ABSTRACT

RIBĀ-FREE MODELS OF MONEY, BANKING, AND INSURANCE

COMPONENTS OF THE ISLAMIC MORAL ECONOMY

By

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The Islamic Moral Economy is a utopian economic, social and political idea where all forms of *ribā* are absent; in a contemporary context, this includes the elimination of all financial interest and usury, utilization of full-reserve banking models, an asset-based money using a commodity that has historical inelastic demand as the numeraire, and quasi-socialist elements of mutual cooperation. Modern Islamic economics is rooted in the concept of profit-and-loss sharing where both transacting parties share in the potential profits and losses.

This study examines the most popular Islamic banking, finance and insurance products in use today. Moreover, this study attempts to determine the permissibility or lack thereof from an Islamic doctrinal perspective within the framework of a *ribā*-free society that imbues Islamic morals and ethics. Although financial interest is the single most notable problem with conventional economics from an Islamic vantage, this study determines that the ubiquitous fractional reserve banking model and fiat currency are

equally problematic for Islamic banks and the establishment of a greater Islamic Moral Economy.

RIBĀ-FREE MODELS OF MONEY, BANKING, AND INSURANCE

COMPONENTS OF THE ISLAMIC MORAL ECONOMY

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CHAPTER 1

INTRODUCTION

The Islamic Moral Economy is an economic, social and political model predicated upon the theological doctrines and values promoted by the Qur'ān and Sunnah.[1] However, the Islamic Moral Economy in its most general sense is a utopian model characterized by equitable distribution of wealth and systemic social structures that provide universal care for all individuals in need.[2] The Islamic Moral Economy's equitable distribution of wealth is parallel to the ultimate objective of Marx and Engel's vision of communist economic equality.[3]

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[1] In Islam, the Qur'ān is considered the Word of God verbatim as revealed by the angel Gabriel to Muhammad beginning in 610 CE. The Sunnah is the tradition or orthopraxy of Muhammad, which is documented in the Ḥadīth literature. Whereas the Qur'ān is considered prescriptive, the Sunnah vis-à-vis the Ḥadīth literature is considered descriptive. Depending on the legal school, these two primary textual sources serve as the foundation for Islamic law. (Note: I have elected to use Abdullah Yusuf Ali's English translation of the Qur'ān and USC's online database of Ḥadīth.)

[2] The Qur'ān not only extols the virtues of charity, but charity becomes a legal mandate through *zakat*, which is mandatory annual alms-giving totaling one fortieth of an individuals net worth. However, *zakat* is only obligatory if an individual meets the predetermined minimum net worth requirement. Moreover, there are several verses in the Qur'ān requiring Muslims to care for orphans, widows, the indebted, and poor (e.g., Qur'ān 2:83, 2:215, 2:240, 2:280, 4:36, 8:41, 76:8).

[3] Whereas Marx and Engel foresee a class struggle between the capitalist and proletariat, the Islamic Moral Economy introduces a divinely ordained mandate requiring all Muslims to participate in the redistribution of wealth through *zakat* and *sadaqah* or religiously prescribed alms-giving and general gifts or charity. See Pals, *Eight Theories of Religion*, 125.

Conversely, the Islamic Moral Economy also exhibits qualities of pure free-market capitalism, consisting of countless perfectly competitive trading partners. As such, no single economic entity may exhibit characteristics of a coercive monopoly over any given sector of the economy. A coercive monopoly is anathema to the Islamic Moral Economy because of its potential to arbitrarily set market prices or production policies, without regard for the divinely ordained market forces of supply and demand.[4]

However, the primary purpose of this study is not to examine the role of coercive monopolistic policies present in traditional capitalist economies. Similarly, this thesis does not aim to prove the superiority of Islamic economies over conventional interest-based economies. Instead, this thesis shall critically study the various legal structures and financial instruments used in Islamic banking and finance sectors within the framework of the Islamic Moral Economy, and to determine its *sharī'ah* tolerance, compliance, or dependence.[5]

In the Islamic Moral Economy, the role of buyer and seller, and thus supply and demand, is imbued with certain moral and ethical expectations rooted in Islamic ideas of honesty, sincerity and an abstention from exploiting asymmetric information advantages.[6]

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[4] See Greenspan, *Capitalism,* 68-9.

[5] According to most Islamic banking and insurance practitioners, there are three levels of Islamic permissibility with regard to financial instruments and contracts today: tolerance, compliance, and dependence. These three terms span a spectrum of low to high compliance with Islamic law. The term "tolerance" refers to the lowest level of solubility with Islamic law; similarly "dependence" is considered the highest level of solubility with Islamic law. See Dar, *New Horizon,* 10-2.

[6] In economics, the term "asymmetric information" refers to the unequal knowledge or information regarding a given transaction that gives one party an advantage. Although asymmetric information is inevitable in degrees, the Islamic Moral

> Two men meeting on the street meet merely as two men, but for over a thousand years the bazaar has been recognized by Islamic law as a special arena of human life, and in law as well as in common understanding two men meet there as 'two men in the bazaar.' As such they share certain moral and even legal obligations—for example, to buy and sell with a shared knowledge of the current market price.[7]

In the Islamic Moral Economy, the role of theological assumptions is also present in price equilibrium models of supply and demand curves because God is the third economic party in a transaction.[8] Coupled with this Islamic theology and the role of the marketplace as a type of sacred space, the Islamic Moral Economy demands that only "God sets prices."[9]

Similarly, no single economic entity may grow so large that it poses a systemic risk to the economy's success or stability. If a market participant were to grow so large that it could potentially destabilize the greater market economy, it would inexorably exhibit elements of a coercive monopoly that fly at the face of the Islamic Moral Economy (e.g., undue and excessive influence over price equilibriums and asymmetric

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Economy aims to "level the playing field" by introducing as much transparency in the transaction as possible. See Mishkin, *The Economics of Money, Banking and Financial Markets*, 37.

[7] Mottahedeh, *The Mantle of the Prophet*, 34.

[8] In economics, the term "equilibrium" refers to a graphical point where the supply and demand curves intersect. More specifically, it is mathematically expressed as aggregate supply equaling aggregate demand: $A_S = A_D$, and thus represents a point where both buyers and sellers mutually agree upon a price and quantity. See Mishkin, *The Economics of Money, Banking and Financial Markets*, 570-7.

Because God is omniscient and omnipotent, He is knowledgeable of all transactions and determines the outcomes. More specifically, if there are two market participants in a transaction, He is the third; if there are three market participants, God is the fourth, etc. See Qur'ān 58:7.

[9] See Mottahedeh, *The Mantle of the Prophet,* 34; and Eliade, *The Sacred and the Profane*, 20-65.

information).[10] As such, the Islamic Moral Economy is more accurately portrayed as a utopian theocracy and social economy that contains elements of free-market capitalism and communism.[11]

Along with these broad philosophical and theological mandates, the Islamic Moral Economy and its market participants may not engage in any activity that is expressly prohibited by Islam. Therefore, economic activities that are engaged in the research, discovery, development, manufacture, distribution, market or sale of alcoholic beverages, porcine food products, pornography or other illicit sexual activity are strictly forbidden.[12] Gambling is another proscribed economic activity, which is discussed in further detail below.

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[10] From an Islamic Moral Economy perspective, the Great Recession of 2007-2010 is arguably a product of coercive monopolies and their utilization of highly speculative and abstract financial instruments. Although we will examine the role of abstractions in financial instruments in Chapter 2 and Chapter 3, our primary interest here is the role systemic failure caused by a single market participant. As stated earlier, if a firm's failure results in a systemic failure of the greater economy, such a condition is sufficient for labeling the firm as a coercive monopoly. In the "Great Recession" the failure of firms such as AIG and Bear Stearns to name only two, were considered necessary to prevent a systemic global economic failure. See Kimberly Blanton. "Six things you need to know to understand the financial crisis," *The Boston Globe* (September 28, 2008), http://www.boston.com/business/markets/articles/2008/09/28/six_things_you_need_to_know_to_understand_the_financial_crisis/ (accessed February 8, 2010).

[11] Any Islamic society will necessarily exhibit qualities of a theocracy because of the importation of religion's primary function in formulating public policy. Similarly, the vision of reforming the current interest-based economy to one that is completely devoid of *ribā* is highly utopian in nature. Moreover, the Islamic Moral Economy espouses economic values and practices that embrace utopian ideals of absolute financial and social equality.

[12] The Qur'ān prohibits wine and gambling in 2:219, and the "flesh of swine" in 2:173. Modern scholars and jurists have varied opinions regarding the permissibility of trading in derivatives of alcohol and porcine commodities. For example, conservative

Most importantly, the Islamic Moral Economy is free from *ribā*, *maysir* and *gharar*, which are generally defined as "financial interest" or "usury," "gambling," and "excessive risk" respectively.[13] The elimination of *ribā*, *maysir* and *gharar* form the foundational basis for modern attempts at establishing an Islamic Moral Economy. In modern Islamic economics, *ribā*, *maysir* and *gharar* are superficially and legally omitted from contracts, or are holistically replaced by true profit-and-loss sharing models that embrace risk and reward reciprocity.

The Problem

Contemporary attempts at establishing an Islamic Moral Economy are predicated upon the "Islamization" of conventional banking models. Conventional deposit relationships, loan products and financial instruments become "Islamic" through Arabic nomenclature and revised contract language superficially eliminating financial interest (e.g., the *murābaha* cost-plus contract implicitly incorporates financial interest through

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scholars forbid the trade or consumption of any and all products that have alcohol or porcine derivatives (e.g., pharmaceuticals), preferring *halal* or permissible variations. Other, more liberal scholars and conservatives argue that derivatives of such products are permissible on the basis that they no longer resemble their original form. Finally, pornography and trade in sex are prohibited in 24:2 among other verses. See *Islamic Food and Nutrition Council of America*, http://www.ifanca.org (accessed January 3, 2010).

[13] Qur'ān 2:275 and 5:90 are two specific verses that explicate the evils and repercussions of usury and gambling. Separately, the term *gharar* or "excessive risk" is often synonymous with "speculation," "uncertainty," or "hazard" and is the subject of great debate amongst contemporary Islamic bankers and economists. For more on *gharar*, see Paxford, *New Horizon,* 21-2.

interest-rate benchmarking and time-value calculations of financial capital returns on investment).[14]

Current Islamic economies face an acute problem when considering the widely accepted definition of *ribā* and its inherent presence in all fractional reserve banking models.[15] To be sure, fiat currency or paper money endowed with artificial value by a hegemonic social structure (e.g., a government body such as a central bank) is also insoluble with the Islamic Moral Economy.[16]

Therefore, the real problem with modern Islamic money, banking, and insurance is not the superficial and legalistic elimination of *ribā*, *maysir* and *gharar*. Instead, it is the absence of a critical and holistic examination of conventional money, banking and insurance models that may or may not be soluble with the utopian Islamic Moral Economy. A study of the Islamic Moral Economy and its myriad *ribā*-free components requires a fresh perspective that is not necessarily dependent upon conventional money, banking or insurance.

Assumptions

The analyses and recommendations provided herein assume that *ribā* is in fact proscribed and non-existent in the Islamic Moral Economy. Although several scholars have addressed the linguistic and exegetical implications of *ribā*, and its permissibility or

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[14] See Chapter 3 for more details on the *murābaha* cost-plus contract.

[15] A banking model where a depositor bank holds a fraction of all deposit liabilities for demand withdrawals by the depositors, and lends the excess funds for profit, which results in the artificial "creation" of money on the balance sheets of banks. See Chapter 2.

[16] The role and types of money that are permissible in an Islamic Moral Economy are also addressed in Chapter 3.

impermissibility in an Islamic context, we will assume that it is defined as financial interest, usury, unequal exchange, or artificial creation in a purely economic context.[17] As such, many *sharī'ah* compliant financial structures are viewed critically and are deemed insoluble with the Islamic Moral Economy.[18]

Significance

A significant amount of scholarship on Islamic money, banking and insurance has been produced since the 1940s beginning with Sayyid Abu'l-A la-Maududī, who coined the term "Islamic economics."[19] Much of the scholarship amongst practitioners of Islamic banking and insurance revolves around the innovation and financial engineering of new instruments and contract structures. Conversely, non-practitioner academicians focus on a specific disciplines' perception of the Islamic Moral Economy (e.g., anthropological, sociological, philosophical, and certainly economic).[20]

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[17] See Chapter 2 for more information on *ribā* and its multiple meanings.

[18] *Sharī'ah* is the term for Islamic law, which is based on the Qur'ān, Ḥadīth, personal interpretation or *ijtihad*, and *ijmā'* or consensus of religious scholars known as *ulama*. In Islamic economics, the term "*sharī'ah* compliant" has a specific meaning apart from "*sharī'ah* based" and the newly coined "*sharī'ah* tolerant." If we were to establish a spectrum of compliance and adoption of *sharī'ah* compliance, "*sharī'ah* based" would unquestionably and wholly embrace all Islamic Moral Economy principles; "*sharī'ah* compliant" would be the middle ground where most Islamic legal scholars deem something to be within an acceptable range of permissibility within *sharī'ah*; finally, "*sharī'ah* tolerant" would meet the minimum Islamic legal requirements. See Dar, *New Horizon,* 10-2.

[19] Kuran, *The American Economic Review*, 438-442.

[20] As a subject of academic inquiry, Islamic banking has attracted the interest of scholars from various fields. Bill Maurer wrote two books and several academic journal articles approaching the subject from an anthropological perspective. Similarly, the field attracts significant attention from legal scholars and theologians alike. See Maurer, *Mutual Life, Limited* (2005); and Maurer, *Pious Property* (2006).

Timur Kuran, a professor of economics and political science at Duke University, argues that the *raison d'être* of Islamic economics is a feeble attempt by Muslim expatriates to resist assimilation and maintain their Islamic culture.[21] Kuran questions the superiority or economic efficiency of *ribā*-free financial alternatives relative to its interest-bearing counterparts. Kuran further questions the ability of an Islamic Moral Economy of sustaining and stimulating the level of global economic growth as that of its conventional secular counterpart.[22]

Similarly, others argue that Islamic economics and its emphasis on an interest-free economy are actually potential solutions to economic instability, unemployment, inflation, and poverty.[23] Nevertheless, the purpose of this study is not to qualitatively or quantitatively prove the superiority of the Islamic Moral Economy or its numerous financial structures. Instead, the purpose of this study is to critically examine the myriad legal structures present in contemporary Islamic economics (i.e., money, banking and insurance), and to determine its *sharī'ah* tolerance, compliance, or dependence.[24]

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[21] Kuran is an outspoken critic of Islamic banking and finance, and he has written extensively on the subject. For more information on Kuran see: Kuran, "Political Science :: People :: Timur Kuran," http://fds.duke.edu/db/aas/PoliticalScience/t.kuran (accessed February 2, 2010). Also see "LaRiba & Bank of Whittier's Advertisement Campaign" in the appendix.

[22] Kuran, *The American Economic Review*, 438-442.

[23] See Kennedy, *Interest and Inflation Free Money,* 1995.

[24] As stated earlier, modern practitioners of Islamic economics have outlined a three-tiered system of determining the legality of a given financial instrument or structure. *Sharī'ah* tolerance is the least permissible of the three, with *sharī'ah* based or dependent being the most legally permissible. Op. cit., 18n.

Literature Review

While a significant amount of scholarship has been produced on the subject, scholarship in the West primarily originates from academics, economists and legal theorists—both Muslim and non-Muslim—in Europe, and more specifically England. Similarly, significant scholarship has also originated from Muslim dominated countries such as Malaysia and the several states in the Middle East. However, scholarship in the United States has been relatively limited mainly because Islamic banking and finance has a very small foothold in the country.[25] Nevertheless, critical scholarship on Islamic banking, finance and economics in the United States has steadily increased especially after 9/11.[26]

Similarly, this study incorporates many of these new American understandings of Islamic economics. Like any discipline, scholarship in Islamic banking, finance and economics is relegated to two primary schools of thought: (1) apologists and defenders; and (2) critics and detractors. As a student of the Institute of Islamic Banking and Insurance (IIBI), a non-profit organization based in London dedicated to training students, and banking and finance professionals in the bourgeoning field of Islamic finance, IIBI takes a very apologetic position. Indeed, many of the mechanic descriptions of the *sharī'ah* compliant structures used in modern Islamic banking and finance are

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[25] There are only a handful of active Islamic banks in the U.S., with California based LaRiba/Bank of Whittier being the largest. See Appendix B.

[26] While evidence of a general increased interest in Islam is largely anecdotal, there is some evidence supporting this generally agreed upon position. A 2008 report published by the American Academy of Religions states that undergraduate courses on Islam doubled in enrollment from 2000 to 2005. See "The Religious Studies Major in a Post-9/11 World: New Challenges, New Opportunities," *Religious Studies News* (Oct., 2009): 21-4.

students. Moreover, all authoritative positions regarding requirements are borrowed from IIBI and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) position statements and working papers.[27]

Additionally, this thesis frames the subject of Islamic banking, finance and economics under the aegis of the moral economy. The term "moral economy" stems from E. P. Thompson's moral economy of the crowd and James Scott's *The Moral Economy of the Peasant.*[28] While both works do not address Islamic banking in any detail, they do establish a framework for morality and ethics within an economic system. While Thompson discusses an English brand of socialism within the context of nineteenth century industrial revolution working class members, Scott reviews the peasantry in Southeast Asia.

As such, this work borrows the term "moral economy" within the context of the modern Islamic banking, finance and economics movement, which began primarily in the 1970s. Moreover, the Islamic Moral Economy is a utopian construct that is predicated upon the ethical and moral values espoused by Islamic doctrine with regard to both economic and social justice. Although several chapters of this thesis are dedicated to describing the mechanics of the various financial instruments used in modern Islamic banking, finance and economics, the ultimate goal is to compare each instrument to the fundamental principles of what constitutes Islamic moral and ethical compliance.

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[27] AAOIFI is a non-government regulatory body that is engaged in the formulation, interpretation, and implementation of Islamic law on Islamic financial institutions.

[28] See Scott, *The Moral Economy of the Peasant* (1976) and Thompson, *The Making of the English Working Class* (1963).

While some apologetic defenders of Islamic banking, finance and economics may ignore such limitations, these groups typically promote Islamic banking, finance and economics as a wholesale solution to the woes and inefficiencies of conventional economics.[29] Additionally, issues of religious legal permissibility are often not addressed explicitly. And if such deficiencies are articulated, excuses are made to justify the existing mechanisms in support of the status quo.[30] This apologetic sentiment is further reinforced by the inevitable need for Islamic banks and financial institutions to compete with conventional interest-based firms.

Indeed, this primary motive of competing with conventional financial firms in every respect renders Islamic banking and financial institutions vulnerable to *sharī'ah* non-compliance. Many American-Muslim scholars have argued that current models of Islamic financial instruments are simply not efficient enough to compete with conventional instruments while adhering to Islamic legal constraints. For example, Kuran, argues in various articles and his book *Islam and Mammon* that Islamic financial

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[29] Many practitioners of Islamic banking and finance have publicly acknowledged Islamic banking, finance and economics as a solution to the problems of the current global economic crises. Such proponents argue that interest is the root of all social and economic inequity. Specific individuals who promote such views include Taqi Usmani, who until recently, was a very vocal advocate of Islamic banking in its current form. Similarly, other practitioners such as Dr. Humayon Dar and Dr. Yahia Abdul-Rahman are vocal about the evils of interest and usury, and how Islamic banking embodies ethical and moral behaviors that may stem from either Islamic doctrine or external influences, ultimately making Islamic banks a viable socially responsible alternative. See Abdul-Rahman's 2010 book titled *The Art of Islamic Banking and Finance: Tools & Techniques for Community-Based Banking* and Dr. Dar's personal blog: http://www.humayondar.com (accessed February 8, 2010).

[30] For example, the use of interest rate benchmarking, which will be discussed in Chapter 2, is a clear cut example of how external interest rates continue to play a significant role in the pricing of Islamic banking and financial products that purport to be interest-free.

instruments are not only inefficient but that they are not soluble with the purported absolute ban on *ribā*.[31] Kuran further adds, "Most Muslims, whether or not they favor a ban on interest, and regardless of how they interpret Islam, readily agree that avoiding interest is among the constraints Islam places on economic behavior, if not its most important economic requirement."[32]

Moreover, Kuran argues that Islamic banking, finance and economics—as a moral and superior solution to the economic woes of modern economics is a recent phenomenon that originates from post-colonial social movements in India, Pakistan and Bangladesh.[33] Kuran says, "Islamic economics has fueled the illusion that Muslims can solve a wide range of social problems simply by embracing Islam and resisting Mammon—the evils associated with immoral forms of economic gain."[34] Ultimately, Kuran concludes that Islamic economics is a ruse and that it is simply a means for strengthening communal and cultural ties for expatriate Muslims: "A major reason for the existence of Islamic economics . . . lies in the objective to tighten communal bonds among Muslims, and in particular among those in the Indian subcontinent."[35]

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[31] Kuran, *Islam and Mammon*, 7-12.

[32] While I agree with Kuran's conclusion that modern Islamic banks do not adhere to interest-free operations except superficially, I also argue that Islamic banks, financial institutions, and governments are complicit in promoting *ribā* through fiat currencies and the fractional reserve banking system. Ibid., ix., and see Chapter 2.

[33] Kuran, *Islam and Mammon*, 13-4.

[34] Ibid., ix.

[35] Ibid.

Likewise, Mahmoud El-Gamal, an Egyptian born professor of economics at Rice University, argues that modern Islamic banking, finance and economics relies to heavily on medieval Islamic contracts that cannot efficiently address the financial needs of a global and integrated complex economy. El-Gamal further adds that Islamic banking, and finance institutions are primarily engaged in *sharī'ah* arbitrage, which he defines as "identifying a captive market, with religious injunctions that forbid a given set of financial products and services, and synthesizing those products and services from variations on those premodern nominate contracts."[36] El-Gamal adds that such a trajectory is "unsustainable and dangerous."[37]

While the unpublished working papers of IIBI, and the journal articles and books of Kuran and El-Gamal are the most significant contributions to the formulation of the arguments contained in this thesis, several additional authors have been referenced and cited. The works of Bill Maurer, a professor of anthropology at the University of California, Irvine, were particularly valuable especially with regard to the medieval mutuality and reciprocity of the *vif-gage* contract, which is strikingly similar to the Islamic *mushārakah* contract. Additionally, the works of Umer Chapra, Rodney Wilson, Masudul Chowdhury, Frederic Mishkin, Fazlur Rahman and a host of other theorists, economists and theologians have been cited or quoted.

