is not common. This could be related to the commercial banking culture that dominates the banking systems where Islamic financial institutions operate. The universal banking model has to be brought closer to the minds of practitioners of Islamic finance. Monetary and financial authorities also need to become more tolerant of universal banking especially that the movement towards banking deregulation has become more prevalent.

Fifth, Islamic financial products have to increase in numbers and variety to form a critical mass that would attract a large number of transactors. Once the Islamic market for financial instruments acquires depth and breadth, the public will find it more convenient to join in.

Sixth, there is sometimes the feeling that Islamic finance works outside the authority of governments. Quite the contrary, Islamic financial institutions are consistently subjected to rigorous regulations and supervision by authorities wherever it is practiced. More often than not, their regulation and supervision are made even more rigorous than that imposed on their conventional counterparts. Those working in the field of Islamic finance are equally concerned about the integrity and the stability of both national and international markets.

With no exception, all institutions practicing Islamic finance work under government regulatory and supervisory authorities in their respective countries. Such authorities are sufficiently empowered to collect information and point to violations. All parties concerned with the health of world finance are invited to cooperate with regulatory and supervisory authorities to make sure that the practices of conventional as well as Islamic institutions cause no concern.

Moreover, many forget that Islamic financial institutions have two layers of supervision as compared to one layer of supervision faced by conventional finance. To practice Islamic finance properly, an institution must have a Shari`ah board. Such board guards the quality of the financial products and protects the institution from reputation risk, that is the possibility of being found to offer Shari`ah incompatible products. Interestingly enough, the board can serve also as customers' advocate. It supervises the distribution of profit among depositors and other resource owners on the one hand and shareholders on the other, in order to insure that such process are orderly and just. Second, any customer can complain to the Shari`ah Board. The Board would look into the matter and make the necessary pronouncement which the management is bound to implement.

Seventh, in order to switch to a new financial system, cooperation is needed from several parties, including bankers, savers, investors, businessmen, and governmental institutions. As economists know too well, when cooperation is scarce, people make irrational decisions that keep them away from an optimal solution. As economists have argued within a *theory of reciprocity* (Falk and Fischbacher 2000) in general and the *prisoner's dilemma* (Janssen 2000) in particular, a subgroup of cooperating agents can, under certain conditions bring the whole population to an optimal solution. This implies that new and unconventional ways, notwithstanding their advantages, would require a sufficient number of pioneers to lead the way and set an example.

Finally, we are inclined to propose that countries should give equal chance to Islamic finance to work side by side with conventional finance. The market itself would finally decide the proper mix of both conventional and Islamic finance that suits the world economy. By

removing restrictions, obstacles and hindrances facing the application of Islamic finance, the world would benefit and economic development can be better served.

In order to help the Islamic financial industry further develop itself and overcome the obstacles it faces, countries must be invited to develop and continue to improve the important infrastructure needed to support the industry and insure its proper functioning. Now the institutional foundations of the regulation and supervision of Islamic finance has been established, efforts must continue to develop further the proper regulatory and supervisory mechanisms that suit Islamic finance and, at the same time, ensure adequate transparency, proper risk management, internal controls, and effective corporate governance.

Like the conventional financial industry, the Islamic financial industry has its success but faces certain challenges. Developing and improving the proper enabling environment will go a long way in helping the Islamic finance industry to deal with the challenges it faces. Once such environment becomes sufficiently workable, the Islamic financial industry can become more capable of handling sophisticated financing techniques and instruments. It can then accomplish more successes, especially in the areas of designing market-based instruments for monetary control and government financing that satisfies the Islamic principles and promotes greater reliance on equity finance.

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