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[36] El-Gamal, *Islamic Finance*, 175.

[37] El-Gamal also maintains an online blog dedicated to Islamic finance. On his website, El-Gamal is very vocal about his disenchantment with the industry. More specifically, El-Gamal advocates a "disengagement" with the industry for fear that it will ultimately "corrupt" any Islamic values one has prior to entering the field of Islamic banking, finance and economics. See El-Gamal, M. "Islam and Economics." May 2005. http://elgamal.blogspot.com (accessed February 9, 2010); Ibid.

Yet, none of these works specifically address the issue at hand. Using the assumption that *ribā* is strictly prohibited in an Islamic social and economic context, the goal of this study is to examine the various financial instruments in use by Islamic financial institutions and to determine the legal compliance or lack thereof generally. As such, the arguments presented in this thesis are critical of Islamic banking, finance and economics. Indeed, my ultimate conclusion is very critical of modern Islamic banking, finance and economics and ultimately echoes those published by Kuran, El-Gamal and others. However, none to my knowledge have been explicitly concerned about the fractional reserve banking model, which implicitly introduce *ribā* into the Islamic Moral Economy. Moreover, none have presented the material within the context of a moral economy.

Methodology

The bulk of the research conducted on behalf of this study was done through the review of existing scholarship on Islamic banking, money and insurance from 2008 to 2010. However, its distinguishing arguments are the result of working as a distance-learner with the London based IIBI in 2009, and participating in residential workshops held by IIBI at Clare College in Cambridge, England.[38] Additionally, informal personal

[38] I was fortunate enough to participate in a three-day residential workshop titled "Structuring Innovative Islamic Financial Products," which was held at Clare College, Cambridge, England from August 7-9, 2009. This workshop involved a critical legal analysis of the permissibility of various financial instruments that are not yet used by Islamic bankers and insurers worldwide. As expressed in my ultimate thesis argument, such conferences further perpetuate the modeling of Islamic financial alternatives after interest-bearing financial instruments, and thus are *sharī'ah* compliant or tolerant at best, instead of embracing and truly innovating *new* financial instruments in the spirit of *sharī'ah* based transactions.

and e-mail interviews were conducted with Islamic banking customers, central bankers, and Islamic bankers in the United States and the United Kingdom.[39]

Sects and Legal Schools of Thought

Islam consists of two primary sects, which comprise most Muslims in the world today: Sunni and Shī'i.[40] However, these two sects themselves have great diversity with regard to jurisprudence, orthodoxy and orthopraxy. For example, Sunni Islam is divided into the four schools of *fiqh*, which include the Hanafi, Hanbali, Maliki and Shafi'i schools. Within these four schools, methods of prayer differ between the groups.[41]

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[39] Personal interviews and e-mail correspondences were conducted and exchanged from August 2008 through February 2010 with Dr. Yahia Abdul-Rahman, co-founder of both LaRiba and Bank of Whittier; Dr. Bill Maurer, professor of anthropology and director of the Institute for Money, Technology and Financial Inclusion at the University of California, Irvine who specializes in Islamic banking and mortgages; Dr. Humayon Dar, CEO of BMB Islamic Bank in the U.K.; Dr. Shaghil Ahmed of the U.S. Federal Reserve Bank in Washington D.C.; Dr. Hamdi Bilici, chair of the finance department at California State University, Long Beach; Dr. Kazi Mohiuddin, professor of finance at California State University, Long Beach; and several officials at the Institute of Islamic Banking and Insurance in London, England.

[40] Sunni and Shī'i brands of Islam are by far the two largest sects. However, within these two sects, there exists significant doctrinal and orthopraxic heterogeneity. Additionally, other groups such as the Ahmadiyya movement and the Nation of Islam may also be considered part of corporate Islam. However, due to the relatively small proportion of Ahmadiyya Muslims and members of the Nation of Islam within the broader global Muslim population, their opinions and interpretations on Islamic banking, finance, and economics are disregarded.

[41] Depending on the region, Sunni Muslims exercise slightly different methods of prayer based on the juristic school to which they belong. For example, Hanafi Muslims perform the *takbir* portion of the obligatory prayer differently from Hanbali Muslims (i.e., Hanafi Muslims do not generally raise their hands when reciting the *takbir* before prostrations, while the Hanbali Muslims raise their hands to their shoulders when reciting the *takbir* before prostrations).

Similarly, the number of authentic imams varies depending on the type of Shī'i Islam.[42] This difference in orthodoxy and orthopraxy also affects each sect's interpretation of Islamic economics. However, of the estimated one billion Muslims worldwide, approximately 90 percent are believed to be some type of Sunni orientation with the remaining 10 percent subscribing or self-identifying as Shī'i.[43] Accordingly, most of the legal positions taken in this study naturally include a Sunni predisposition.

According to El-Gamal, the Hanbali school permitted the use of deferred payment structures similar to a forward sale contract.[44] Similarly, both the Hanbali and the Hanafi schools permitted silent partners within the *mudārabah* partnership contract; however, the Maliki and Shafi'i schools considered them impermissible.[45] In addition, El-Gamal argues that the prevailing governance rules with regard to the type of financial capital that is permitted to be used in forming *mudārabah* partnership contracts is a synthesis of Hanafi, Hanbali and Maliki jurisprudence.[46] Separately, the Maliki school places

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[42] Shī'i Islam consists of several subsects including the Twelver, Ismaili and Zaidi groups; within the Ismaili group exist additional divisions: Musta'līs and Nizārīs. The primary political difference between Sunni and Shī'i Islam rests in the idea of hereditary lineage and succession of the caliphate and imamate. Whereas Sunni Muslims believe that a caliph should be elected from the community based on merit, Shī'i Muslims believe in the religious legitimacy of hereditary imamate originating with Muhammad. See Rahman, *Islam*, 175-80.

[43] "Mapping the Global Muslim Population: A Report on the Size and Distribution of the World's Muslim Population," (The Pew Forum on Religion & Public Life, Pew Research Center, Washington, D.C., Oct., 2009), 1-62.

[44] See Chapter 3. Also see El-Gamal, *Islamic Finance*, 92.

[45] El-Gamal, *Islamic Finance*, 121.

[46] Ibid., 122.

especial importance on the proscription of *ribā*, considering it one of the gravest sins.[47] El-Gamal adds, "most surviving Sunni schools have chosen to follow the rules of Islamic legal theory as established by Al-Shafi'i, who declared that '*ijtihad* is *qiyas*' (i.e., the only permissible form of juristic inference is through analogical reasoning)."[48]

The variegated juristic opinions of whether interest is forbidden or marginally permissible crosses both sect and school, often simply for lack of alternative options. For example, El-Gamal cites Ayatullah Sistani, a Shī'i cleric who has condoned the use of conventional financial products.[49] Similarly, Yusuf Al-Qaradawi issued a *fatwa* or religious judgment recommending Muslims to finance home purchases through conventional interest-based mortgages.[50] While this study is not intended to determine or affix any religious legal opinion to a specific school of thought, it is important to note that when making such judgments they are not universal or representative of one homogenous Muslim community. Instead, like all vibrant and thriving religious traditions, issues are evaluated with differing lenses, which ultimately result in differing conclusions.

Organization

This thesis is organized into six separate chapters including this introductory chapter. Each of the following chapters, except for Chapter 6, examines a specific *ribā*-free component of the Islamic Moral Economy.

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[47] Ibid., 49.

[48] Ibid., 17.

[49] Ibid., 19.

[50] Ibid.

The first chapter is titled "Introduction" and it prefaces the remaining chapters and contextualizes my research and arguments within the broader scholarship of Islamic economics and finance. More specifically, it articulates the goal of studying the subject from a religious studies perspective, with a special focus on permissibility and impermissibility of the various Islamic banking and insurance contracts and instruments in use today.

The second chapter is titled "What is *Ribā*?" and it addresses the differing definitions and exegetical interpretations of the term. Additionally, Chapter 2 illustrates the pervasive and ubiquitous presence of *ribā* in both conventional and Islamic economics.[51] This chapter also examines the fractional reserve banking model and its relation to *ribā*.

The third chapter is titled "*Ribā*-Free Money" and it examines historical modes of exchange, especially money used in pre-Islamic Arabia and other Islamic civilizations in history. More importantly, Chapter 3 discusses the solubility of fiat currency and exogenous money supplies in an Islamic Moral Economy.

In the fourth chapter, I review most of the major Islamic financial structures used by Islamic banks and financial institutions. Additionally, there are several figures and diagrams that are meant to explain and illustrate the banal, yet sometimes innovative ways Islamic financial contracts ostensibly or totally avoid *ribā*.

The fifth chapter is dedicated to the study of Islamic insurance or *takāful* and its various ancillary instruments and structures; these structures are further explained

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[51] Although *ribā* is arguably present in several Islamic financial instruments, as we will see in Chapter 4, it is not omnipresent.

through the use of diagrams and illustrations. The concept of regulatory and supervisory bodies is also elaborated in Chapter 5.

Finally, Chapter 6 offers a review and summary of all the topics discussed thus far. More importantly, it offers a conclusion or recommendation on how contemporary Islamic banks can contribute to the establishment of an Islamic Moral Economy within the context of mainstream and near unanimous understandings of the constraints Islam imposes on economics and finance.[52]

[52] It is important to note that I do not delve into the quantitative proofs regarding the efficacy of any given Islamic financial instrument, and its consequent ability to achieve the utopian ideals of justice, equality and fairness. Instead, my recommendation uses the framework of *sharī'ah* and assumes that *ribā* is proscribed, and offers alternatives by which Islamic money, banking and insurance can become soluble with Islamic doctrines of *ribā*-free economics.

CHAPTER 2

WHAT IS *RIBĀ*?

Islamic banking and finance is predicated on a narrow definition of *ribā*, which is interpreted as "usury" or "financial interest." Within the economic context, *ribā* can also be understood as "unearned" capital or wealth, "illogical increase," or an "unfair" or "unequal exchange" between two parties.[1] If we define *ribā* solely in this manner, we find that its proscription is very similar to Judaism's restriction of *ribit*, and Christianity's limited prohibition of usury and interest.[2]

The proscription of *ribā* is multifaceted and incorporates both philosophical, theological and social justifications. Many economic scholars argue that interest-based financing and fiat currencies with flexible money supplies are the reason for the turbulent ebb and flow of expansion and contraction in the economy.[3] The manipulation of the

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[1] El-Gamal, *Islamic Finance,* 49-51; and Rahman, *Islamic Studies*, 1-43.

[2] In Judaism, the practice of charging interest is forbidden between two Jews; however, it is permissible for a Jew to charge interest to a gentile (see Exodus 22:25-27, Leviticus 25:35-37, Deuteronomy 23:19-20, Nehemiah 5:10-11, Psalms 15:5, Proverbs 28:8, Jeremiah 15:10, and Ezekiel 18:7-17 and 22:12). In Christianity, however, the practice of charging and collecting financial interest is somewhat unclear. Several verses proscribe the practice in keeping with Jewish law, whereas verses from the book of Matthew and Luke paradoxically promote usury (Cf. Matthew 25:25 and Luke 19:23 with the Old Testament verses cited above).

[3] While the issue of interest contributing to a cyclical economy that expands and contracts is limited to marginal thinkers within conventional economics and a majority of Muslim economists, the idea that money supplies effect economic growth and contraction

money supply vis-à-vis interest rates, fractional reserve banking, and fiat currency result in a perpetual devaluation of money and a relative increase in the general price level.[4]

Proscriptions of Usury in Philosophy and Religion

Classical philosophers also considered usury and financial interest philosophically problematic and socially unjust. Plato used words such as "sting" and "children" referring to the evil and multiplicative nature of usury that are harmful to society:

> On the other hand, the men of business, stooping as they walk, and pretending not even to see those whom they have already ruined, insert their sting—that is, their money—into some one else who is not on his guard against them, and recover the patent sum many times over multiplied into a family of children: and so they make drone and pauper to abound in the State.[5]

Not surprisingly, Plato's student Aristotle summarily admonishes usury as illogical and unnatural:

> The most hated [mode of wealth-getting], and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of

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is widespread. Noted economist Milton Friedman established the monetarist school of thought, which advances the idea that the role of money plays a significant role in the real economy. In economic expansions, money is easily obtainable; in economic contractions, the lack of money results in further economic contraction. See Friedman's 1956 work *Studies in the Quantity Theory of Money.*

[4] In the modern market economy, governments regularly intervene to manipulate the money supply through various mechanisms (e.g., open market operations that involve the purchase and sale of securities, the increase or decrease of interest rates, or simply the printing of new fiat currency notes). In the event the money supply increases, the laws of supply and demand naturally result in more currency chasing the same goods resulting in an increase in general price levels. This increase in general price levels renders the currency less valuable relative to the previous values (i.e., before the money supply was altered). See Mishkin, *The Economics of Money, Banking and Financial Markets*, 333-67.

[5] Plato, *The Republic*, 435.

> money from money, is applied to breeding of money because the offspring resembles the parent. Wherefore of all modes of getting wealth this is the most unnatural.[6]

Aristotle's theme of unnaturalness is carried forward in Dante's *The Divine Comedy of Dante Alighieri*, where Virgil explains the reason why usury is an offense to God and describes the path of the usurer in hell: "But in another path / The usurer walks; and Nature in herself / And in her follower thus he sets at nought, / Placing elsewhere his hope."[7]

Similarly, other Roman philosophers such as Cicero and Cato frowned upon usurious financial transactions and compared usury to murder.[8] Interestingly, rates of usury were also controlled and regulated in ancient Rome.[9] Later, thinkers such as Francis Bacon considered interest an economic necessity.[10] Etymologically, the term "interest" becomes analogous to "usury" once the Latin word *interess*, which was a monetary penalty for the unpaid balance of a loan, became commonplace and evolved

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[6] Aristotle's primary argument stems from the unnaturalness and illogical nature of money begetting money; it is the creation of something from nothing, which logically cannot occur. As an aside, the Greek word for interest is *tokos*, which may be translated as "offspring." See Aristotle, *Politics*, 71-2.

[7] In Canto XI, Dante meets Virgil who explains why usury is an offense against God. In fact, the phrase "Placing elsewhere his hope" refers to the displacement of expectations from nature and God to the financial yield resulting from usury, which is unnatural. Later, the narrative describes notable persons in Hell, including Giovanni Bujamonti, who was a notorious usurer of his time. See Alighieri, *The Divine Comedy of Dante Alighieri,* 48, 71 and 7n.

[8] To be clear, such records are Cato's words cited by Cicero. See Astin, *Cato the Censor*, 319.

[9] Blydenburgh, *A Treatise on the Law of Usury*, 3.

[10] Bacon, *Essays, Civil and Moral*, 101-4.

into "interest."[11] Thus, the terms interest and usury are colloquially equivalent despite the legal differences in certain jurisdictions.[12]

This contemptuous view of usury and financial interest is not limited to Classical philosophers or Medieval Christians; Vedic Hindu and Buddhist texts also expressed disdain for usury.[13] Religious traditions and philosophical ideologies have either imposed legal restrictions or recommendations against usury and interest. As such, Islamic banking and its assumed *ribā*-free contracts are not only considered religiously inspired modes of finance, but are also considered socially responsible by non-Muslims.

As stated earlier, *ribā* is generally interpreted as usury or a form of interest, and is considered impermissible in Islam. However, if we remove the economic lens, *ribā* can be used literally and metaphorically for "swelling," "foam," "hill," "raise," or "power."[14] In fact, Islamic jurisprudence distinguishes *ribā* into two distinct typologies, which refer to their textual origins: (1) *ribā al-fadl* or *ribā al-ḥadīth*; and (2) *ribā al-nasiah* or *ribā al-qur'ān*.

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[11] According to the Oxford English Dictionary, which cites a definition dating back to 1529, *interess* is "money repayde with interesse [sic]." See *Oxford English Dictionary*, 2nd ed., s.v. "interess."

[12] The terms "usury" and "interest" have similar but different meanings. The term interest refers to financial interest, which is used pervasively in every day banking and finance. However, the term "usury" connotes an illegally high rate of interest. See *Marquette Nat. Bank v. First of Omaha Svc. Corp.*, 439 U.S. 299 (1978).

[13] In Vedic Hinduism, the term for "usurer" or "lender on interest" was *kusudin*, which was pejorative in nature. Moreover, Visser and McIntosh assert that there are records of Hindu ruler Vasishtha of prohibiting *brāhmaṇas and kṣatriyas* from engaging in usurious transactions. Similarly, the *Jatakas* Buddhist texts are cited to vilify usurers by saying them "hypocritical ascetics." See Visser et al., *Accounting, Business & Financial History*, 175-89.

[14] Rahman, *Islamic Studies*, 1-2.

Ribā al-fadl

Ribā al-fadl or *ribā al-ḥadīth* refers to an unfair exchange of goods between two parties and is derived from *ḥadīth* literature. More specifically, *ribā al-fadl* is exemplified by the trading of goods of a superior or inferior quality for goods of an inferior or superior quality respectively. The concept of unequal exchange is the subject of several *ḥadīth* passages:

> Narrated 'Umar bin Al-Khattab: Allah's Apostle said, "The bartering of gold for silver is *ribā*, (usury), except if it is from hand to hand and equal in amount, and wheat grain for wheat grain is usury except if it is from hand to hand and equal in amount, and dates for dates is usury except if it is from hand to hand and equal in amount, and barley for barley is usury except if it is from hand to hand and equal in amount."[15]

Transactions involving an unequal exchange are further clarified to refer to fungible goods that are identical in quality: "Narrated Ibn 'Umar: Allah's Apostle forbade Muzabana; and Muzabana is the selling of fresh dates for dried old dates by measure, and the selling of fresh grapes for dried grapes by measure."[16]

Both of these narratives illustrate two fundamental rules regarding *ribā al-fadl*: (1) impermissible transactions include the unequal exchange of fungible commodities; and (2) fungible commodity transactions should be made on the spot as opposed to forward sales.[17] A fungible commodity is defined as any good or commodity that is

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[15] *Sahīh Bukhari*, Vol. 3, Bk. 34, No. 344.

[16] *Sahīh Bukhari*, Vol. 3, Bk. 34, No. 380.

[17] A forward sale is defined as the purchase or sale of a given asset at time T_0 for a discounted price with the agreement to receive or procure the asset at time T_1. The purpose is to generate an influx of cash for the seller or provide the purchaser a discounted price on an asset with the opportunity to profit by selling purchased assets on

interchangeable with like goods or commodities (e.g., fruits, vegetables, gold, silver, and money). A spot transaction involving fungible goods is also required because it eliminates *gharar* or "speculation" of the future price of the good, which is unknowable.

Ribā al-nasiah

Although *ribā* in the Islamic economic context refers to both *ribā al-fadl* and *ribā al-nasiah*, the latter is far more pervasive and explicit with regard to financial transactions. In the Qur'ān, *ribā al-nasiah* is interpreted as a form of usury or financial interest applied to monetary capital. The following Qur'ānic verse is quoted often in Islamic banking circles:

> Those who devour usury will not stand except as stand on whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury," But Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: The will abide therein (for ever).[18]

These verses continue: "Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked."[19]

These two verses not only support the religious proscription of *ribā*, but the verses also conjoin the practice with severe punishment.[20] Moreover, two interesting

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the spot at time T_1. For more information on forward transactions apply to the Islamic Moral Economy, see Chapter 4.

[18] It is important to note the comparison of trade with *ribā*. This particular argument becomes particularly relevant when critically analyzing the *murābaha* cost-plus contract in Chapter 4. See Qur'ān 2:275.

[19] Qur'ān 2:276.

comparisons are made: first, *ribā* is compared to commercial trade or *bai'* where the Qur'ān addresses the false analogy between the two; and second, a diametric opposite for *ribā* is established as charity or *sadaqah*.[21] Despite the unanimous acceptance of the *ribā* and usury equivalence interpretation, religious scholars have argued that *ribā* and more specifically *ribā al-nasiah* are not completely equivalent to modern financial interest.[22]

Reasons for Proscribing *Ribā*

Instead, many Islamic scholars have argued that *ribā al-nasiah*, and the consequent proscription against *ribā* generally, both on moral and legal grounds, refers to a very specific financial transaction practice that was prevalent in pre-Islamic Arabia. To be sure, the pre-Islamic *ribā* practice may have dealt exclusively with the doubling and redoubling of borrowed capital, and thus did not exhibit a perpetual time value of money as practiced in modern economics.[23]

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[20] It is interesting to note that according to the Qur'ān, God's wrath will strike down upon individuals that practice usury. The severity of the moral and later legal violation of religious and civil law has often been attributed to the social ills that usury ultimately causes. Such severe negative connotations are also present in Christianity. For example, Bacon cites the Latin phrase *in sudore vultus alieni*, which translates to "in the sweat of thy face shalt thou eat bread—not in the sweat of another's face." See Bacon, *Essays, Moral and Civil*, 101.

[21] By establishing *sadaqah* as the polar opposite of *ribā*, it is clear that charity or miserliness and greed are peripheral characteristics of *ribā*. A moral position is taken when one considers Islam's emphasis on generosity. This polarity is also present in Bacon's understanding of Christianity: ". . . it is a pity the devil should have God's part, which is the tithe." Although not directly addressing the *ribā* and *sadaqah* duality, Bacon does implicitly compare usury with alms giving. See Qur'ān 2:262-264 and Bacon, *Essays, Moral and Civil*, 101.

[22] Throughout this thesis, I will refer to these two types of *ribā* interchangeable and collectively unless stated otherwise.

[23] Rahman, *Islamic Studies*, 5.

Fazlur Rahman, the late professor of Islamic Studies at the University of Chicago, argued that the doubling and redoubling of financial capital was first morally prohibited because it was considered unjust to members of pre-Islamic Meccan society.[24] Usury has widely been considered socially unjust because it introduces unfairness into a transaction; the lender is guaranteed to earn a return above and beyond the original capital sum lent despite the borrower's yield, profit, or financial status. Only after Islam gained political hegemony did *ribā* become legally proscribed and subject to God's wrath.[25]

To support this position, Rahman cites several Islamic jurists and their respective positions on what the pre-Islamic practice of *ribā* was, and how it differed from commercial transactions for profit:

> The *ribā* of the pre-Islamic days was a system whereby the principal sum was doubled and redoubled through a usurious process; because of this process of doubling and redoubling the principal, the Qur'ān refused to admit that *ribā* was a kind of fair business transaction; and while permitting the commercial profit, the Qur'ān encouraged the spirit of co-operation as opposed to that of profiteering.[26]

Conversely, Sayyid Abu'l-Ala-Maududī, who is considered the "father" of modern Islamic economics, argues that *ribā* was categorically prohibited because all forms of

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[24] Ibid.

[25] Several verses in the Qur'ān promise eternal punishment for usurious practices. See Qur'ān 2:275-278, 3:130-131, and 4:161. Additionally, for further treatment on the historical development of Islam as a formal religious tradition and the theocratic government that eventually arose, see Berkey, *The Formation of Islam*, 57.

[26] It is important to note the emphasis on economic cooperation as opposed to individual profiteering. In Chapter 5 we will discuss the manifestation of mutual cooperation through the Islamic insurance contract *takāful*, which espouses several elements of Marxist ideologies of communal ownership and collectivism. These socialist ideas are further elaborated by *The Making of the English Working Class* (1963) and *The Moral Economy of the Peasant* (1976). See Rahman, *Islamic Studies*, 5 and 32.

usury and interest are illogical and socially unjust. Maududī says, "[*ribā*] denotes 'Excession [sic] to wealth and an addition to the principal.'"[27]

Many economists agree with Maududī and the general Islamic proscription of *ribā*, and consider an interest-free economy to be beneficial for employment, macro-economic stability, and inflation.[28] Margrit Kennedy, a professor of economics from Germany adds, "Interest, in fact, acts like cancer in our social structure."[29] Similarly, both Keynes and Adam Smith called for strict controls over the interest rates and usury laws.[30]

Azeemuddin Subhani, a recent graduate student at McGill University, has advanced a theological and linguistic argument explicating why *ribā* is proscribed. According to Subhani, the Arabic word *ribā* is a loose cognate of the word *rabb*, and thus the Qur'ānic proscription of *ribā* is more theological than social or economic. Because of this linguistic similarity, Subhani argues that *ribā* is actually a form of *shirk* or association with God's absolute monotheism.[31] In Islam, only God is perpetual and infinite; yet, with *ribā* it is possible for a material object to perpetually and infinitely

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[27] Ala-Maududī, *Economic System of Islam*, 161.

[28] Modern monetary and fiscal policies are designed to promote sustainable and stable real economic growth, general price-level stability vis-à-vis curbing inflation, and full employment or minimally limiting unemployment. See Jarsulic, *Journal of Economic Issues*, 545-53.

[29] Kennedy, *Interest and Inflation Free Money,* 21.

[30] See Smith, *Wealth of Nations*, 284-5, and Keynes, *The General Theory of Employment, Interest and Money,* 348-51.

[31] Subhani, *New Horizon,* 11.

increases over time, which theologically insoluble. To illustrate this position further, Kennedy provides a colorful scenario:

> . . . one penny invested at the birth of Jesus Christ at 4% interest would have bought in 1750 one ball of gold equal to the weight of the earth. In 1990, however, it would buy 8,190 balls of gold. At 5% interest it would buy 2,200 billion balls of gold equal to the weight of the earth. The example shows the enormous difference 1% makes. It also proves that the continual payment of interest and compound interest is arithmetically, as well as practically impossible.[32]

This theory also works in concert with Aristotle's position that "breeding" money is unnatural."[33] The logical impossibility of something begetting itself from itself is the source of the philosophical disdain for the practice of usury and interest.[34] Moreover, the exponential growth pattern of usury as illustrated in Figure 1 is identical to Rahman's explanation of pre-Islamic *ribā* viz., the doubling and redoubling of capital.

Taisir El-Qoulaq, a graduate of San Diego State University, wrote about the theological argument against *ribā* discusses the metaphysical concept of time in his master's thesis:

> What was never accepted was the argument that interest was justified because lending bridged the time gap. The argument, a theological one as much as anything, was that time was common to all, was the property of God and could not be appropriated by man, and argument similar to that

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[32] Kennedy, *Interest and Inflation Free Money,* 21.

[33] The Greek term is *tokos* and literally means offspring. The illogical nature of usurious practices is evident in the perpetual creation of money, a fungible good, through usury and interest calculations leading to a potentially infinite sum. See Aristotle, *Politics*, 71-2.

[34] Also see the works of Plato, Cicero and Cato and their thoughts on usury and interest, which have been cited above.

was advocated by Seneca. Thus one could not charge for the passage of time.[35]

El-Qoulaq's emphasis on the metaphysical concept of time and God's singular control over time is essential to the Islamic proscription of time-value, which has applications on pricing of financial products.

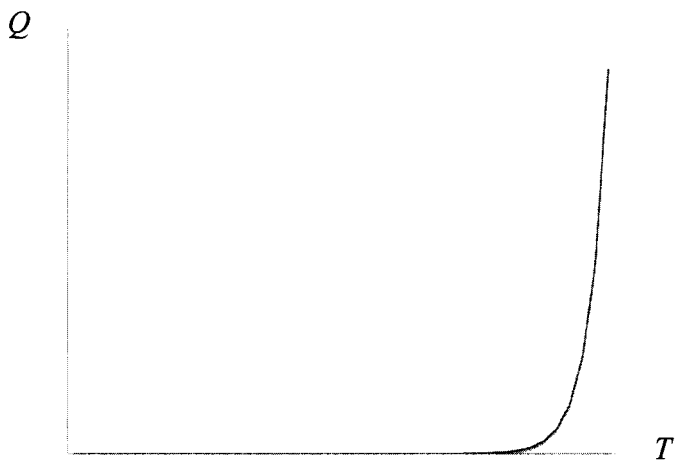

FIGURE 1. Exponential growth curve. This curve illustrates the exponential doubling and redoubling of Q including the borrowed principal and *ribā* over time T, which is an almost perfect inversion of natural growth curves that inevitably decline over T.[36]

Ribā in Contemporary Economics

The presence of *ribā* in the forms of interest and usury is ubiquitous in the modern debt-based economy; *ribā* is clearly present in credit cards, automobile loans, and

[35] El-Qoulaq, Taisir, "Toward Better Understanding of the Islamic Financial System," (thesis, San Diego State University, 1997), 10.

[36] See Kennedy, *Interest and Inflation Free Money,* 21.

home mortgages in the form of simple or compound interest.[37] As such, Islamic bankers have devised various legalistic means of avoiding terminology that refers to interest or any time-value of borrowed capital through the concept of *bai'* or trade; the *murābaha* cost-plus contract is one example of how Islamic banking superficially avoids interest.[38]

Benchmarking

Several Islamic banks use interest rate benchmarks to price *sharī'ah* tolerant or at best *sharī'ah* compliant products (e.g., the *murābaha* profit margin). In Islamic banking, the term "benchmarking" refers to the practice of pricing financial instruments by using an interest-rate benchmark. Widely used interest rate benchmarks such as the London Interbank Offer Rate (LIBOR), U.S. Federal Funds Rate (FFR), and the Wall Street Journal Prime Rate are all used as reference rates for loan pricing.[39] By using an interest-

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[37] Although both simple interest and compound interest formulas would arguably fall under the umbrella of *ribā al-nasiah* by most Islamic bankers and economists, especially those from the Maududī school, there is a rather stark distinction between the two.

The former involves a single rate of interest applied to the total sum lent, where p is the principal borrowed, i is the rate of interest, and n is the duration of the loan. The product of the three variables results in the total cost of interest for the borrower (e.g., if *A* borrowed $100 from *B* for five years at a 10 percent rate of interest, the total cost of interest would be $100 \times 0.10 \times 5$, which equals $50 in interest payments; the total cost of capital would be $150). Conversely, in a compound interest transaction, the interest rate accrues n times throughout the duration of the contract period.

The compound interest formula is expressed as $A = P\,(1 + [i \div n])^{nt}$. In which case, if we use the above example and add a monthly compounding period, the total cost of capital would be as follows: $A = \$100\,(1 + [0.10 \div 12])^{12 \times 5}$ where A equals $164.53. See Bittinger et al., *Calculus and its Applications*, 10-1.

[38] The mechanics of the *murābaha* cost-plus contract structure are discussed further in Chapter 4.

[39] See El-Gamal, *Islamic Finance,* 74-5.

rate benchmark, Islamic banking products arguably incorporate an implicit element of *ribā*.

Fractional Reserve Banking

More importantly, *ribā* remains present in conventional and Islamic banks alike because both utilize the fractional reserve banking model. Arguably the most innovative development in banking, fractional reserve banking allows bank firms to "create" money in a banking system by lending its deposits. Additionally, fractional reserve banking has become the de facto system of banking operations all over the world.

If individual *A* deposits $100 with bank *B*, the $100 is an asset for *A* and a liability for *B*. Through *B*'s expertise as a banking firm, *B* knows that *A* will not likely demand the entire $100 deposit at any given time. As such *B* will keep ten percent or $10 as a reserve for the $100 deposit, and *B* will lend the remaining $90 to individual *C*.[40] *C* then deposits the $90 borrowed from *B* with bank *D*, thus allowing *D* to lend the remaining $81 and keeping only $9 in reserve, and so forth. *A*'s original $100 deposit ultimately "creates" an additional $900 in the fractional reserve banking system in which it operates.[41]

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[40] This is an overly simplified example that assumes the reserve requirement is ten percent. Typically the reserve requirement varies from time-to-time and by country, as determined by the central bank.

[41] The resulting "created" bank deposits are mathematically expressed as: $\Delta D = (1 \div r) \times \Delta R$. In this equation, ΔD equals the change in total checkable deposits in the banking system, r is the reserve requirement, and ΔR denotes the change in reserves for the banking system.

For example, if we calculate the example stated above, $r = 0.10$, ΔR is $100, and ΔD is the unknown variable. If we substitute the values as follows: $\Delta D = (1 \div 0.10) \times$ $100, we get $\Delta D = 10 \times$ $100, which results in a total change in checkable deposits of $1,000. See Mishkin, *The Economics of Money, Banking and Financial Markets*, 344-5.

Fractional reserve banking and the simple deposit multiplier formula that is mathematically expressed as $\Delta D = (1 \div r) \times \Delta R$ can also be illustrated through the use of T-Accounts, which list the assets and liabilities of bank deposits and loans.

TABLE 1. Hypothetical Fractional Reserve Banking T-Account[42]

Bank B

Assets		Liabilities	
Reserves	$10	Checkable Deposits	$100
Loans	$90		

In *B*'s T-Account, *A*'s deposit is recorded in the liability section, and the ten percent reserve requirement and consequent loan of the excess reserves is listed as an asset.

Bank D

Assets		Liabilities	
Reserves	$9	Checkable Deposits	$90
Loans	$81		

Similarly, *C*'s deposit of $90, which *C* borrowed from *B* is recorded as a liability for *D*, and the consequent ten percent reserve of $9 and a loan of $81 representing the excess reserve is recorded as an asset for D.

Bank X

Assets		Liabilities	
Reserves	$8.10	Checkable Deposits	$81
Loans	$72.90		

If we continue this hypothetical example further and assume that *D* lent its excess reserve of $81 to individual *Y*, who in turn deposited the borrowed funds with bank *X*, the total additional "created" stock of money in the banking system totals $171 (i.e., $90 + $81) from the original $100 deposit by individual *A*. Moreover, the money "creation" process can continue through loan origination and deposits in the banking system (e.g., $90, $81, $72.90, $65.61, $59.05, etc.) until the banking system "creates" an additional $900 in bank deposits.

[42] Ibid.

If we apply the *ribā al-nasiah* definition of "illogical increase" and the Aristotelian derivative "unnatural" to the simple deposit multiplier inherent in the fractional reserve banking system, it is clear that *ribā* is part-and-parcel of the model and arguably lending in general. As such, any bank that purports to follow the principles of Islamic *ribā*-free doctrines must utilize a separate model that does not inherently require the "creation" money.

Instead, an Islamic bank would be a financial intermediary that serves three specific functions with regard to financial capital: (1) the safe storage of financial capital; (2) act as a clearinghouse for financial transactions (i.e., the day-to-day management of deposits and payments between market participants); and (3) the deployment of surplus financial capital for real and productive purposes that also yield an economic profit. However, before we can begin to explore the possible forms and structures of a *sharī'ah* based bank, it is first important to critically examine *ribā*-free money.

CHAPTER 3

RIBĀ-FREE MONEY

The Islamic Moral Economy is predicated on the theological precept that all wealth is bequeathed to man by God.[1] As such, money is not equivalent to wealth; money is simply an abstract representation of wealth. In the Islamic context, wealth is limited to real assets that have a productive purpose (e.g., agricultural crops, livestock, land, furniture, fixtures, equipment, etc.). Money, which is simply a universally accepted mode of exchange, serves as a numeraire for the market forces of supply and demand.[2]

Historically, money took the form of precious metals or other commodities that had exhibited inelastic demand.[3] Gold and silver are two such commodities that have served as a mode of exchange and store of wealth for much of human history, including pre-Islamic Arabia. As such, the gold *dinar* and the silver *dirham* have a special place in

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[1] In the Islamic tradition, God has bequeathed all material wealth to mankind in a trust; man serves as God's vicegerent or custodian on earth. The Islamic idea of human vicegerency impacts all aspects of economic life demanding socially responsible activities. See Qur'ān 2:30 and 38:26; *Sahīh Muslim*, Bk. 36, No. 6606, and Murata and Chittick, *The Vision of Islam*, 120.

[2] A numeraire is simply a unit of measure used as a standard for any given thing or commodity.

[3] The term inelastic demand refers to a disproportionate change in demand relative to price changes in a commodity. In today's industrial economy, gasoline is said to have inelastic demand; despite drastic price volatility, the quantity of gasoline demanded remains relatively unchanged regardless of said price volatility—both increases and decreases. See Miller, *Understanding Modern Economics*, 75-82.

Islamic economics as documented in the Qur'ān and Sunnah.[4] However, historically, other metals and commodities have been used as money in Islamic civilizations.[5] The role of *ribā* in classical Islamic money transactions was limited to *ribā al-fadl*, or unequal exchanges of fungible goods.[6] However, with the advent of commodity-based currency, fractional reserve banking and later fiat currency, the prevalence of *ribā* became more widespread.[7]

Fiat Currency

Unlike commodity or asset-based currencies, fiat currencies are a tautological abstract representation of government promises of value. To be sure, a fiat currency is simply a piece of paper that is artificially and arbitrarily imbued with value—and thus accepted as a mode of exchange and store of value—because a government body asserts its value through law.[8] Moreover, the stock quantity of fiat currency may be manipulated

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[4] The term "dinar" is used by M. H. Shakir's translation of the Qur'ān in 3:75, which states ". . . if you entrust one of them with a *dinar*. . ." which is slightly different from Yusuf Ali's version which replaces "dinar" with "silver coin." The term "dirham" is found in Yusuf Ali's translation in 12:20 referring to the selling price of Joseph by slave traders in Egypt.

[5] Eaton, *The Rise of Islam and the Bengal Frontier,* 11.

[6] See Chapter 2.

[7] Fractional Reserve Banking and fiat currencies share a common origin. Both evolved out of the goldsmith's ingenious realization that gold profits could be earned through the issuance of paper receipts because only a fraction of gold deposits were ever needed in the normal course of business. See Chapter 2.

[8] Fiat currencies are characterized by a hegemonic institution instilling value into the paper currency through political influence. The paper money itself is worthless without the government promise of value, and as such, is not exchangeable for any other mode of currency except for paper currency. For example, if one were to take a $20 bill to the U.S. Federal Reserve with the intent of requesting the equivalent value of $20 in

through government monetary and fiscal policy, which introduces the implicit presence of *ribā*.[9] However, any such monetary or fiscal policy tool that increases the money supply is in fact "creating" money from nothing, and is thus an example of *ribā*.[10]

This position becomes increasingly clear because the Islamic concept of money is limited to a mode of exchange and a temporary implicit store of value. Money is not the end, but a means of exchange for real assets; money is the numeraire or pricing mechanism vis-à-vis supply and demand for real and tangible assets. In the fiat currency model, money becomes a commodity and an asset itself, and is considered wealth. Yet, in the Islamic Moral Economy context, God is solely responsible for the creation and allocation of wealth.

Therefore, all material wealth is finite and fixed in quantity. More importantly, if money is a mode of exchange representing wealth as a numeraire or unit of measure, and if the money supply increases, then the value of the money decreases. More specifically,

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some tangible asset that is "real" money, the U.S. Federal Reserve will either exchange the $20 bill for another in kind, or a combination of $1, $5, or $10 bills totaling no more than $20. The only value inherent in the $20 bill—or any fiat currency for that matter—is the mutually and universally accepted value the currency represents.

The principle of exchanging fiat money in kind as opposed to some asset-based standard is transgressing beyond currency. Following the Great Recession of 2007, many investors have sought a flight to security in bonds resulting in a decrease in bond yields. (Bond yields are inversely related to bond prices. As bond prices increase, the yield on the bond decreases; as bond prices decrease, the yield on the bond increases). Given this general trend of decreasing bond yields, many bond issuers are paying creditors in kind with more bonds. See Harrington et al., "Wall Street's New Flight to Risk," *Bloomberg Businessweek* (February 10, 2010): 26-7.

[9] In an effort to curb or stimulate interest rates, inflation rates, or employment, central banks and government treasuries can implement policies to increase or decrease the money supply. See Mishkin, *The Economics of Money, Banking and Financial Markets*, 373-91.

[10] See Chapter 2.

let us imagine that all material wealth is worth x in any given currency. Let us also imagine that for reasons left unexplored, the government central bank wishes to increase the aggregate supply of fiat currency by 50 percent. From an Islamic Moral Economy perspective, the effective result of such a government policy would simply depreciate the value of the fiat currency by 33 percent.[11]

This example can also be illustrated through a simple economic supply and demand curve graph.[12] Economic supply and demand models are applicable to the aggregate supply and aggregate demand of any commodity, including fiat currency. As with all equilibrium points, the price equilibrium P^E and quantity equilibrium Q^E are mathematically expressed by equating the intersection of the supply and demand curves, or A_D and A_S. Using the above hypothetical scenario, the A_S curve would simply move to the right to $A_{S'}$ on the x-axis representing and increase in fiat currency quantity Q resulting in P^E moving to $P^{E'}$.

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[11] If we assume that the aggregate stock quantity of all material wealth is given a price value of x in any given currency, and that y is the total stock quantity of that currency but not necessarily equal to x, then $x \div y$ equals 1. If we further assume that the central bank issues 50 percent more currency into the economy, the function become changes to $x \div 1.5y$ which results in a quotient of 2/3, or 33 percent less than the original currency value of 1. Effectively, such an increase in the money supply results in currency depreciation and ultimately leads to inflation. Of course, this scenario is predicated upon the assumption that money supply is the only variable that affects inflation.

[12] See fig. 2.

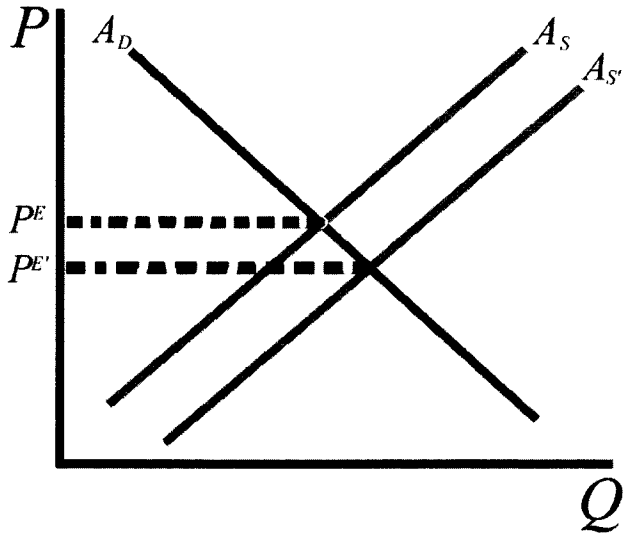

FIGURE 2. Money supply and demand curve.

In addition to the problems of money supply manipulation by central banks and governments under the fiat currency model, the very affixation of artificial and arbitrary par value to a fiat currency is also problematic within an Islamic Moral Economy context. Money is considered a mode of exchange, and the commoditization of fiat currency as a form of wealth because governments affix value to fiat currency is a form of *ribā*. This position is similar to the illogical and unnatural nature of *ribā* itself; paper money cannot be considered wealth unless it represents something other than the intangible abstract representation of promised value by a government.

Seigniorage

Similarly, the proscription of *ribā al-fadl* prohibits profiting from currency trading and seigniorage because currency is money similar to gold and silver in pre-Islamic Arabia.[13]

> Narrated Ibn Shihab: that Malik bin Aus said, "I was in need of change for one-hundred dinars. Talha bin 'Ubaid-Ullah called me and we discussed the matter, and he agreed to change (my dinars). He took the gold pieces in his hands and fidgeted with them, and then said, "Wait till my storekeeper comes from the forest." 'Umar was listening to that and said, "By Allah! You should not separate from Talha till you get the money from him, for Allah's Apostle said, 'The selling of gold for gold is *ribā* (usury) except if the exchange is from hand to hand and equal in amount, and similarly, the selling of wheat for wheat is *ribā* (usury) unless it is from hand to hand and equal in amount, and the selling of barley for barley is *ribā* (usury) unless it is from hand to hand and in equal amounts.[14]

This narrative clearly connects *ribā* with currency trading and seigniorage, which are products of the current fiat currency and fractional reserve banking models.

After the collapse of the Bretton Woods monetary system in 1974, all global currencies moved toward a floating rate system whereby exchange rates were determined by the market.[15] The floating-rate currency model also completely decoupled fiat

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[13] The term seigniorage refers to the government's profit from printing fiat currency. More specifically, it is the difference between the face or par value of a fiat currency and the cost of producing said currency. However, seigniorage is also possible with international currency exchange and international trade. As we will see later, the U.S. government takes advantage of seigniorage by pegging the U.S. dollar to the price of oil.

[14] *Sahīh Bukhari*, Vol. 3, Bk. 34, No. 383.

[15] In 1944, the Bretton Woods Conference was held to resolve a global currency system that was not only fixed to gold, but one that also granted flexibility to countries without gold reserves (e.g., the United Kingdom and much of Europe). Inspired by Nazi Germany's monetary policies during the war, Bretton Woods allowed governments to

currency from the gold standard; money became a commodity that could be "created" on demand by governments.[16]

Despite this collapse, the U.S. dollar retained its position as the reserve currency of choice for foreign governments. This is especially true because the U.S. dollar is the only currency used to price essential commodities such as petroleum.[17] As such, the U.S. dollar has an almost inelastic demand in the currency market; all petroleum dependent industrial economies need U.S. dollars to purchase oil. Similarly, the U.S. government is in a unique position to profit from its currency through the purchase of petroleum:

> Many commodities, such as oil, are priced in dollars, which is advantageous to the United States. For decades Americans had the luxury of enjoying cheap oil partly because it was priced in dollars. America could finance its oil imports simply by printing more of its currency.[18]

Under the *ribā al-fadl* restrictions, the seigniorage that results from an unfair or unequal exchange of U.S. dollars for a oil commodities is problematic from a *sharī'ah* perspective.

Seigniorage is also problematic from a religio-cultural perspective and is perceived as such by Muslim economists and policymakers. In 2003, the Bahrain

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convert their currencies to dollars, which would be convertible to gold at some fixed parity level. However, non-government market participants were not permitted to convert participating currencies to gold. See Van Dormael, *Bretton Woods*, 5-9.

[16] Once Bretton Woods was dismantled in 1974, all global currencies were rendered pure fiat currencies. Unlike currencies under the Bretton Woods system, a foreign currency (e.g., the Pound Sterling) could not be converted to U.S. dollars and then gold. Instead, the price of gold was permitted to fluctuate with the ebb and flow of supply and demand.

[17] Carbaugh and Hedrick, *Challenge*, 98.

[18] Ibid.

Monetary Agency—the Bahrain equivalent to the U.S. Federal Reserve—published the following article that attacks the practice of seigniorage, and namely the U.S. government's dominance in pricing petroleum in U.S. dollars:

> There are also other means by which Muslim resources are being 'stolen' through this fiat money system. The magic word is seigniorage. Seigniorage refers to the value of money, which is much higher than its costs of production. It is the benefit the issuer derives from the issue of a currency. The U.S. dollar enjoys significant seigniorage since it is currently the international reserve currency. If the U.S. buys crude oil from Saudi Arabia using newly created fiat money, then the U.S. enjoys benefits from this. Of course Saudi Arabia may not lose because it can purchase other items with the money but the fact is that the U.S. is able to obtain the oil with money created out of thin air.[19]

Although oil producing countries receive remuneration in U.S. dollars, which permit such countries from engaging in additional international trade, the issue and grievance within the Muslim world is the injustice fiat currency and seigniorage represent.

More specifically, that the United States has an unfair advantage analogous to a coercive monopoly over the commodity of U.S. dollars.[20] Whereas other countries must achieve economic efficiency to purchase U.S. dollars in the foreign exchange currency market, the United States can simply print additional paper currency to finance its petroleum needs. Thus, the issue of seigniorage is problematic from a contemporary political perspective, as well as from a religious jurisprudential perspective. The disdain

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[19] Mydin-Meera, *Bahrain Dinar*, 23-8.

[20] See Chapter 2.

for fiat currency and seigniorage has led the way for the development of asset-based currencies and endogenous money supply systems.[21]

Fixed-Exchange Rates

Until the Great Depression of the twentieth century, most countries employed some type of gold standard in their money system.[22] Gold and silver were also employed metal of choice through much of Islamic history.[23] In addition, copper was also frequently used as a coinage system throughout the Muslim world, especially in India.[24] However, after European political conquest and colonization, agency over monetary policy was no longer in the hands of Muslims, and therefore was not subject to *sharī'ah*.[25]

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[21] Indeed, from an ideological perspective, fiat currencies are not soluble with the basic Islamic proscription of *ribā*.

[22] In fact, the Bretton Woods monetary system was a derivative of an asset-based currency system supported by gold. Only after 1974 did the global economy introduce a pure fiat currency. See Mishkin, *The Economics of Money, Banking, and Financial Markets*, 466.

[23] There are numerous mentions of gold and silver in the Qur'ān (e.g., 3:14, 3:75, 3:91) and the corpus of Ḥadīth literature, which have already been cited. Additionally, Islamic governments continued to use gold primarily until the 12th century. Thereafter, a paradigmatic shift occurred where gold began to be used primarily in Europe—where silver was the primary coinage—and the Near East switched from gold to silver. Despite the ebb and flow between gold and silver, fiat currencies did not arrive until the modern era. See Pamuk, *A Monetary History of the Ottoman Empire*, 21-2.

[24] See Del Mar, *A History of Money in Ancient Countries*, 94-117.

[25] European colonialism is often cited as an explanation for the relatively recent development of Islamic banks. An inchoate version of an Islamic bank was established as early as 1898 in Cairo, Egypt. This was followed by several other attempts throughout the colonized Middle East. However, it was not until the 1970s—after a significant influx of petro-dollar revenues—did an Islamic bank actually begin operating. See Wohlers-Scharf, *Arab and Islamic Banks*, 13-28.

It is also important to remember that a true gold standard has not been in use in the modern global economy.[26] Instead, currencies throughout the twentieth century utilized partial gold convertibility standards (i.e., only a portion of all circulating currency could be converted into gold making the situation similar to the fractional reserve banking model).[27] With the evolution of the Bank of England, partial convertibility became normative.[28] Indeed most currencies of the world in the 20th century were only partially convertible to a metallic standard such as gold.[29] Currencies were not fixed to a certain quantity of gold; instead, there was room for market fluctuations of gold prices, and thus was considered a more stable system as opposed to a truly fixed system.[30]

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[26] Although Bretton Woods was partially convertible to gold, it was not a true gold standard because currencies other than the U.S. dollar were not convertible to gold.

[27] While such a monetary policy was effective for much of the 20th century, partial gold convertibility is problematic from an Islamic perspective. Again, if Islam proscribes the presence of *ribā* from the economy, it naturally follows that any currency that is only partially convertible to a natural resource commodity is violating this very principle. Thus, partial gold convertibility is an insufficient monetary system for the Islamic Moral Economy because it implicitly and artificially creates monetary value when there is no natural resource support. More specifically, the currency that is not redeemable for gold reserves—because it is only partially convertible—remain currency and thus is guilty of *ribā*. Such a system is analogous to the fractional reserve banking model because it essentially creates money from nothing.

[28] Despite the prevalence, debates began as early 1810 to revert back to a fully convertible paper currency. David Ricardo is generally credited as being the primary vocal proponent for such a system, whereby the central bank would reduce the quantity of paper currency in the economy until it is equal to the gold or silver reserves held by the bank. See Skousen, *Economics of Pure Gold Standard*, 36-7.

[29] Gesell, *The Natural Economic Order*, 157.

[30] Mishkin, *The Economics of Money, Banking and Financial Markets*, 466-71.

In such a system, the shipment of gold from point *A* to point *B* was a transaction cost that hindered international trade. For example, if the exchange rate between the pound sterling and the U.S. dollar was 4:1, and the cost of shipping one pound sterling was three cents, then the trading ceiling for one pound sterling worth of gold could not exceed $4.03.[31] Although these rates remained fixed for much of the early 1900s, the fixed rate system was suspended during World War I and was later reinstated at the previous parity rates without concern for inflation.[32]

The reversion to the old parity rates resulted in significant price inflation for governments that did not adjust their currency exchange rates for inflation.[33] The pound sterling was one such currency that was adversely affected by this policy, and ultimately resulted in the depletion of England's gold reserves.[34] In an effort to prevent a full depletion of the country's gold reserves, the Bank of England suspended the convertibility of paper currency to gold.[35]

A similar situation occurred in the United States following the stock market crashes of 1929. In 1931, the Federal Reserve raised the discount rate substantially thus

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[31] If the exchange rate is 4:1 U.S. dollars to pound sterling, then one pound sterling is equal to four dollars. Additionally, if the cost of transportation for four dollars worth of gold is three cents, then the total exchange transaction cost is four dollars plus three cents (i.e., $4.03).

[32] Mishkin, *The Economics of Money, Banking and Financial Markets*, 466-71.

[33] Ibid.

[34] During the Great Depression, confidence in the Bank of England was decreasing, which ultimately resulted in mass gold withdrawals. Such a large scale gold withdrawal effectively resulted in bankrupting the country's banks. See Feavearyear, *The Pound Sterling*, 366-71.

[35] Ibid., 368-9.

reducing the convertibility of currency to gold.[36] Although this stopped a depletion of the country's gold reserves, it also caused a money supply contraction resulting in an economic recession for much of the 1930s.[37] In fact, from 1914 through 1944, there was no clearly defined exchange rate system in the United States resulting in monetary disorder.[38]

However, under Bretton Woods, the U.S. dollar and gold served as the dual foundations for a global exchange-rate system. The U.S. dollar was valued with gold as its numeraire; one ounce of gold was valued at $35. Foreign currencies that were members of Bretton Woods were expressed in U.S. dollars, leaving a marginal trading range. After Bretton Woods was dissolved in 1974, currency valuations fluctuated freely in the market.[39] As such, several factors influenced exchange rates including current and expected interest rates, government fiscal policies and economic expectations among others.[40]

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[36] The discount rate is the interest rate that the U.S. Federal Reserve charges member banks for discount loans. By increasing the discount rate, the Federal Reserve prodded banks in the United States to charge higher interest rates on depositor accounts, thereby adding an incentive to keep money in U.S. banks instead of withdrawing funds (i.e., gold withdrawals). See Mishkin, *The Economics of Money, Banking and Financial Markets*, 420-1.

[37] Because banks offered a higher rate of interest, depositor funds held in banks did not circulate freely in the economy. In economic terms, the velocity or rate of circulation of money diminished, which ultimately served as a catalyst for a deeper recession. Ibid., 494-5.

[38] Ibid., 420-2.

[39] Ibid., 466-7.

[40] Ibid.

Asset-Based Currency

A true asset-based currency system has not been implemented in the global industrial economy. Muslim proponents of the asset-based currency model propose gold as the currency numeraire primarily because of its cultural importance and its role in Islamic economic history. Additionally, gold is often touted as the ideal money specie and numeraire because of its historical demand inelasticity; gold is homogenous, divisible, storable, durable, and has limited productive use.[41] It also meets the Islamic Moral Economy prerequisite of being fixed in total quantity because it is a divinely created natural resource (i.e., it cannot be created or destroyed by humanity).

Although gold certainly meets some of the requirements for an inherently *ribā*-free mode of exchange, other equally valid commodities may be used as a numeraire. For example, a basket of several *sharī'ah* based commodity alternatives could be used as the numeraire of choice for an Islamic *ribā*-free currency (e.g., gold, silver, petroleum, land, agricultural yields, etc.).[42] While many conventional economists have responded by saying Special Drawing Rights (SDR) used since the 1970s by the International Monetary Fund (IMF) operated and failed on a similar footing, the basket used for the SDR simply

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[41] Mydin-Meera, *Bahrain Dinar Digest*, 23-8.

[42] The term "basket" in this context refers to the economic concept of using multiple commodities together as the numeraire. The purpose of using is a basket is to hedge or reduce any concentration risk that stems from using any one specific commodity. For example, if the asset-based currency is only convertible into gold, any new discoveries of gold may potentially lead to price depreciation and inflation. (This example assumes that money supply is the only significant factor that may affect inflation.)

consisted of other fiat currencies.[43] Some Islamic economists have also suggested wholly new and experimental money supply models that do not necessarily depend on an asset standard, and depart from the exogenous money models in use today.[44]

Exogenous and Endogenous Money

The terms exogenous money and endogenous money refer to the externality and internality of factors that effect money in an economy. In the exogenous money theory, money is both positively and adversely impacted by external factors such as interest rates, economic output, and the stock quantity of money.[45] In an endogenous money supply model, the stock quantity of money cannot be externally controlled (e.g., central bank open market operations of buying and selling securities to increase or decrease the money supply).[46] Instead, the endogenous money system is fixed relative to the total economic

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[43] Following the dismantling of Bretton Woods, the IMF issued SDRs as an alternative reserve currency. However, unlike the proposed Islamic model of an asset-based currency priced and convertible into a basket of natural resources, SDRs are a basket of major currencies. See Mishkin, *Money Banking and Financial Markets*, 471.

[44] An exogenous money supply refers to the idea that the stock quantity of money has a material effect on economic productivity and output. Conversely, an endogenous money theory posits that the stock quantity money is affected because of a variety of economic factors, including but not limited to interest rates, economic output, and the total stock quantity of money itself. See Desai, *Money*, 146-50.

[45] This brief list of contributing factors is considered exogenous because they are all external factors that may affect money. For example, if interest rates increase in the United States, the demand for U.S. dollars will increase in an attempt to reap the increased potential return on investment in the United States. Therefore, foreign investors that exchange their foreign currencies for U.S. dollars will like pay a premium resulting in a strong U.S. dollar and a weaker foreign currency respectively.

[46] Although open market operations are not discussed in detail—primarily because they are not relevant to the utopian nature of the Islamic Moral Economy—they are basically a set of tools that a central bank can use in an economy to manipulate the money supply. For example, if a central bank wants to encourage economic activity, the

productivity of an economy, and is subject to the real economic resources at its disposal.[47]

As such, the exogenous money system is reflective of the current monetary theory systems in place today. More specifically, the exogenous money system reflects a dependence on fiat currency and a government's ability to manipulate the total stock quantity and aggregate flow of money supply to effect some output (e.g., lower interest rates, lower unemployment, higher economic productivity, etc.).[48]

The endogenous money system would be more soluble with an asset-based money system that is acceptable to the Islamic Moral Economy framework. Economists such as Keynes and Friedman advance conventional theories incorporating the variability of money supply stocks and flows, and the consequent effect of the money supply in the financial economy on the real and productive economy.[49] Economists from an Islamic perspective disagree and posit that money simply serves as a mode of exchange. In the

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central bank will typically purchase government securities in the open market; the purchase of the securities will result in a net increase of currency in the market, which ultimately leads to additional economic activity. See Mishkin, *Money, Banking and Financial Markets*, 336.

[47] Given the theological constraints of *ribā*, the endogenous money supply is nearly synonymous with an asset-based currency, and seemingly soluble within the Islamic Moral Economy.

[48] See Desai, *Money*, 146-50.

[49] While Keynes argued that the money supply played a nominal role in the real economy, Friedman argued that money played a very significant role in the real economy. From an endogenous money supply and Islamic Moral Economy perspective, such theories become seemingly moot. Instead, money is not a commodity, but it is simply a mode of exchange. See Friedman, *Studies in the Quantity Theory of Money*, 3-24.

Islamic Moral Economy, money does not play a significant role in economic output; it simply enables market participants to engage in trade.

Masudul Chowdhury, a professor of economics in Australia, is a proponent of the endogenous money supply model. Chowdhury argues that such a money system would not only be soluble with the Islamic Moral Economy and the *tawhīdī* framework, but that endogenous money is an ideal solution for the injustices of the modern economic system:

> . . . it must be said that most work on monetary theory in Islamic economics to date have dwelled on received theories of Western schools without questioning their inappropriateness for the *ummatic* capital market. Basic to this inappropriateness is the unquestioned acceptance of the quantity theory, the Keynesian theory of money and their various adaptations in literature. Such theories are based on the philosophy of money being exogenous stock. Therefore it must carry with it a price of its own. Such a price is based on the expactionary nature of money demand (speculation) on the one hand, and the price of the stock set by monetary authorities (supply) on the other. The intrinsic presence of interest and its role in measuring economic efficiency and exchange plague the entire range of economic activities without exception.[50]

The idea that money does not need an interest rate for pricing purposes is completely soluble with the Islamic Moral Economy and its proscription of *ribā*. Moreover, such a money system is completely soluble with a gold or asset standard, although Chowdhury argues that it is unnecessary.[51]

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[50] Again, the quantity theory of money argues that an increase in money supply will ultimately impact both the financial and the real sectors of an economy. See Chowdhury, *Money in Islam*, 51; and Friedman, *Studies in the Quantity Theory of Money* (1956).

[51] Ibid.

From 1932-1933, small-scale experiment of "free money" in Wörgle, Austria inspired by the theories of Silvio Gesell proved somewhat successful.[52] Using Gesell's theories, the experiment did not grant money a time-value characteristic that would inexorably promote usurious lending. Instead, it penalized market participants from using "free money" by assessing a fee for unused money thereby increasing the velocity or circulation of money.[53] Although the money was not convertible to any commodity good, money's role was exclusively that of a mode of exchange.[54]

Gesell's vision included an interest-free meritocracy where debt was eliminated and economic parity was established between social classes.[55] Although the experiment

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[52] Several notable economists including Keynes and Irving Fisher monitored the experiment. Both considered the experiments successful ability to induce currency depreciation as a possible solution to modern monetary policy problems. See Kennedy, *Interest and Inflation Free Money*, 38-9.

[53] Again, the term "velocity" refers to the turnover of currency in an economy. More specifically, it is the number of times a given currency is used for economic transactions in an economy. For more see Mishkin, *The Economics of Money, Banking and Financial Markets*, 494-5.

[54] To illustrate money's role as a pure mode of exchange, Gesell cites entertaining excerpts of Daniel Defoe's adventuresome tales of Robinson Crusoe. Through the narrative, Gesell explains that money's use as a store of value ultimately leads to moneychangers and usurious financial practices. More specifically, that material goods are only valuable when used (e.g., the hides and wheat in the story). Thus, in an economy where barter or free money is used (i.e., money that is only a mode of exchange and not a store of value), interest is non-existent. Instead, it is essential to increase the velocity of money—both asset and fiat currencies—in an effort to mitigate the use of money as a store of value. See Gesell, *The Natural Economic Order*, 365-71.

[55] While the endogenous money system envisioned by Gesell did not involve any asset based currency, the system did embrace the money as mode of exchange principle instead of as a store of value. Moreover, Gesell's promoted the use of a tax on unused currency notes. This tax would result in an economic incentive to spend or use the money instead of keeping it as a store of value. Any debt obligations would simply be repaid in kind, which is similar to the Islamic principles of replacing fungible goods

was short-lived and was not implemented with any Islamic preconceptions, Gesell's experiment illustrates a possible Islamic ideal for money, and the appropriateness of any endogenous money system in the Islamic Moral Economy.

Summarily, current models of money inherently incorporate forms of *ribā* through fiat currency and seigniorage. Additionally, fiat currency as used today is necessarily priced through interest rate benchmarks, which are explicitly *ribā*.[56] The interest rate benchmark is also an example of how the exogenous money supply system is insoluble with the Islamic Moral Economy.[57] Instead, an Islamic Moral Economy would necessarily require the use of a *ribā*-free endogenous money system. Money's role would be limited to that of a mode of exchange and temporary store of value, reflecting the intermittent stages of investment by economic market participants. Similar to Gesell's "free money" experiment, the Islamic Moral Economy ideal would involve significantly increased money velocity, where currency as a mode of exchange circulates from transaction to transaction extremely quickly.[58]

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when borrowed for fungible goods in kind, both in quality and quantity. This concept is similar to my ultimate recommendation with regard to a two-tiered 100 percent reserve banking system as outlined in Chapter 6. See Gesell, *The Natural Economic Order*, 380.

[56] For more information on interest-rate benchmarking, see Chapter 2.

[57] More specifically, the role of various external factors including explicit and implicit forms of financial interest, which are considered types of *ribā*, are not compatible with the Islamic Moral Economy. Of course, such judgments are made based on the constraints and definitions established and agreed upon with regard to the proscription of *ribā*. See Chapter 2.

[58] Op. cit. 55n.

CHAPTER 4

RIBĀ-FREE BANKING

The interest-free contract structures that are ubiquitous in the Islamic banking industry today emerged only after oil-producing Muslim countries benefited from an increase in oil prices in the early 1970s.[1] Expatriate Muslim economists, bankers and financial engineers were then called upon to help create the building blocks for the establishment of an Islamic economic system; its components aimed to be free from the injustices of fiat currencies and the global interest-based conventional financial system.

The financial products that were consequently developed were praised for their ingenuity and innovation, and were also criticized for simply masking the presence of interest through legal chicanery. The continued implicit presence of interest in many Islamic financial alternative contracts is likely the result of the founding generation's experience and training in conventional interest-based economics.[2] In these Islamic

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[1] Although the 1970s were particularly difficult for the U.S. economy, which suffered from the war in Vietnam and the unprecedented phenomenon of stagflation, inchoate Muslim economies greatly benefited. Countries such as Iraq, Saudi Arabia, United Arab Emirates, Bahrain, Qatar and Kuwait experienced an influx of U.S. dollar denominated assets. See Wohlers-Scharf, *Arab and Islamic Banks*, 13-4; also see El-Gamal, *Islamic Finance*, 137.

[2] Matthews, Owen. "How the West Came To Run Islamic Banks." *Newsweek*, October 31, 2005. http://www.msnbc.msn.com/id/9775291/site/newsweek (accessed February 1, 2010).

financial contracts, the role of interest was ostensibly removed and was replaced with profit-and-loss paradigms.

The contracts juxtaposed medieval Islamic rules and structures with modern financial arrangements; terms such as *murābaha, ijārah*, and *mushārakah* replaced mortgages, leases and partnerships respectively.[3] Although contract language varied with the structure, the ultimate purpose was to embrace the fundamental Islamic economic principle of reciprocity; both parties in a transaction were exposed to the existential risks and potential rewards. Because of this emphasis on reciprocity in Islamic economics, fixed rates of return, which serve a purpose in conventional financial markets, were ideologically impossible. As such, the Islamization of certain conventional financial products is ideologically impossible (e.g., bonds, short-sales, derivatives, etc.).[4]

Similar to conventional legal contracts, agreements under Islamic law require the following prerequisites: (1) two or more parties that are legally eligible to enter into a contract; (2) an offer and an acceptance by both parties with free mutual consent; and (3) compliance with *sharī'ah* and the jurisdictional law if applicable.[5] Some of the most prevalent financial instruments and legal contracts used by Islamic financial institutions

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[3] El-Gamal, *Islamic Finance*, 40.

[4] Classical jurisprudence asserts that trading debt beyond the par value is prohibited. Moreover, most jurists argue that short-selling and derivatives contracts are subject to excessive speculation. See Kuran, *Anthropology Today,* 28-9.

[5] "Islamic Commercial Law and the Concept, Principles and forms of *Bai'* (Trading): Module II, Lesson 1" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 12-13; El-Gamal, *Islamic Finance*, 9.

include: (1) *wakālah*; (2) *ijārah*; (3) *murābaha*; (4) *mushārakah*; (5) *mudārabah*; (6) *salām*; (7) *istisna'ā*; (8) *tawārruq*; (9) *qard*; and (10) *sukkuk*.[6]

Wakālah

A *wakālah* contract is an agency agreement whereby one party agrees to be represented by a second party.[7] The scope of authority between the two parties is articulated in the *wakālah* contract language. However, the *wakālah* contract many not include non-commercial provisions (e.g., requiring the agent to perform prayers, fasts, or other religiously mandated activities required by all Muslims).[8] The *wakālah* contract has several applications among the *ribā*-free contracts used by Islamic banking and insurance (e.g., the *murābaha*, *salām*, and *istisna'ā* contract which we shall discuss later in the chapter).[9]

In an Islamic banking context, the agent or *wakīl* in a *wakālah* contract is typically the borrower of financial capital and works on behalf of the lender in pursuit of acquiring the goods or assets financed by the lender.[10] This is the case because the agent

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[6] "Islamic Banking Operations: Financing by Islamic Banks, Module III, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 1-18.

[7] "Islamic Commercial Law and the Concept, Principles and Forms of *Bai'* (Trading): Module II, Lesson 8" (working paper, Institute of Islamic Banking & Insurance, London, n.d.), 1-6.

[8] The religious obligations expected of mature and sane adults are not subject to any legal provisions stipulated in a commercial transaction. Ibid.

[9] The *wakālah* is basically an Islamized power of attorney. Accordingly it used pervasively between "borrower" and "lender" in financial transactions where one party represents the other depending on core competencies.

[10] This is similar to conventional loans and leases whereby a bank agrees to finance the purchase of any given good or asset, with the borrower responsible for the

is experienced with the purchase, construction or general procurement of the financed good or asset, whereas the Islamic bank is considered an expert only in banking and capital allocation.

However, the agency principle is not only applicable to general lending and leasing arrangements; Islamic banks also use the *wakālah* contract with its depositors. Under the fractional reserve banking model, an Islamic bank enters into a *wakālah* agreement with its depositors insofar that the bank is an agent responsible for the deployment of depositor funds in the hopes of earning a *sharī'ah* compliant profit.[11] Similarly, the *wakālah* contract has an application in import and export transactions requiring financing; the *wakālah* contract becomes effective for the transacting parties where the bank serves as an agent for the importing and exporting parties.

In order for a *wakālah* contract be considered *sharī'ah* compliant, it must meet certain requirements as established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which governs all Islamic financial institutions in the world.[12] As with all conventional and *sharī'ah* contracts, a *wakālah* agency

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procurement or construction of the good or asset; the borrower is the agent or *wakīl* in this context. The borrower's core competency is the business in which he or she is engaged that requires financing. However, the lender is simply a financial intermediary engaged in capital allocation and investment.

[11] "Islamic Banking Operations: Deposit/Resources Mobilisation by Islamic Banks & Financial Institutions, Module III, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 3.

[12] AAOIFI is a non-government regulatory body that is engaged in the formulation and implementation of *sharī'ah* rules and regulations pertaining to the Islamic banking and insurance industries. Established in 1990 and based out of Bahrain, AAOIFI is considered the primary regulatory body responsible for ensuring harmonized and standardized *sharī'ah* compliance among the Islamic financial institutions of the

agreement must include an offer and acceptance by the respective parties.[13] Additionally, a *wakālah* contract may grant specific or general powers to the agent.[14] In most asset-specific and forward-sale contracts, the *wakālah* contract grants specific powers to the agent because such finance agreements are typically limited in scope to a specific type of project.[15] A general agency contract enables the agent or *wakīl* to purchase or sell any variety of assets or goods on behalf of the bank.[16]

Additionally, the agent must be considered legally competent to enter into a contract. Such a proviso prohibits individuals who are too young or old, mentally

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world. See "AAOIFI – Accounting and Auditing Organization for Islamic Financial Institutions," http://www.aaoifi.com (accessed February 10, 2010).

[13] According to Usmani, only bilateral contracts are considered valid contracts in Islamic law. See Usmani, *An Introduction to Islamic Finance*, 49-50.

[14] The permissibility of granting specific or general powers of attorney to an agent is similar to conventional power of attorney provisions, whereby the agent is able to legally represent an individual or organization as if it were the same legal entity.

[15] For example in an asset-specific finance transaction, if a *wakālah* contract is executed between a bank and a borrower/agent for the purposes of constructing a new real estate structure, the *wakālah* contract would grant the borrower/agent the legal power to engage in contracts on behalf of the bank for the sole and exclusive purpose of constructing said real estate structure for the total aggregate sum agreed upon in the finance contracts. The borrower/agent would not have the legal authority to enter into contracts beyond the scope of the construction or procurement of the asset financed.

Similarly, if a bank and borrower/agent enter into a forward-sale finance contract whereby the borrower is responsible for the re-sale of agricultural crops that were financed in advance of their fruition at the contract time of delivery, the borrower is limited in his or her legal power to engage in a commercial transaction for the sale of the commodities only; the borrower/agent would not be granted legal authority to engage in other commercial transactions unrelated to the finance agreements between the bank and the borrower.

[16] "Islamic Commercial Law and the Concept, Principles and forms of *Bai'* (Trading), Module II, Lesson 1 (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 12.

unstable or insane individuals from serving as an agent.[17] In practice, an agent is granted the authority to receive and make payments on behalf of the contracting party.[18] If the agent accepts receipt of a purchased item and if it is damaged because of a natural disaster or another force majeur incident, the agent may not be held liable for the damages resulting therein.[19] The *wakālah* contract may be terminated at any time if mutually agreed upon by all parties.[20] Finally, the *wakālah* contract must have a fixed term and is terminated immediately upon the death of either party.[21]

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[17] This provision is similar to conventional legal requirements. In *sharī'ah*, it is supported by the Qur'ān: "O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties: let not the scribe refuse to write as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear His Lord Allah, and not diminish aught of what he owes. If the party liable is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully, and get two witnesses, out of your own men. . ." (Qur'ān 2:282).

[18] The *wakālah* agreement emphasizes fiduciary responsibility, which is similar to that of modern limited partnerships and managing partners, and corporations and its officers or directors insofar that managing partners, officers and directors of a corporation have a legal and ethical responsibility to properly manage the assets of the partnership or corporation as articulated by the various governing contracts and articles.

[19] The concept of force majeur is particularly important in the faith based economic and legal models promulgated by the Islamic Moral Economy and *sharī'ah*. Because God is considered omnipotent, omniscient, omnipresent, and omni-benevolent, all inconsequential events that may adversely effect commercial transactions are considered acts of God, and thus theologically predetermined.

[20] "Islamic Commercial Law and the Concept, Principles and forms of *Bai'* (Trading): Module II, Lesson 8" (working paper, Institute of Islamic Banking & Insurance, London, n.d.), 5.

[21] Ibid., 13-5.

Murābaha

The *murābaha* contract is more colloquially referred to as the "cost-plus" method, and is arguably the most prevalent and ubiquitous Islamic financial contract used by modern Islamic banks.[22] In a *murābaha*, three parties are engaged in a single commercial transactions with the cost, intermediate sale price and final sale price disclosed to the end-user purchaser. A *murābaha* contract theoretically avoids *ribā* by replacing time-value pricing methodologies on financial capital with the opportunity cost of purchasing and selling a good, asset or service for a profit.[23]

Let us assume that buyer A wishes to purchase good x for price P from seller C. Naturally, A does not have P funds available to purchase x, and C will not sell x for less than P. To remedy this problem, A approaches bank B seeking financial assistance to purchase x for P. As such, A enters into a *murābaha* contract with B, where B agrees to purchase x for P from C, and A agrees to purchase x from B for P', which includes a

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[22] Rafi Khan, *Profit and Loss Sharing*, 64.

[23] The idea of time-value pricing does not have a place in the Islamic Moral Economy because it is equivalent to usurious practices replete of financial interest. Money is only an abstract representation of a fixed stock of natural resource wealth bequeathed by God; man is simply the vicegerent or custodian of God's wealth. As such, man is incapable of increasing the aggregate stock of wealth as only God has the ability to increase or decrease the aggregate stock of natural resource wealth.

Thus, the hypothetical Islamic moral Economy model espouses the idea that money supply does not increase or decrease, and hence the general price level of goods or services cannot increase on a macroeconomic level solely as a function of time. (This hypothesis does not account for the microeconomic ebb and flow of price levels subject to the economic laws of supply and demand.) It necessarily follows that the money supply does not increase, thus a general price level stabilization is likely to occur. As such, money cannot have a metaphysical time-value pricing mechanism inexorably affixed to it, as the purchasing power of one unit of money remains constant because the tangible natural resource wealth it represents remains constant. See Chapter 3.

mutually agreed upon and disclosed profit margin for B.[24] Additionally, A and B further agree that A will pay P' in installments over the course of a specific period of time T.[25]

The *murābaha* contract has been used to finance myriad goods and services including smaller consumer transactions that would normally be purchased through credit cards, to larger transactions involving more capital intensive assets (e.g., automobiles, aircraft, real estate, equipment, etc.).[26] The *murābaha* contract may also be used for commercial revolving credit facilities that typically finance working capital requirements of for-profit and non-profit enterprises.[27]

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[24] In this hypothetical example, for B to earn a profit, P' is necessarily more than P. More specifically, B's gross profit (B_{GP}) may be calculated by subtracting P from P'. thus the following mathematical expression would represent the mutually agreed upon profit to be earned by B by entering into a *murābaha* contract with A and C:

$$P' - P = B_{GP}$$

[25] By introducing the element of deferred payment, it arguably engenders the establishment of a loan between A and B where A is given the flexibility of periodic installment payments. Moreover, the for-profit nature of the *murābaha* loan that results inexorably utilizes the metaphysical time-value price mechanism for money because the lender does not incur any real financial risk of ownership. Title to the financed asset is transferred nearly simultaneously, and is made on a *murābaha* transaction-to-transaction basis; B is never truly engaged in the trade of x. Instead, B only engages in the trade of x when there is a market demand for financing x. See fig. 3.

[26] "Islamic Commercial Law and Contracts: Credit Sales: *Murabaha* and *Musawamah*, Module II, Lesson 5 (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 10-6.

[27] For example, a *murābaha* contract may be used to purchase inventory by a business firm requiring widgets. Instead of ABC Widget Retail Company purchasing widgets from XYZ Widget Supply Company, ABC Widget Retail Company would purchase widgets from a bank at a mutually agreed upon price, which includes the bank's "mark-up" profit margin, and agrees to repay the bank in deferred installment payments over a period of time.

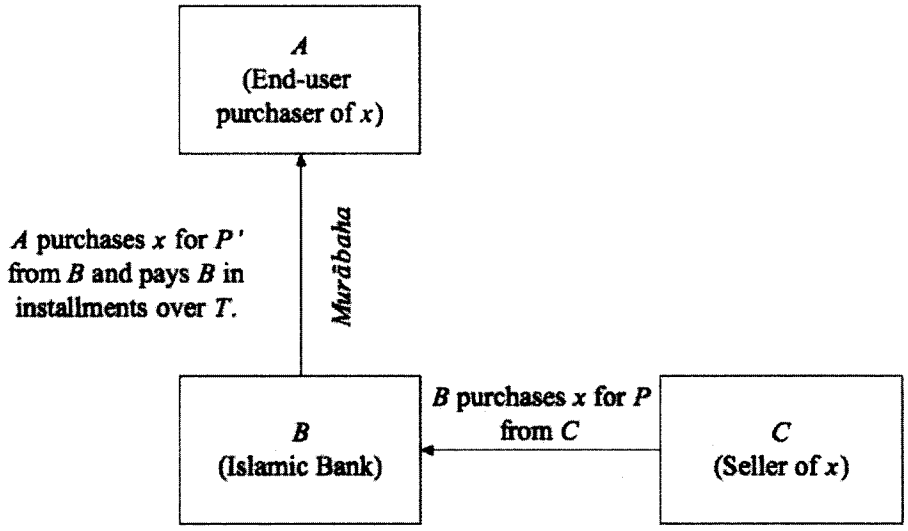

FIGURE 3. *Murabāha* structure. Again, P' is necessarily greater than P for B to earn a gross profit from the sale of x to A.

In addition to the problem of marginal ownership risk for lenders in a *murābaha* contract, most Islamic banks also utilize an interest-rate benchmark (e.g., LIBOR, FFR or the Wall Street Journal Prime Rate) for pricing the gross "profit-margin" on *murābaha* transactions.[28] Thus, the *murābaha* not only eliminates the fundamental principle of profit-and-loss sharing vis-à-vis ownership risk for the "lending" institution, but the pricing mechanism is also explicitly tied to the time-value function of a usurious financial metric.

Muslim apologists argue that Islamic banking as a sector has not matured enough to support truly *sharī'ah* compliant contract structures free from an interest-rate

[28] Although interest in Islamic banking products is growing in the United States, the primary growth sectors remain in Europe and the Middle East. As such, LIBOR is a more popular interest rate benchmark compared to U.S. interest rate benchmarks such as the FFR or the Wall Street Journal Prime Rate. See Chapter 2.

benchmark.[29] In fact, AAOIFI as well as other *sharī'ah* supervisory bodies have condoned the practice of pegging cost-of-capital rates of return to an interest rate benchmark such as LIBOR because *sharī'ah* compliant alternatives are non-existent. A vocal supporter of this position is Islamic legal jurist Taqi Usmani, who argues that interest rate benchmarking is equivalent to a soft-drink manufacturer pricing their beverages with similar profit margins of a distiller or brewery of alcoholic beverages; the product sold remains unchanged and thus, *sharī'ah* compliant.[30]

However, Usmani mistakenly equates the soft drink and alcohol as analogous to interest rate benchmarking for *sharī'ah* compliant financial instruments.[31] The very presence of an interest rate benchmark engenders a time-value price mechanism, which is anathema to principles of an Islamic economy.[32] As El-Quoulaq aptly stated, time is a

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[29] While this position is largely anecdotal, it was reaffirmed to me personally during several informal conversations with academics and practitioners of Islamic banking, finance and economics in Cambridge.

[30] Usmani, *An Introduction to Islamic Finance*, 48-9.

[31] While the pricing mechanism of interest rate benchmarking may reflect the pricing mechanism of a brewer of alcoholic beverages and soft drink manufacturer, the difference is substantive. Usmani's example is an incorrect analogy because he mistakenly equates the product with the price. In Usmani's example, alcohol is forbidden; not the price. However, in interest rate benchmarking, the product financed is presumably permitted; what is not permitted is the abstract pricing mechanism of financial interest, which inexorably incorporates time-value calculations of money's worth at some future date in time. The presence of time-value implicitly introduces *ribā*.

[32] Indeed, several scholars are critical of Usmani's conclusion. Further, El-Gamal argues that the subject of the transaction (i.e., the good or asset purchased/sold) is not the issue. He adds, "the ingredients of the financial transaction are the same as those for conventional mortgage[s] (cost of funds, credit risk, collateral property risk, etc.), and the output is the same (a debt on the customer equal to the sum of money he need to purchase the property plus finance charges exceeding the bank's cost of funds.)" See El-Gamal, *Islamic Finance*, 75.

metaphysical reality for all of humanity and can only be appropriated by God—any pricing methodology that increases or decreases as a function of time is not permissible within the theological framework of the Islamic Moral Economy.[33] Instead, pricing mechanisms should account for the costs and risks incurred related to the manufacture, distribution and sale of a specific good or asset.[34]

The *murābaha* contract is problematic from a *sharī'ah* compliance perspective as practiced by most Islamic banks today.[35] The *murābaha* contract does not expose the transactional parties to reciprocal opportunities for potential loss or profit. Using the example from Figure 3 again, *B*'s ownership risk of *x* is negligible and arguably non-existent because the time between *murābaha* contract execution and delivery of *x* is negligible.[36] Additionally, the pricing mechanism used by most *murābaha* transactions is

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[33] El-Qoulaq, Taisir, "Toward Better Understanding of the Islamic Financial System," (thesis, San Diego State University, 1997), 10.

[34] Such pricing mechanisms must be free of any interest rate benchmark comparisons, which naturally raise the question of whether inflation is a component of the Islamic Moral Economy. If inflation is a part of the Islamic Moral Economy, clearly the only benchmark that needs to compared is inflation; pricing would naturally have to exceed the cost of inflation at any given point in time, and not calculated for future or projected rates of inflation at some future point in time.

However, it is also important to emphasize the role of an asset-based or endogenous money system where changes in the stock quantity of money do not affect the general price level of an economy. Therefore, it is more plausible to presume that the Islamic Moral Economy that utilizes such a money system will experience microeconomic increases or decreases in prices reflecting the ebb and flow of supply and demand for any given product or service as opposed to all products or services in an economy.

[35] El-Gamal, *Islamic Finance*, 75.

[36] In fact, most Islamic banks do not ever take physical possession of the good or asset financed by a *murābaha* transaction. As El-Gamal notes, the ownership risk is

usually an interest rate benchmark that implicitly expresses a time-value of money, which is insoluble with the Islamic Moral Economy.

Proponents of the *murābaha* contract argue that the transaction is in fact *sharī'ah* compliant, or at the very least *sharī'ah* tolerant, because the Qur'ān explicitly differentiates *bai'* or trade and *ribā*.[37] Muslim jurists considers the *murābaha* contract less than ideal when compared to true profit-and-loss sharing equity partnership contracts such as the *mushārakah*, which we will discuss in greater detail later in the chapter. However, most jurists agree that a *murābaha* contract does not involve *ribā* when the "lending" bank takes actual ownership risks related to financing a good, asset, or service.

If a *murābaha* contract begins only as a mutual promise and not an effectual sale between the intermediary seller (i.e., the bank) and the end-user purchaser where legal title of the asset is not transferred, then the bank is taking a real risk, warranting *sharī'ah* compliant status. However, few Islamic banks adhere to the letter and spirit of the *sharī'ah* rules regarding the *murābaha*. One such example is Kuwait Finance House, which actually operates an automobile dealership as a wholly owned subsidiary for the purposes of adhering to the spirit and letter of the *murābaha* contract related to car "loans."[38]

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often "minutes, if not seconds." Therefore, any ownership risk is essentially non-existent. El-Gamal, *Islamic Finance*, 67-8.

[37] See Qur'ān 2:275.

[38] In addition to its car dealership subsidiary, Kuwait Finance House has plans for entering into other real and tangible businesses for the purposes of providing market participants capital intensive products that normally require financing through the *murābaha* contract. Unlike a traditional banking firm, Kuwait Finance House is engaging in real ownership risk through carrying the inventory of a full-scale auto

Technically, in a *murābaha* contract, the buyer/borrower and the seller/lender mutually agree in principle to proceed with a transaction; a promise is made, but a contractual agreement is not made between the two parties transferring legal title of the asset financed. The buyer/borrower then typically serves as the *wakīl* in a separate *wakālah* agency contract, where he or she is responsible for negotiating and procuring the asset in question.[39] The buyer/borrower then purchases the asset on behalf of the seller/lender, and the seller/lender then purchases and holds legal title to the asset. The buyer/borrower then purchases the asset from the seller/lender at the mutually agreed upon "marked-up" price.[40]

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dealership, and thus any *murābaha* credit-sale is clearly distinguished from a traditional interest-based loan. The Kuwait Finance House model is analogous to the concept of mutuality, which is discussed in the next chapter. Additionally, it is also similar to Marxist ideas of communal ownership, or at the very least communal financing. See *Kuwait Finance House*, http://www.kfh.com/en/commercial/cars/new-cars.aspx (accessed February 10, 2010).

[39] The buyer/borrower often serves as an agent for the seller/lender because the asset financed is often technical in nature (e.g., industrial equipment, construction of a factory, etc.). In such situations, the *wakīl* is eligible to earn a fee for his or her services as an agent on behalf of the bank; however, in the *murābaha* context, this fee is typically calculated as a cost for the bank, and thus included in the "mark-up" gross profit margin between the actual cost of the financed good or asset, and the final selling price of the good or asset. See "Islamic Commercial Law and Contracts: Credit Sales: *Murabaha* and *Musawamah*" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 10-6.

[40] The "mark-up" gross profit cannot increase commensurate with the duration of the repayment period. More specifically, if the buyer/borrower wishes to repay the total cost of x over ten years, this "mark-up" cannot exceed the "mark-up" used to calculate the price of x if paid over five years. The purpose of this restriction is to eliminate the time-value price mechanism. However, when interest rate benchmarks are used, the restriction is negated by the implicit presence of a time-value price mechanism vis-à-vis interest rates. Ibid., 8-9.

For the *murābaha* transaction to be considered *ribā*-free, the bank must take ownership risk of the asset by assuming title for the good. In modern Islamic banking, title is transferred to the bank for a fractional moment in time, thus eliminating any real ownership risk. In a typical *murābaha* transaction, the seller/lender transfers legal title of the asset to the buyer/borrower thus limiting the actual ownership risk, and thus resulting in a marginal form of *ribā*.[41]

Despite the flexibility of the *murābaha* contract, it is often considered an inappropriate contract structure for long-term asset financing simply because of the myriad variables involved in a long-term contract (e.g., inflation rates, interest rates, etc.), which may change the contract profitability and expected rates of return.[42] For example, if the *murābaha* contract were used in a real estate transaction, the deferred payment would inexorably require the seller/bank to incorporate some sort of time-value or opportunity cost variable as a pricing mechanism.[43]

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[41] El-Gamal, *Islamic Finance*, 67-8.

[42] Because it is more difficult to predict future inflation and interest rates, the *murābaha* contract is limited to short-term financing. See "Islamic Commercial Law and Contracts: Credit Sales: *Murabaha* and *Musawamah*, Module II, Lesson 5" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 18-20.

[43] Although alternatives to interest rate benchmarks have been proposed, viz., a rental rate index, such a benchmark would only be applicable if the seller/lender had an equity stake in the asset financed, as seen in a *mushārakah* contract, which we will discuss in further detail later in the chapter.

Tawārruq

The *tawārruq* contract is similar to a buy-back agreement, which is generally impermissible in *sharī'ah*, although with some important contractual differences.[44] A *tawārruq* contract enables merchants or producers to purchase a good on credit, and then resell the good for a presumably lower cash price. The net effect of the transaction is a cash advance collateralized by assets purchased on credit resulting in a debt obligation at a future point in time.[45] For example, A sells x to B at time T_0 for \$100 payable at time T_{n+1}. B then sells x for \$80 on the spot to C at time T_n.[46] The \$20 difference between the second spot transaction (T_n) and the first forward sale transaction (T_{n+1}) is the effective payment for time value of capital for A (i.e., \$100 - \$80 = \$20).

Many Muslim jurists frown upon the practice of *tawārruq* because of its similarity to *bai' al-inah*, a buy-back agreement, and its propensity to incur *ribā* in the transaction. However, contemporary *sharī'ah* scholars allow *tawārruq* contracts as a necessity for cash flows of businesses in an Islamic society. In an attempt to make the transaction more compliant with *sharī'ah*, latency between the repurchase of the good financed in the

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[44] A buy-back agreement is also called a *bai' al-inah*, which is impermissible in Islamic law because it is considered a form of *ribā*. In a *bai' al-inah* contract, party A would sell x for P to party B, and then party A would immediately agree to repurchase x for P' which is greater than the value of P payable at some later point in time. See "Islamic Commercial Law and Contracts: Accessory Contracts: *Wakalah*, *Kafalah*, *Jua'lah*, *Tawarruq*, *Istijrar*, *Amanah*, Module II, Lesson 8" (working paper, Institute of Islamic Banking & Insurance, London, n.d.): 10-3.

[45] Ibid., 10.

[46] In this example, T_n is at some later point in time relative to T_0.

tawārruq is generally recommended by *sharī'ah* technicians to engender ownership risk.[47]

More specifically, the party purchasing the goods for the second time should be exposed to a market and financial risk because of the legal transfer of title, when trying to resell the goods again at a lower cash or spot price.[48] Potential ownership risks may manifest because of a fall in prices, damage to the goods purchased, or a complete inability to resell the merchandise. Despite its ostensible legal permissibility within *sharī'ah*, most Islamic bankers are discouraged from utilizing it as a financial instrument by contemporary Muslim jurists.[49]

Mushārakah

The *mushārakah* contract is seen as the most innovative and religiously viable financial contract within today's Islamic banking product repertoire. Etymologically derived from the Arabic word *shāraka*, the *mushārakah* contract involves two or more equity partners engaged in the purchase or operation of a good, service or business enterprise respectively.[50] Unlike the *murābaha* contract, which necessarily entails an

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[47] Ibid., 12.

[48] Ibid.

[49] Ibid., 10-3.

[50] The *mushārakah* was originally referred to as the *mufawadda*, which was considered permissible by the Hanafi and Maliki schools. See Rafi Khan, *Profit and Loss Sharing*, 48.

effectual loan between the lender and the borrower, the *mushārakah* contract embodies an equitable partnership between two or more parties.[51]

In a *mushārakah* contract, party *A* enters into a partnership agreement with *B* for the purchase of *x* for *P*, where *A* and *B* both contribute capital totaling *P*.[52] The profits or losses resulting from the *mushārakah* contract are to be shared proportionate and respective to each partner's capital investment or mutual agreement.[53] For example if *A* invests $100 and *B* invests $900, for a total capital outlay of $1,000, the ratio of ownership is 10:90 respectively. However, if both *A* and *B* mutually agree that profits will be distributed in a 20:80 ratio where *A* will receive 20 percent of the profits and *B* will receive 80 percent of the profits, such an arrangement is permissible.[54]

The reasoning for the disproportionate profit distribution may be the result of *A*'s labor contribution to the business. For example, *A* may be responsible for securing sales with a third-party and that may be the basis for the disproportionate distribution of

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[51] El-Ashker, *The Islamic Business Enterprise*, 133.

[52] Most legal schools of thought allow only liquid assets for the initial capital formation of the *mushārakah*. However, the Shafi'i school of thought asserts that other non-liquid commodities may be used if the commodity used to fund the business is fungible and replaceable. Otherwise, the commodities should be sold and the liquid asset proceeds should be used instead. See "Islamic Commercial Law and Contracts: The Concept of Partnership: *Musharakah* and *Mudarabah*, Module II, Lesson 3 (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 9.

[53] In a *mushārakah* contract, each parties must share the losses incurred by the partnership commensurate with the capital invested. However, profits may be distributed disproportionate to the capital invested by each partner, assuming that there is a mutual agreement between the parties. However, such agreements must be reached prior to the *mushārakah* earning an actual profit. Ibid., 10-1.

[54] Ibid.

profits.[55] However, if the *mushārakah* partnership realizes an operational loss, both *A* and *B* must share the loss in the original 10:90 proportion reflecting the ratio of capital invested in the partnership.[56]

Although the *mushārakah* contract is generally a joint-venture partnership used in business arrangements, it is found in three primary forms: permanent, temporary and diminishing.[57] The diminishing *mushārakah* is used to finance capital-intensive real assets (e.g., consumer and commercial real estate, automobiles, aircraft, and heavy equipment).[58] Within the diminishing *mushārakah* structure, there are two contract types: *shirkah al-aqd*, which is a contract partnership typically executed for the purchase of an asset for use by one of the investing parties; and (2) *shirkah al-milk*, which is an ownership partnership typically used for home mortgages and automobile financing.[59]

Both contract types generally involve a separate *ijārah* lease agreement between the partners of the *mushārakah*.[60] In addition to the lease contract, a separate buy-sell

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[55] A disproportionate ratio of profit distribution may result because one partner is a working partner and the other a silent partner. Thus, the working partner may be eligible receive additional profits as a commission on sales or a type of salary.

[56] Ibid., 10-4.

[57] See "Islamic Commercial Law and Contracts: Diminishing *Musharakah*, Module II, Lesson 4 (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 1.

[58] Ibid.

[59] Ibid., 2.

[60] An *ijārah* contract is similar to a conventional capital lease. However, the contract structure differs from conventional capital leases insofar that the lessor is exposed to ownership risks of the asset; therefore, if the asset is destroyed in a force

contract is typically involved, which "diminishes" the ownership interest in the asset of one partner, and increases the ownership of the other. Although both the *shirkah al-aqd* and the *shirkah al-milk* contracts are divisions of the *mushārakah* contract structure, minor differences exist. For example, the *shirkah al-aqd* does not permit the predetermination of a purchase price in the diminishing *mushārakah* structure.[61] Conversely, in the *shirkah al-milk* contract, Muslim jurists consider the predetermination of the purchase price of units or shares in the *mushārakah* partnership permissible. Thus, the *shirkah al-milk* contract is often very similar in pricing to a conventional interest-based asset loan.[62]

Both the *shirkah al-aqd* and the *shirkah al-milk* contracts require three specific components to be considered a valid *sharī'ah* contract: (1) the partnership contract must be between two or more partners; (2) one of the partners must execute an *ijārah* contract from the *mushārakah* partnership; and (3) one of the parties must agree to buy or sell

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majeur incident, the lessor must bear the financial loss. We will discuss the *ijārah* contract type in further detail later in the chapter.

[61] "Islamic Commercial Law and Contracts: Diminishing *Musharakah*, Module II, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 3.

[62] Because the *shirkah al-milk* contract type fixes the price of the shares at the time of contract execution, it reflects the purchase price of the asset financed using the *mushārakah* contract. This is analogous to a conventional mortgage, which amortizes the purchase price of an asset over a fixed period of time, and incorporates calculations for discounted cash flows vis-à-vis interest. However, the *shirkah al-aqd* contract disallows this practice of predetermining the repurchase price of equity shares in the partnership. Thus, the actual cost of ownership may ebb and flow with the market valuations of the asset financed.

ownership in the *mushārakah* from the other partner(s), thereby increasing and/or decreasing each partners' ownership in the joint venture respectively.[63]

Both types of diminishing *mushārakah* contracts are used for consumer financing (e.g., homes and automobiles), as well as commercial financing analogous to private equity or venture capital investment in entrepreneurial firms.[64] Using the *mushārakah* model, a business firm may raise capital for the inception or expansion of an enterprise.[65] After selling equity positions of the business firm to an Islamic financial intermediary, the business firm would have the option of repurchasing the shares sold to finance the business at a mutually agreed upon predetermined price or market price.[66] Thus, the

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[63] "Islamic Commercial Law and Contracts: The Concept of Partnership: *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking & Insurance, London, n.d.): 4.

[64] While it is theoretically possible to use *mushārakah* contracts for short-term credit needs, it is seldom, if ever used for such a purpose. Instead, the *mushārakah* is generally limited to larger transactions that involve partners willing to sell equity. Therefore, it is generally used for residential and commercial real estate, as well as general business financing. See El-Ashker, *The Islamic Business Enterprise*, 133-4.

[65] The *mushārakah* is ideal for investments in for-profit business enterprises because it is very similar to private equity and venture capital investments in private and public corporations. Similar to a *mushārakah* partnership for the finance of some tangible asset, a business firm may enter into a *mushārakah* with an Islamic financial intermediary for the purposes of injecting additional financial capital in exchange for equity shares in the business firm.

[66] Thus, it is a diminishing *mushārakah* form that is used for private equity and venture capital type investments. Analogous to most private business firms today, selling equity in the firm indefinitely is not an attractive option unless owners of the business firm have the option of repurchasing the sold shares at some later date in time. In fact, private equity and venture capital firms typically have a fixed time period in which its funds must be returned.

Additionally, the *shirkah al-milk* contract allows for a predetermined valuation of partnership shares, thereby fixing the total asset price of the *mushārakah* partnership. However, the *shirkah al-aqd* contract disallows this practice as it discounts the role of

business firm would increase its equity position over time, and the financial intermediary would decrease its equity position in the business firm over time, effectively serving as an hybridized equity/loan instrument.

To illustrate the *mushārakah* partnership more clearly, the following is a hypothetical scenario of a *shirkah al-aqd* contract.[67] Assume that *A* has $20,000 and wishes to purchase a home for $100,000. Instead of borrowing the remaining $80,000 from a bank and paying interest, *A* approaches *B* for the purposes of forming a diminishing *mushārakah* partnership. After *B* conducts its due diligence, *B* concludes that the home purchase may be a profitable investment. *A* and *B* enter into a *shirkah al-aqd mushārakah* partnership agreement where *A* contributes $20,000 and *B* contributes $80,000; the ownership ratio of the home and all the income and expenses it may generate shall be distributed in the 20:80 ratio for *A* and *B* respectively.

Additionally, *A* enters into a separate and independent agreement to rent the newly acquired home from the *mushārakah* partnership in the form of an *ijārah* lease agreement at a hypothetical market rent of $1,000.[68] Because *A* owns 20 percent of the

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price volatility and is thought to have a great deal of *gharar* or speculation. Thus, the *shirkah al-aqd* contract requires every transaction between the partners in a *mushārakah* contract to be made at prices reflecting the market value of the assets in the *mushārakah* at the time of sale. Naturally this may result in a price risk for both parties insofar that the ultimate cost of the asset rises with the commensurate appreciation in the asset price. See "Islamic Commercial Law and Contracts: Diminishing *Musharakah*, Module II, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 3.

[67] See fig. 4.

[68] To determine market equivalency, Islamic banks typically evaluate several metrics including size, location and amenities of a home for the purpose of establishing a market rent. Additionally, factors such as the date of construction and condition of the home are necessarily incorporated into the calculation of the monthly rent payment.

partnership and *B* owns the remaining 80 percent, $200 of the gross rent belongs to *A* and $800 belongs to *B*. With the $200 rental income, *A* then purchases $200 of additional equity interest in the *mushārakah* partnership in the form of units or shares from *B* thereby increasing *A*'s ownership interest to $20,200 and decreasing *B*'s ownership interest to $79,800.[69] Therefore any increase or decrease in ownership by *A* or *B* respectively is similar to the declining loan balance of a conventional interest-based mortgage.

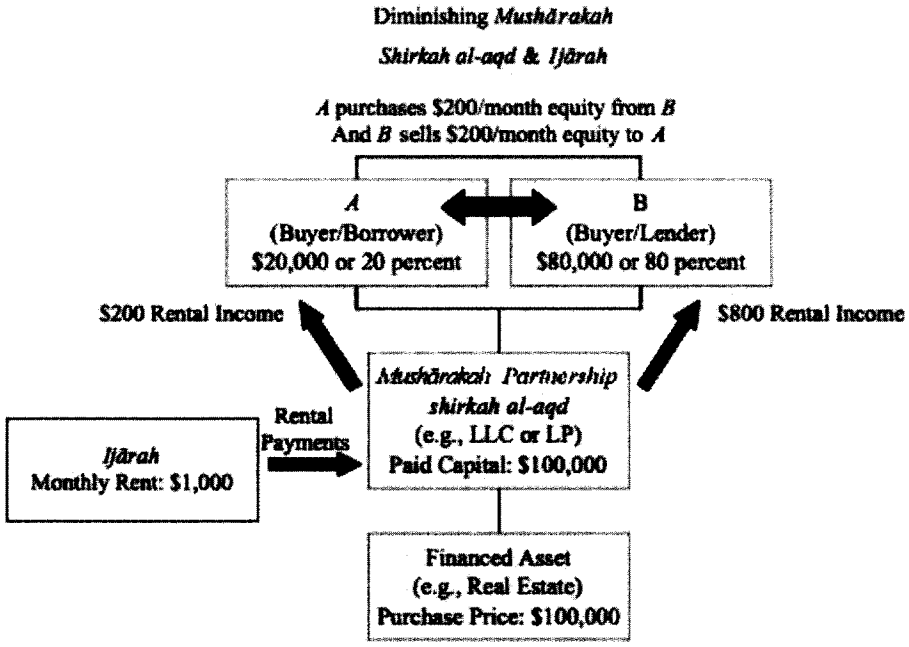

FIGURE 4. Diminishing *Mushārakah* structure.

Finally, because the *mushārakah* contract is a partnership, both *A* and *B* necessarily have voting rights with reference to determining the monthly rents at the inception of the contract, as well as during the duration of the contract's existence. See Usmani, *An Introduction to Islamic Finance*, 22-3, 35.

[69] This example assumes that the market value of the home does not decrease or increase after the first month. It also assumes that *A* has the right to purchase additional equity ownership in the home from *B* beginning in the first month of the *ijārah* contract.

The *mushārakah* contract embodies all of the prerequisites for a valid reciprocal profit-and-loss sharing agreement. If the home price doubles in value to $200,000 then both *A*'s and *B*'s equity stakes are worth $40,000 and $160,000 respectively.[70] Similarly, it will cost *A* twice as much to acquire full ownership interest in the home if the value doubles to $200,000.[71] Conversely, if the home price decreases in value to $50,000 then both *A*'s and *B*'s equity stakes are worth $10,000 and $40,000 respectively.[72] It would cost *A* half as much to acquire full ownership interest in the home compared to the original $100,000. Therefore, both parties benefit in an increase in market value, and both parties will also realize a loss from a depreciation in market values.[73]

Although the *mushārakah* partnership contract was not prevalent in early Islamic history, it has the potential to be a solution to the perceived Islamic banking problem of

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[70] If the home price doubles in value to $200,000, *A*'s ownership stake is 20 percent: $200,000 × 20% = $40,000, and *B*'s ownership stake is 80 percent: $200,000 × 80% = $160,000.

[71] Unlike a conventional mortgage, the cost of acquiring the financed asset is not fixed to the original purchase price plus the cost of capital (i.e., an interest rate).

[72] If the home price decreases in value to $50,000, *A*'s ownership stake of 20 percent would be calculated as follows: $50,000 × 20% = $10,000 and *B*'s ownership stake of 80 percent would be calculated as follows: $50,000 × 80% = $40,000.

[73] The concept of reciprocal risk and reward with regard to financing is similar to the Medieval English contract of *vif-gage*, which literally translates to "live agreement." The *vif-gage* agreement was considered a non-usurious contract because it required lenders to share in the losses of agricultural yields that benefited from financing from the lender, and it also granted rights to profits if agricultural yields were profitable. Thus, the agreement was considered "alive." However, the current *mort-gage* is literally an evolution of the "dead gage" agreement, which was considered usurious in Medieval England; creditors who died while holding *mort-gage* contracts were considered to have died in sin for usury. See Maurer, *Pious Property*, 14-27.

being characterized as a legalistic and ritualistic inefficient economic alternative.[74] The *mushārakah* partnership may be used for modern business enterprises vis-à-vis its joint-venture characteristics. The *mushārakah* contract can also be used in lieu of the modern corporation insofar that individual investors may pool capital together for the purposes of larger, capital intensive commercial enterprises.[75]

In exchange for the capital invested, each *mushārakah* partner would receive a *mushārakah sukkuk* certificate, which is a representation of the rights to claims of profit and assets of the enterprise.[76] Similar to the corporation, the investor's liability is limited to the capital invested in the enterprise; the personal assets of the individual investor are not at risk from the *mushārakah*'s losses.[77]

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[74] Islamic banking and insurance contracts may seem trivial and ritualistic at times. The need to veil *ribā* in *murābaha* contracts often results in a repetitive sequence of symbolic acts that are the basis for anthropological definitions of ritual. J.Z. Smith, a professor of religious studies at the University of Chicago says "ritual and its capacity for routinization" is a "building block" of religion. See Smith, *Imagining Religion*, 54.

This position is echoed by El-Gamal and Kuran, who both argue that Islamic financial contracts such as the *murābaha* contract are simply routinized and only superficially *sharī'ah* compliant structures. See El-Gamal, *Islamic Finance*, 14-5; and Kuran, *Islam and Mammon*, 11-2.

[75] "Islamic Commercial Law and Contracts: The Concept of Partnership: *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 28-9.

[76] The Arabic word *sukkuk* is a derivative of the word *sakk*, which is the etymological root for the modern Latin word "cheque." A *sukkuk* is an certificate representing claims or ownership in an asset or contract (e.g., *murābaha*, *ijārah*, *mushārakah*, etc.). It is used widely in Islamic economics as a replacement for debt notes such as bonds and stock certificates. See Adam and Thomas, *Islamic Bonds*, 43.

[77] In contemporary business, the corporation is considered a separate legal entity. As such, the losses of the corporation are not passed down to individual investors. Rather each investor is only liable for the capital that he or she invested in the corporation. See Ross et al., *Fundamentals of Corporate Finance*, 7.

However, there are differences between the modern corporation and the *mushārakah*. First, the modern corporation is able to issue common and preferred stock.[78] Preferred stock is often sold at a premium relative to its common stock counterpart because preferred stock guarantees dividends or voting rights.[79] These additional features are not permissible in the *sharī'ah* compliant framework of the *mushārakah*. A guaranteed dividend is equivalent to *ribā*, and thus this type of ownership is invalid in the Islamic context.[80]

Balance Transfer Facility

The *mushārakah* contract is not only applicable to new asset purchases, but it may also be used to refinance assets that have existing equity and are already owned. Assets may be refinanced or pledged as collateral for additional financial capital through a "balance transfer facility."[81] Similar to the procedural steps of a traditional *mushārakah* partnership transaction, the existing owner of an asset may enter into a balance transfer

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[78] The modern corporation is capable of issuing two primary types of stock: common and preferred. Common stock usually amounts to one vote per share of stock, and is repaid investor capital after all debts and preferred stockholders are made whole. Preferred stock may be structured in several classes granting each class additional voting rights or seniority over common or preferred stockholders. Additionally, preferred stock is generally structured to pay a fixed dividend. See Bodie et al., *Essentials of Investments*, 40-3.

[79] The additional voting rights flies at the face of the Islamic principle of reciprocity. Accordingly, the preferred stock instrument is generally considered impermissible.

[80] See Chapter 2.

[81] "Islamic Commercial Law and Contracts: Diminishing *Musharakah*, Module II, Lesson 4 (working paper, Institute of Islamic Banking & Insurance, London, n.d.): 9-10.

facility for the purposes of expansion or renovation of the asset.[82] Again, the owner is equivalent to the "borrower" and the bank becomes a co-partner (or in conventional banking terms, a "lender") in the new *mushārakah* partnership.[83]

The previous outright owner then becomes a partner in the new *mushārakah* and a lessee in the new *ijārah* lease agreement. Similar to a new diminishing *mushārakah* contract coupled with an *ijārah* lease agreement, the lessee/occupier/borrower has the right to repurchase shares in the *mushārakah* partnership over time, which is theoretically financed by the rental incomes generated by the *mushārakah* to the *ijārah*, thereby increasing his or her ownership interest, and "diminishing" the bank's ownership in the asset.[84]

Securitization

Securitization of the *mushārakah* partnership is made possible through *sukkuk* certificates, which enable a *mushārakah* partnership to be traded on a primary and secondary market.[85] The *mushārakah* may be sold in the primary market to raise capital

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[82] In conventional consumer finance, the function of a balance transfer facility is similar to refinancing a home mortgage. In such a transaction, the titled owner of a mortgaged property with equity may opt to borrow against the equity of the asset to increase the aggregate total loan amount using the asset as collateral. Prior to the Great Recession of 2007, consumer home loan refinancing was a common practice to "cash out" equity or simply renovate properties. See Romano, *The New York Times* (2002).

[83] This example assumes that the bank has conducted its due diligence and has decided that investment in the asset is permissible and profitable.

[84] See fig. 4 and "Islamic Commercial Law and Contracts: Diminishing *Musharakah*, Module II, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 9-10.

[85] *Sukkuk* certificates may be used in the primary market for purposes of raising capital for a *mushārakah* partnership. Similarly, a *sukkuk* certificates may also be traded

to fund a business enterprise.[86] However, the *sukkuk* certificates may not be resold on the secondary market before the business enterprise acquires non-cash assets.[87] This restriction is placed because any price appreciation of a *mushārakah sukkuk* certificate that occurs when the assets of the *mushārakah* are cash would result in *ribā*.

Ijārah

The *ijārah* contract is similar to a conventional capital lease, whereby the lessor maintains legal ownership of the leased asset, and the lessee is granted usufruct privileges.[88] The capital lease is more akin to a conventional term loan because it

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as a securitized as in the secondary market, where securities are traded after being sold in the primary market to raise capital, if the bulk of the assets are not cash; if the price of the *sukkuk* exceeded the par value in a secondary market, it would result in *ribā*. For more on the primary and secondary markets, see Bodie et al., *Essentials of Investments*, 63-8.

[86] This is similar to the sale of corporate equity and debt securities on the primary market. Equity sales are typically through initial public offerings or additional stock sales on the primary markets. Ibid., 63-4.

[87] Most *sharī'ah* scholars require less than one third of the assets of the *mushārakah* be in non-cash assets for it to eligible for trade on a secondary market, where the price of the *sukkuk* certificate may exceed the par value. See "Islamic Commercial Law and Contracts: The Concept of Partnership: *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 29.

[88] The word "usufruct" refers to the legal right to own or use a good or asset. See *Oxford English Dictionary*, 2nd ed., s.v. "usufruct."

amortizes the cost of the asset over the term of the lease contract.[89] Thus the lessee may have the option to purchase the leased asset for a nominal sum.[90]

However, from an Islamic Moral Economy perspective, the capital lease contract is considered an unfair and unjust financial arrangement because the lessor maintains legal ownership of the asset.[91] Yet, the lessee is responsible for the ownership risk of the leased asset.[92] Any contingent costs arising from the ownership risk of the leased asset are borne by the lessee and not the lessor.[93] Moreover, a capital lease may not be cancelled before the lease contract maturity; this provision implicitly eliminates any possibility of reciprocal risk for the lessor and thus violates *sharī'ah* requirements for a valid contract.[94] A capital lease guarantees a fixed rate of return to the lessor, and is priced to reflect the actual cost of the asset plus the cost of capital (i.e., a calculation for

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[89] "Islamic Commercial Law and Contracts: *Ijarah* (Leasing) in Islamic Finance, Module II, Lesson 7" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 4-5.

[90] For example, the residual value for a capital lease may involve a one dollar buy-out of the asset leased. Therefore, at the conclusion of the capital lease contract, the lessee has the option to purchase the leased asset from the lessor for a nominal sum (i.e., one dollar). Capital leases are structured as such because the value of the asset is effectively amortized throughout the lease period. See Ross et al., *Fundamentals of Corporate Finance*, 784.

[91] Ibid.

[92] If a business firm elects to lease equipment under a capital lease agreement, the business firm as the lessee is generally responsible for all ownership risk (i.e., the business firm is responsible for insuring the leased asset, its maintenance and care, etc.). Ibid.

[93] Ibid.

[94] As discussed earlier, risk reciprocity between transactional partners is a necessary component for a defining a transaction compliant with Islamic law. Ibid.

discounted cash flows and interest rates) over the course of the lease term. By the contract maturity, the lessor will have recouped its initial capital outlay for the purchase of the leased asset and any opportunity cost for the capital.[95]

Conversely, an operating lease does not necessarily calculate the cost of the asset over the lease term.[96] Instead, it is a rental contract that reflects the rental cost or depreciation of an asset over the lease term.[97] After the lease contract terminates, the lessor has the option to re-lease the asset to another party for another lease term.[98] Operating leases are typically for very short periods of time ranging from two to five years.[99] Similar to a capital lease, in an operating lease, the lessee does not record the leased asset on its balance sheet, and typically considers the monthly lease payment an operating expense.[100]

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[95] See "Islamic Commercial Law and Contracts: *Ijarah* (Leasing) in Islamic Finance, Module II, Lesson 7" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 7-9.

[96] See Ross et al., *Fundamentals of Corporate Finance*, 784.

[97] Ibid.

[98] Ibid.

[99] Ibid.

[100] In an operating lease, the lease agreement simply transfers usufruct privileges to the lessee in exchange for periodic rental or lease payments. However, legal ownership of the leased asset remains with the lessor. Thus, the leased asset may not be recorded as an asset of the lessee on its balance sheet. Instead, ownership risk and accounting charges are recorded by the lessor; the lessee is only able to charge the rental expense as an operating charge during the lease contract. See Ross et al., *Fundamentals of Corporate Finance*, 785-6.

Unlike the capital lease, an operating lease may involve lessor paid maintenance and/or insurance.[101] After the term of the lease contract, the lessee may have the option to purchase the asset leased for a residual value.[102] Both the capital lease and the operating lease incorporate a predetermination of a monthly lease payment and residual value or purchase price option at the end of the lease contract, which is established at the time the lease contract is executed.[103]

On the other hand, an *ijārah* lease must be asset-based, and more specifically, an asset that is considered durable; additionally, both parties must be exposed to reciprocal risk.[104] Thus, fungible commodity products may not be leased, as they will not maintain their essence after the lease term.[105] Eligible assets include manufacturing equipment, vehicles, furniture, fixtures, and real estate.[106] Unlike the conventional capital and

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[101] Ibid., 784.

[102] The residual value of the leased asset is typically calculated by deducting the incurred depreciation of the leased asset throughout the course of the lease contract. Thus, it effectively attempts to predict the discounted value of the asset at a future point in time. Although this depreciation methodology is ostensibly permissible within *sharī'ah*, it becomes problematic for assets that do not typically depreciate over time (e.g., undeveloped land) and inexorably introduces the metaphysical time-value of money, which is equivalent to *ribā*. Ibid.

[103] Ibid.

[104] "Islamic Commercial Law and Contracts, *Ijarah* (Leasing) in Islamic Finance, Module II, Lesson 7" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 12-7.

[105] For example, fruits are perishable; textiles used in the manufacturing process inexorably change their form, shape or character; oil is used in various chemical and industrial processes, which fundamentally change its nature and identity, etc. Ibid., 12-3.

[106] Basically, any good or asset that is not corrupted or consumed through use. Ibid.

operating lease contracts that guarantee a return for the lessor, an *ijārah* lease must permit the possibility for reciprocal loss to maintain *sharī'ah* compliance.[107]

Other than the element of reciprocity, the *ijārah* lease is not too dissimilar from its conventional capital and operating lease counterparts. However, an additional exception is the Islamic mandate requiring independent contracts for multiple obligations by either party. Whereas a conventional capital or operating lease may include provisions for the lessee to serve as an agent responsible for acquiring the leased asset, or the option to purchase the asset at the end of the lease term, an *ijārah* contract may only allude to cursory promises.[108]

An *ijārah* contract may state that the lessee has the option to purchase the asset after the conclusion of the lease contract, but it may not serve as the purchase and sale agreement between the two parties for said asset.[109] Similarly, if the lessee is going to

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[107] For example, if a lessor leases a piece of equipment to a lessee, and the equipment is destroyed in a natural disaster or other force majeur event (i.e., a circumstance beyond the control of the lessee), the lessor must bear the financial loss. Again, the idea that force majeur acts are the result of an omnipotent, omniscient, and omni-benevolent God result in the belief that adverse events are the Will of God, and are part-and-parcel of the *tawhīdī* god-consciousness framework of the Islamic Moral Economy. See Chapter 2 and Chapter 3.

[108] All *sharī'ah* compliant contracts must be independent and free standing, and can only include a single offer and acceptance. Thus, if the lessee is granted the option to purchase the leased asset from the lessor at the maturity of the *ijārah* contract, such an option must be limited to a promise in the *ijārah* contract, with a separate and independent contract articulating the details of the purchase and sale, which would be executed at the time of sale (i.e., at the conclusion of the *ijārah* contract).

[109] According to most jurists, each contract must retain independence. Obligations or offers to purchase and sell the asset leased are generally documented in a separate legal contract. See "Islamic Commercial Law and the Concept, Principles and Forms of *Bai'* (Trading), Module II, Lesson 1" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 12-3.

serve as the agent for the lessor with regard to procuring the asset to be leased, a separate *wakālah* agreement must be executed articulating each party's obligation in the agreement.[110] Moreover, if after the agent/lessee has purchased the asset on behalf of the lessor, and a natural disaster destroys the asset, the lessor must bear the financial loss and the agent/lessee cannot be held liable for the financial loss.[111]

Given the prevalence and ubiquity of operating leases in consumer finance, and the similarity between the *ijārah* contract and conventional leases, the *ijārah* mode has flexibility and the potential for widespread appeal within the modern financial markets. Indeed, the *ijārah* lease provides an Islamic alternative to commercial enterprises for short-term capital financing, as well as for financing assets such as equipment, furniture, fixtures, and real estate.

Instead of borrowing the money in a conventional term loan paying interest, or leasing the equipment in a capital lease where all of the obligations are borne by the lessee, an *ijārah* lease provides the lessee a more balanced and fair lease arrangements with the benefits of a capital or operating lease consistent with *sharī'ah*. The lessor legally owns the asset, but the lessee maintains full usufruct privileges. However, unlike a conventional capital or operating lease, the lessor is responsible for the asset in force majeur events (e.g., acts of God, natural disasters, etc.). Moreover, unlike a capital lease,

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[110] Ibid.

[111] Again, the issue of force majeur in the Islamic context originates from the theological position that God is omniscient, omnipotent, and omni-benevolent. All actions originate from God, and thus any adverse natural disaster or accident is the responsibility of the owner of an asset. See Chapter 3.

the lessee does not begin to pay monthly lease installments until the lessee receives physical possession of the leased asset.[112]

Mudārabah

The *mudārabah* is a partnership contract involving one or more limited partners or investors known as the *rabb al-māl* and a general partner or entrepreneur known as a *mudārib*.[113] The investors are responsible for supplying the *mudārabah* partnership with capital and maintain the legal right to profits of the enterprise in proportion to capital invested; losses are borne by the *rabb al-māl* and are limited to the capital invested.[114] The *mudārib* or entrepreneur is not liable for the losses of the enterprise unless such losses are due to negligence or fraud.[115]

Although the *mudārib* typically does not invest his or her own capital into the *mudārabah* partnership, if the *rabb al-mal* investors mutually agree to allow such an

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[112] See "Islamic Commercial Law and Contracts, *Ijarah* (Leasing) in Islamic Finance, Module II, Lesson 7" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 16.

[113] The *mudārabah* is one of the oldest legal contracts found in Islamic history. Muhammad was participant in the *mudārabah* structure in his early life as a contract merchant. According to Islamic tradition, Muhammad was a *mudarib* for his future wife Khadija, who was the *rabb al-māl*. See El-Gamal, *Islamic Finance*, 121; and "The Concept of Partnership: *Musharakah* and *Mudarabah*, Islamic Commercial Law and Contracts, Module II, Lesson 3" (working paper, Institute of Islamic Banking & Insurance, London, n.d.): 19-26.

[114] See Rafi Khan, *Profit and Loss Sharing*, 48-9.

[115] Ibid.

investment, it is considered acceptable to *sharī'ah*.[116] If the *mudārib* is granted the opportunity to invest his or her own capital into the *mudārabah* partnership, then the *mudārib* also becomes a *rabb al-mal*, and thus the same rules of profit and loss distribution apply.[117] Additionally, any profit distributions made to the *mudārib/rabb al-māl* would be in addition to the fees earned in the *wakālah* agreement as an agent and *mudarib* for the *mudārabah*.[118]

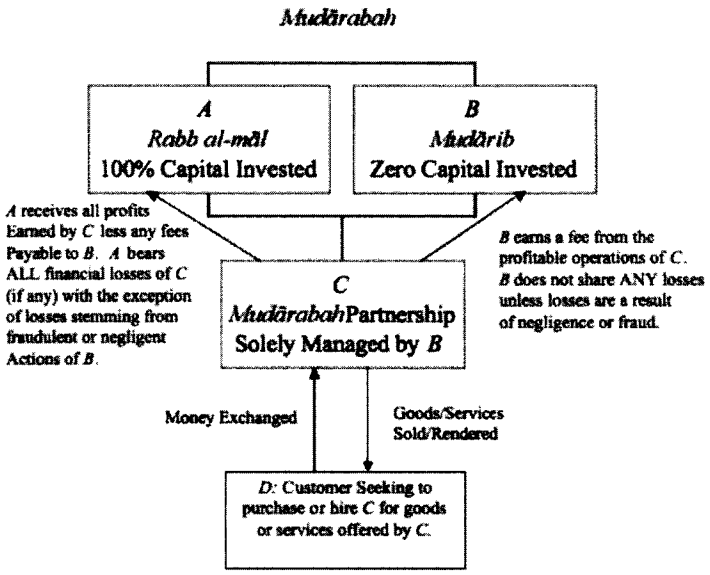

FIGURE 5. *Mudārabah* structure.

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[116] See "The Concept of Partnership: *Musharakah* and *Mudarabah*, Islamic Commercial Law and Contracts, Module II, Lesson 3" (working paper, Institute of Islamic Banking & Insurance, London, n.d.): 19-26.

[117] Ibid.

[118] See fig. 5. The *mudārib* concept is analogous to the *wakālah* agency contracts and modern limited partnerships, limited liability companies, and corporations. The *mudārib* is essentially the hired officer or manager of the new partnership contract, and is responsible for the day-to-day management of the business affairs of the partnership. The investors or *rabb al-māl* are responsible for the contribution of financial and/or fixed asset capital necessary for the partnership's existence and operation. Op. cit. 53n.

Two-Tier *Mudārabah*

Although the *mudārabah* partnership contract has been historically used for trade contracts, modern Islamic banks use the contract for banking operations in its two-tier system.[119] Instead of the investor and entrepreneur relationship, the two-tier *mudārabah* for banking is analogous to the depositor and bank relationship.[120] Two *mudārabah* contracts are executed: (1) a contract is executed between the depositor and the bank, where the depositor is considered the *rabb al-māl* and the bank is the *mudārib*; and (2) a separate *mudārabah* contract is executed where the depositor is still the *rabb al-māl* along with several other investors and the bank is the *mudārib*.[121] However, the second agreement articulates the distribution ratios of any profits earned from the investment of depositor capital.[122]

Similarly, when an Islamic bank utilizes the *mudārabah* contract for financing purposes, the traditional lender/borrower relationship is replaced by an entrepreneur/investor relationship. Thus, the entrepreneur seeking capital receives financing from the bank/investor, and profits and losses are shared in proportion to the

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[119] Ala-Maududī, *Economic System of Islam*, 161.

[120] El-Gamal, *Islamic Finance*, 138.

[121] "Islamic Commercial Law and Contracts: The Concept of Partnership *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 24-6.

[122] See fig. 6.

capital invested. However, the wholesale loss of the banks' capital is not borne by the entrepreneur; the entrepreneur is only responsible for the capital he or she invested.[123]

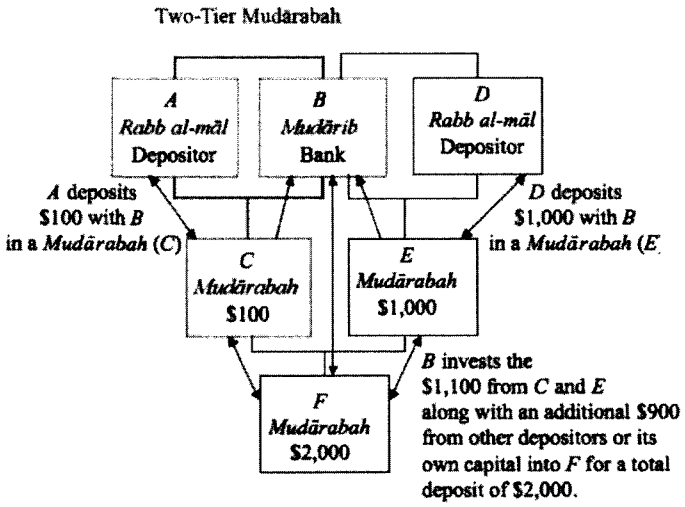

FIGURE 6. Two-Tier *Mudārabah* structure. The double arrow represents the potential for profits and losses; the single direction arrow represents the one-way direction of fees. In this case, *B* is the *mudārib* for all parties. However, *B* may also be exposed to losses from *F* because it potentially includes its own capital.

The *mudārabah* contract is used in the deposit/bank relationship, as well as in commercial financing activities. The deposits are collectively used for investment purposes in the hopes that the *mudārib* will be able to generate a profit from *rabb al-māl* deposits. In a similar way, the bank serves as the *wakīl* and/or *mudārib*, and is entitled to a fee for its investment management services; the depositors are entitled to share in the profits of the investments managed by the *mudārib*.

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[123] "Islamic Commercial Law and Contracts: The Concept of Partnership *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 27.

Conversely, the *mudārabah* contract may also be used for commercial lines of credit for business enterprises. Such credit facilities may be extended for the business activities of a company, or a specific business line—assuming that the accounting records can be segregated and the business is permitted by *sharī'ah*. In such a *mudārabah* contract, the bank is entitled to profits for capital invested, and the business enterprise or *mudārib* is entitled to a fee for its commercial activities, and any profits due from its own capital contribution in the project.[124]

Similar to other Islamic contracts, the *mudārabah* contract may also raise capital through securitization. Again, *sukkuk* certificates may only be sold in primary markets until the assets of the business enterprise acquire non-cash assets.[125] Both the *mushārakah* and *mudārabah sukkuk* certificates are analogous to common stock certificates, replete with voting rights and claims to profits and assets of the business enterprise.[126]

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[124] This is similar to the disproportionate profit distribution arrangement found in certain *mushārakah* partnerships.

[125] Once the business enterprise acquires non-cash assets, *sukkuk* certificates may only be sold in the secondary market. However, the price of the *sukkuk* certificates may not exceed the face or par value. See Bodie et al., *Essentials of Investments*, 63-8; and "Islamic Commercial Law and Contracts: The Concept of Partnership: *Musharakah* and *Mudarabah*, Module II, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 29.

[126] See Bodie et al., *Essentials of Investments*, 63-4.

Istijrār

An *istijrār* contract is characterized by repetitive selling of a specific or general category of goods or services.[127] In effect, it is similar to a blanket purchase order with shipment and delivery schedules occurring during the course of a mutually agreed upon predetermined given period of time.[128] For example, widget manufacturer *A* signs an *istijrār* contract with *B* to supply widget component *X*, for one year. The *istijrār* contract specifies that *A* will sell *X* for every widget it manufacturers for a period of one year, and the price of *X* will be determined after delivery of *X* on a monthly basis. Thus, an *istijrār* is a convenient commercial transaction enabling commercial enterprises the ability to determine pricing for each delivery, after each delivery, or after all deliveries.

However, if the *istijrār* contract is executed on the basis of a *murābaha* cost-plus contract, the rules for *sharī'ah* compliance are slightly different. First, it is important to note in a *murābaha* contract, *B* may either execute a *wakālah* contract with a party to procure *X* and the consequent *istijrār* contract, with bank financing in the form of a *murābaha*. Or, *B* may assign its bank as its *wakīl* thus requiring the bank and *B* to sign a separate *wakālah* agreement for the purposes of financing and purchasing *X*. In either case, a "master" *murābaha* contract would be required clearly articulating the responsibility of each party, at a profit margin mutually agreed upon by *B* and the bank.

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[127] "Islamic Commercial Law and Contracts Accessory Contracts: *Wakalah, Kafalah, Jua'lah, Tawarruq, Istijrar, Amanah*, Module II, Lesson 8" (working paper, Institute of Islamic Banking & Insurance, London, n.d.), 16-18.

[128] Ibid.

Moreover, each delivery will require independent contracts explicitly offering and accepting the terms of the consignment.[129]

Ju'ālah

A *ju'ālah* contract is unlike an *ijārah* contract insofar that a *ju'ālah* contract is equivalent to a reward for the execution or performance of a given task.[130] A *ju'ālah* contract requires the use of a *wakālah* agency agreement, whereby an individual is contracted to do such and such thing. For example, a *ju'ālah* contract may be used for the exploration and mining of natural resources. If the natural resource is found, the individual serving as an agent in the *ju'ālah* contract will be rewarded by receiving fixed remuneration based on a formula or sum established in the original contract. Whereas an *ujrāh* contract is strictly for wages of an employee.[131]

Moreover, the *ju'ālah* contract may be paid in advance or after completion of the assigned task. However, if the individual is unsuccessful in completing the assigned task, the pre-paid monies become a debt obligation for the individual. The contract may be terminated at any time, unless there are contrary provisions stated in the original contract. Similar to the principles of a *wakālah* contract, the promissor of a *ju'ālah* contract serves as an agent and trustee of the assets by the offeror. If the individual serving as an agent

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[129] Ibid.

[130] Ibid., 7-10.

[131] The Arabic term "*ujrāh*" is a root cognate of the word "*ijrāh*," which is used for referring to *sharī'ah* compliant lease arrangements. However, *ujrāh* refers to remuneration earned for individual physical labor. The similarities stem from the fact that in the *ujrāh*, wages are paid to the individual performing work; in an *ijārah*, the owner of an asset is paid for usufruct privileges, which are equivalent to wages or rental of artificial labor. Ibid.

in the *ju'ālah* opts to terminate the contract after work has been completed, he or she is entitled to wages for work performed until that point in time.[132]

Kafālah

A *kafālah* is a surety or guarantee from an individual attesting to a debt obligation. It is non-commutative in the sense that a guarantor of a debt is not eligible to receive any remuneration for their service because this would implicitly yield a profit for loan origination. More specifically, a *kafālah* is a promise by a third-party to repay the loan of another individual.[133] Let us assume that *A* borrows $100 from *B* for a period of one year. Additionally, *C* guarantees the $100 borrowed by *A* from *B* in the form of a *kafālah*. The following year, when the loan term has matured, *A* is unable to pay the loan principle of $100 to *B*; *C* is now legally obligated to satisfy the debt obligation of $100 to *B*.

Salām

A *salām* transaction is a forward sale permissible only for fungible commodity products.[134] In a *salām* sale, the producer or seller of a good may sell a fungible commodity product, with a fixed quantity, quality, price, place and time, to a buyer for

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[132] Ibid.

[133] Ibid., 13-6.

[134] This is similar to the *tawārruq* contract with the exception that the fungible commodity purchased is delivered at some later date in time as opposed to deferred payment. See "Islamic Commercial Law and Contracts: Future Sales: *Salam* and *Istisna'a*, Module II, Lesson 6" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 3.

cash payment in advance.[135] The producer or seller of the fungible commodity product is then obligated to supply the buyer with the fungible commodity product as specified in the *salām* contract.[136] The *salām* contract is similar to the forward sale contracts in conventional financial markets, with the exception that the *salām* contract introduces the element of risk on behalf of the buyer.[137]

In a bank context, a producer or seller of a given fungible product may enter into a *salām* contract to supply 1,000 kilograms of such and such quality of crops at a price of one dollar per kilogram, delivered to the bank's facility at time *T*.[138] the bank then pays $1,000 in advance to the producer/seller. If the market price of the commodity falls to $0.75 per kilogram, the financial loss of the transaction is borne by the bank. Similarly, if the price of the commodity increases to $1.25 per kilogram, the opportunity cost loss is borne by the producer/seller and the profit is the right of the bank. The *salām* contract may not be used for the forward sale of commodities that are considered money (i.e., gold or silver).[139]

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[135] Ibid., 3-6.

[136] Ibid.

[137] In conventional economics, the forward transaction is typically used as a hedge to eliminate risk. Cf. Ross et al., *Fundamentals of Corporate Finance*, 664-5.

[138] Again, in conventional economics, forward transactions similar to the *salām* contract involve other fungible goods including currencies. Although using *salām* for forward currency exchanges is not generally considered *sharī'ah* compliant, there is a debate as to whether using *salām* for non-tangible assets (e.g., *sukkuk*) is permissible.

[139] Commodities such as gold, silver, and other precious metals are considered money, and thus are not eligible for forward sale transactions. If these commodities were to yield a profit through forward or standard sale transactions, it would result in *ribā*.

If a bank enters into a *salām* contract, it is inexorably introduced to myriad financial and operational risks related to the transaction. The primary risks involved in a *salām* contract are: (1) default; (2) price volatility; (3) logistical or operational; (4) asset replacement risk; and (5) fiduciary.[140] If the producer/seller fails to fulfill its obligations as part of the *salām* contract, the buyer/bank is exposed to a financial loss. The default risk potential may include non-performance by the producer/seller, where the goods sold are not delivered at all, or issues may arise regarding the quality, quantity, place or time of delivery. Similarly, commodity price volatility is a real risk for the buyer/bank. If the price of the fungible commodity falls before the delivery date of the *salām* transaction, the bank is exposed to an unrealized financial loss, and thus is exposed to a level of financial risk resulting from price volatility.[141]

Considering banks are engaged primarily in financial transactions, the storage of purchased goods after delivery is also an operational and logistical risk. After delivery, the liabilities resulting from damage of goods because of improper storage is borne by the buyer/bank, and thus may pose logistical or operational risks. The buyer/bank is also subject to an asset replacement risk, especially if a "parallel" *salām* transaction is involved.[142]

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[140] "Islamic Commercial Law and Contracts: Future Sales: *Salam* and *Istisna'a*, Module II, Lesson 6" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 13-4.

[141] Ibid.

[142] Because Islamic law generally requires ownership risk in all financial transactions, the significant ownership risk in Islamizing forward sale transactions is very risky for Islamic banks. Ultimately, like conventional banks, Islamic banks are primarily engaged exclusively in financial transactions—not real assets. However, this is only the

Parallel *Salām*

For example, if the buyer/bank serves as a seller in a separate "parallel" *salām* transaction with another third-party buyer, the bank is obligated to deliver the fungible commodity goods as part of the "parallel" *salām* regardless of whether the buyer/bank's seller delivers the goods.[143] As such, the buyer/bank is also exposed to a fiduciary risk in the even that the original seller/producer fails to deliver the products that are to be resold in the second "parallel" *salām* contract.[144]

This type of parallel *salām* contract enables a bank to maintain liquidity—which is essential for fractional reserve banking operations—and also yields a profit from the forward sale. As with the *murābaha* and *istisna'ā* contract, the parallel *salām* contract may utilize the services of an agent through a *wakālah* agency contract to act on behalf of the bank to resell the fungible commodity goods. Thus, in the example above, *A* may serve as an agent to sell to *C* on behalf of *B*, if an executed and mutually agreed upon agreement exists between *A* and *B*.

Istisna'ā

Whereas the *salām* contract is limited to fungible goods, an *istisna'ā* is limited to non-fungible products that must be custom fabricated, produced or manufactured.[145]

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majority position; exceptions exist including Kuwait Finance House mentioned earlier in the *murābaha* contracts involving automobiles.

[143] "Islamic Commercial Law and Contracts: Future Sales: *Salam* and *Istisna'a*, Module II, Lesson 6" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 9-10.

[144] Ibid.

[145] Ibid., 14-8.

However, it is similar to the *salām* contract insofar that it is a forward sale; unlike the *salām* contract, the *istisna'ā* contract may be paid in installments as the construction, fabrication, or production of the good purchased progresses.[146] Neither the *salām* or the *istisna'ā* contracts are limited to the producer/manufacturer of the good; any individual or entity may be a seller of goods in these forward sale contracts.[147] Thus, a bank may serve as a seller of the asset or good in question, which becomes essential for a "parallel" *salām* or *istisna'ā*.

Qard

The practice of lending capital, and the concept of debt are two inexorable results of a disparate distribution of resources.[148] The unequal distribution of resources has plagued human civilizations since the beginning of the concept of private ownership. Islamic economic and financial models are similar, with the exception that pricing for such loans must eliminate the use of any *ribā* mechanism. A *qard* loan is more similar to a charitable donation or gift rather than a conventional loan, because the principal amount should be forgiven in the event the borrower is incapable of repaying the loan.[149]

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[146] Ibid.

[147] Ibid.

[148] Economics is the study of how to efficiently allocate capital in a given situation. Given the fact that market participants are not equal in a social economy, the possibility of loans and debts are inevitable. For example, one economics textbook defines the study as "the study of how people allocate their limited resources in an attempt to satisfy their unlimited wants." See Miller, *Understanding Modern Economics*, 4.

[149] The Qur'ān states that the debtors that face difficulty repaying their loans should be granted a reprieve: "If the debtor is in a difficulty, grant him time until it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew." (Qur'ān 2:280).

Dayn

The Arabic word *dayn* refers to a debt obligation; more specifically it is the abstract representation of monies owed to given party at a given date in time.[150] Examples of *dayn* include trade receivables of a firm or individual, or may also include a loan portfolio of a bank. Again, the Qur'ānic proscription of *ribā* in any form is strictly enforced, and thus the principal amount is generally the only sum due upon loan maturity.

However, within the prophetic tradition, we find that the repayment of loans often included a customary increase in payment in addition to the principal loan amount in the form of a gift.[151] This "gift" of repayment was considered a social convention of honest trade, and thus implicitly encouraged the practice of lending. Yet, such a repayment premium may not be included the loan contract. Inclusion of such terms and conditions would equate to *ribā* and would thus be considered void in *sharī'ah*.

Given the Qur'ānic suggestion to forgive loans to those incapable of repaying them, the likelihood of moral hazard in the Islamic Moral Economy seems likely. However, just as the Qur'ān endorses empathy and compassion to those in debt, it also conjoins great punishment to those who intentionally delay or refuse to repay a debt.[152]

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[150] "Islamic Commercial Law and Contracts: *Qard* and *Dayn* in Islamic Commercial Law, Module II, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 2.

[151] "Narrated Jabir bin Abdullah: I went to the Prophet while he was in the Mosque. (Mis'ar thinks that Jabir went in the forenoon.) After the Prophet told me to pray two Rakat, he repayed [sic] me the debt he owned me and gave me an extra amount." *Sahīh Bukhari*, Vol. 3, Bk. 41, No. 579.

[152] See Qur'ān 2:282. Similarly, the Ḥadīth literature also states the importance of repaying one's debt obligations: "Narrated Abu Huraira: The Prophet owed a camel of a certain age to a man who came to demand it back. The Prophet ordered his companions

Indexation

Indexation is a practice used to re-price loan portfolios in accordance with currency valuation changes and inflation throughout the course of the loan.[153] For example, if a loan is issued for $100 on January 1st when the exchange rate of one U.S. dollar is equivalent to 100 Japanese Yen, and later on June 1st the U.S. dollar decreases in value where the exchange rate of one U.S. dollar is 110 Japanese Yen, the above loan becomes less profitable on June 1st.[154] Thus, loan indexation is often used as a method to re-price the interest rates as a means of recalibrating the loan performance throughout the course of the contract.[155]

Within the Islamic Moral Economy, such mechanisms are prohibited because they attempt to eliminate any element of risk, and more importantly elements of *gharar* or uncertainty and/or speculation in the contracts. The future price or value of a given commodity is not determinable at the inception of a loan contract, and thus the repayment of the loan as a contingency of the given commodity's value is unreasonable. Any excess or change in the principal sum, including increases due to currency valuations, is arguably *ribā*.

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to give him. They looked for a camel of the same age but found nothing but a camel one year older. The Prophet told them to give it to him. The man said, "You have paid me in full, and may Allah pay you in full." The Prophet said, "The best amongst you is he who pays his debts in the most handsome manner." *Sahīh Bukhari*, Vol. 3, Bk. 41, No. 578.

[153] Rafi Khan, *Profit and Loss Sharing*, 69.

[154] Because of the depreciation in the U.S. dollar relative to the Japanese Yen, the loan becomes worth less—that is the purchasing power of the original capital lent decreases—on June 1st relative to its value on the preceding January.

[155] Rafi Khan, *Profit and Loss Sharing*, 69.

CHAPTER 5

TAKĀFUL: RIBĀ-FREE INSURANCE

According to conventional economics, along with a healthy banking system, the existence of an insurance system is necessary for economic activity.[1] The idea of conventional insurance may be summarized as a transfer of risk from the insured to the insurer in exchange for an insurance policy premium and an insurance payout respectively.[2] Essentially, the insurer promises to make the insured whole again through monetary payouts as agreed in the insurance policy agreement. Similarly, Islamic banks use a type of insurance or mutual guarantee called *takāful* to mitigate risk and hazard.[3]

Conventional Insurance Requirements

A conventional insurance contract must have several elements, which include: (1) good faith; (2) insurable interest; (3) proximate cause; (4) indemnity; (5) subrogation; (6) contract execution; (7) articulation of responsibility; (8) insurance policy; and (9) burden of proof.[4] Good faith refers to a mutual and honest disclosure of facts by the insured to

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[1] Assuming that the rule of law is observed, insurance is necessary in modern economics to mitigate potential losses stemming from unforeseeable disasters or events by transferring risk from one party to another.

[2] Mishkin and Eakins, *Financial Markets and Institutions*, 547.

[3] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 4.

[4] Ibid., 7-8.

the insurer that may affect the risk potential of insurer.[5] Insurable interest refers to a specific thing that is in the legal title or possession of the insured; if the insurable interest is a person, there must be a legitimate financial dependency between the insured and the insured's beneficiaries.[6] Proximate cause refers to the logical direct cause of an insurance claim event.[7] However, indirect actions are not causal events, and thus are not subject to insurance claim payouts.[8] Additionally, indemnity is the promise between the insurer to the insured requiring the insured to be returned to financial normalcy before an insurance claim event.[9] The term "subrogation" refers to the assignment of authority by the insured to the insurer to recover any damages from a third-party that causes damage to the insured.[10]

As with all commercial agreements, insurance policies require contract execution between the agreeing parties, whereby the responsibilities of both parties, and terms and

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[5] Ibid. Also see Mishkin and Eakins, *Financial Markets and Institutions*, 548.

[6] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 7-8.

[7] Ibid. Also see *Oxford English Dictionary*, 2nd ed., s.v. "proximate"

[8] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 7-8.

[9] Ibid.

[10] The legal definition of "subrogation" refers specifically to the assignment of authority and legal power from one party over to another to serve as a creditor. Ibid. Also see *Oxford English Dictionary*, 2nd ed., s.v. "subrogation"

conditions of the insurance policy are articulated in writing.[11] Similarly, the "articulation of responsibility" is an extension of the good faith element that is required by the insured, and is reinforced by the fact that the insurance contract may be rendered void if the insured negligently or intentionally fails to disclose relevant information to the insurer.[12]

The insurance policy is effectively the mutually agreed upon insurance contract, which articulates and stipulates the responsibilities and terms under which the insured expects financial protection, and the insurers' responsibility in protecting the insured in the event of an insurance claim event.[13] Finally, the "burden of proof" refers to the responsibility of the insured to notify the insurer in the event of a legitimate insurance claim; although the insured is responsible for notifying the insurer, it is not the insured's responsibility to prove loss in the event of an insurance claim event.[14]

For example, *A* can only insure item *B* if it is in the legal possession of *A*, or if *A* has some sort of legal usufruct privileges of *B*.[15] *A* cannot purchase an insurance policy for item *B* if it belongs to, and is solely used by *C*. Similarly, it is possible for a husband

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[11] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 7-8.

[12] Ibid.

[13] Mishkin and Eakins, *Financial Markets and Institutions*, 548.

[14] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 7-8.

[15] For example, a person could not purchase an insurance policy for a random stranger's home. In the event of damage to the home, it would be unlikely that the person would suffer any monetary damages. See Mishkin and Eakins, *Financial Markets and Institutions*, 548.

to purchase a life insurance policy for himself, listing the beneficiary of the policy as his wife and children, because his wife and children are financial dependents.[16] However, it is not possible for person *X* to purchase a life insurance policy for person *Y* when they are complete strangers, and have no direct or indirect familial or financial dependence relationship.[17] Similarly, if person *P* threw a ball to point *x* and then person *Q* threw the ball to point *y* causing material damage to person *R*, *P* is not responsible for the damages to *R*. Instead, *Q* is solely responsible because his action of throwing the ball to *y* is the proximate cause in this hypothetical scenario. These conventional insurance prerequisites are also used in Islamic insurance known as *takāful*.

Takāful

The term *takāful* did not exist during the time of Muhammad in seventh century Arabia.[18] The concept of insurance in its modern connotation was also non-existent at the time. However, a practice of mutual financial protection did exist in the form of *al-āqilah* where tribe members would contribute funds in a pool, and would payout funds to individuals or families for injuries or murders respectively.[19] The modern *takāful* utilizes

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[16] Ibid.

[17] Ibid.

[18] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 13.

[19] This pre-Islamic practice stems from the tribal strife that was rampant throughout Arabia. Several literary recount the bloodshed that arose from such strife. One entertaining example is the War of Basús, which narrates the vengeance that arose because a camel was let loose. Cf. Nicholson, *A Literary History of the Arabs*, 57-60. Also see "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module

this concept of mutual ownership as a communal emergency pool or fund for the community.[20]

The term *takāful* is a derivative of *kafālah*, which means to "take care of one's needs."[21] As such, the term *takāful* is a *sharī'ah* compliant way for individuals in a community to pool their resources to pay for injuries, accidents or deaths that are unforeseen.[22] Modern *takāful* models were not introduced until the 1970s in conjunction with Islamic banks that were funded by petro-dollar revenues.[23] *Takāful* is very similar to conventional insurance with exceptions that arguably make it *sharī'ah* compliant. For example, conventional insurance products are typically sold by for-profit financial institutions that invest in myriad financial instruments including *haram* investments (e.g., interest bearing instruments, investments in alcohol or porcine processing, gambling or pornography). However, *takāful* is structured as a mutual insurance company where the policyholders are also the owners of the *takāful* fund.[24]

VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 13.

[20] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 13.

[21] Ibid.

[22] Ibid.

[23] Wilson, *Banking & Finance in the Arab Middle East*, 67-8.

[24] "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 13. Also see Mishkin and Eakins, *Financial Markets and Institutions*, 550.

Like all Islamic financial products, the *takāful* fund is limited to *sharī'ah* compliant investment products and sectors. The primary difference between a conventional insurance company and a *takāful* operator is the *sharī'ah* compliant investment portfolio. Moreover, *takāful* is limited to the mutual insurance model that promotes profit-and-loss sharing models for the policyholders and shareholders.[25] This is an important distinction because conventional insurance firms operate as joint-stock companies where the stockholders—who are not necessarily policyholders—potentially benefit when insurance premiums exceed claims.[26] However, *takāful* is more similar to a mutual insurance company where the policyholders—who are also the shareholders—benefit from any surplus in the fund or suffer a loss in the event of a deficit in the fund.[27]

Similar to all Islamic financial institutions and products, the purpose of the *takāful* insurance model is not simply profit. Instead, it operates under the construct of Islamic

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[25] Mishkin and Eakins, *Financial Markets and Institutions*, 550.

[26] A joint-stock company is a limited liability fictitious legal entity (e.g., a corporation, public limited company, etc.) whereby its shareholders elect a board of directors, who in turn hire officers to manage the day-to-day affairs of the business. In the joint-stock model, managers and directors of the insurance firm have a fiduciary responsibility to earn the highest possible profit with the least amount of risk; the role of a moral or ethical framework is absent, with the exception of abiding by local laws and customs. Moreover, the shareholders are not necessarily the policyholders of the insurance company's insurance policies. Any surplus or deficit is borne by the stockholders, and does not benefit nor adversely affect the policyholders. Ibid.

[27] The mutual insurance company is cooperatively owned by the policyholders. Any surplus or deficit arising from the investment of the insurance premiums legally belong to the policyholders/shareholders. This is required in *takāful* because it prevents individuals or organization participants from potentially profiting unfairly from an insurance claim event. Cf. Mishkin and Eakins, *Financial Markets and Institutions*, 550; and "*Takaful*–Islamic Insurance: Concept, Objective and Basis of *Takaful*, Module VI, Lesson I" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 26-7.

morals and ethical values, and it is intended to promote a just society and economy of communal and mutual cooperation.[28] *Takāful* is one way for the larger community to help and benefit from their collective resources; individualism is shunned and communal financial responsibility is embraced. The objective of *takāful* is to a espouse a sense of social responsibility, cohesion and solidarity; *takāful* is meant to distribute concentrated risk from a single individual to the community, thereby mitigating any negative financial or social effects of an adverse risk/hazard or accident.[29] By mitigating risk, *takāful* inexorably engenders social stability, and serves as an efficient and permissible means of saving and mobilizing capital for productive purposes in an moral economy and society.

In *takāful*, the responsibilities of underwriting and management of *takāful* policies and funds is delegated to the *takāful* operator, who receives a fee for such services.[30] A *takāful* agreement must consist of two primary elements: *ijab* and *qabul* or "proposal" and "offer" respectively.[31] Additionally, the *takāful* agreement typically consists of four parties, where a single party may be considered twice (e.g., *takāful* participants are equivalent to *takāful* fund shareholders).[32] These parties include participants, an

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[28] Ibid.

[29] Ibid.

[30] The *takāful* operation works under the framework of a *wakālah* agency agreement. See Chapter 4.

[31] "*Takaful*–Islamic Insurance, Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 6.

[32] Ibid.

operator, insured parties, and beneficiaries.[33] The participants are individuals or organizations that participate or contribute funds into the communal *takāful* fund, and are analogous to policyholders in a conventional insurance model. The *takāful* operator is often a group of managers responsible for the day-to-day management of the insurance operations; responsibilities include *takāful* fund management, actuarial and underwriting, and other administrative duties.[34] The *takāful* operator earns a fee for the services rendered on behalf of the *takāful* fund.[35] The insured parties are individuals or organizations that have contractual coverage by the *takāful* fund (i.e., the *takāful* fund has a contract obligation to financially protect these parties).[36]

The participants generally serve the multiple roles of participant, insured and beneficiary. The beneficiary is an individual or organization that benefits from an insurance claim event; in the case of a family *takāful* life policy, the beneficiary may be the family of the deceased, in which case the participant could not be the beneficiary.[37] However, in the case of a general *takāful* automobile policy, the participant may be both

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[33] Ibid.

[34] The *takāful* operator is responsible for all business operations. Similar to the power of attorney arrangement of a *wakālah* contract, the operator is granted the legal authority to manage the funds and policy on behalf of the fund donors. Ibid.

[35] See Chapter 4.

[36] "*Takaful*–Islamic Insurance, Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 12.

[37] The family *takāful* policy is similar to a conventional life insurance policy. In the event of death, the decedent's beneficiaries, as stated in the *takāful* policy are paid from the *takāful* fund. Such payments are administered and managed by the *takāful* operator. Cf. Mishkin and Eakins, *Financial Markets and Institutions*, 552-5.

the insured and the beneficiary if fault for the insurance claim event (i.e., accident) rest on a third-party.[38]

As with all Islamic contracts, a *takāful* agreement must adhere to the rules of *sharī'ah*, which proscribe *haram* investment activities, including but not limited to *ribā*, *maysir,* and *gharar*.[39] All investment activities are subject to the guidelines of the Islamic Moral Economy, which proscribes exploitation of any individual or group.[40] The *takāful* agreement clearly articulates several criteria: (1) specialty condition; (2) cooperative condition; (3) mutual condition; (4) partnership condition; (5) investment condition; and (6) management condition.[41] The "specialty" condition refers to the mandate that the *takāful* operator must subscribe to the "cooperative" conditions as set forth in *sharī'ah*.[42] The cooperative condition is also closely linked to the concept of *tabarru* or donation of the *takāful* fund "premium" which is collectively pooled.[43]

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[38] This is effectively similar to a conventional automobile insurance policy. If the insured party is subject to an automobile accident, he or she is eligible to receive payment from the *takāful* fund, thus becoming a beneficiary of the *takāful* fund, while remaining insured by the *takāful* fund. Cf. Mishkin and Eakins, *Financial Markets and Institutions*, 558-9.

[39] Again, business activities that violate Islamic doctrines are also deemed impermissible within the Islamic Moral Economy (e.g., porcine food processing, alcoholic beverage production or sale, pornography, etc.).

[40] The ethical and moral precepts that establish the Islamic Moral Economy are rooted in honesty, reciprocity, and mutuality. See Chapter 1.

[41] "*Takaful*–Islamic Insurance, Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 8-9.

[42] Ibid.

[43] Ibid., 14-5.

Finally, like all Islamic financial institutions, the "management" condition states that a *Sharī'ah* Supervisory Board must audit the *takāful* operator on a regular basis.[44]

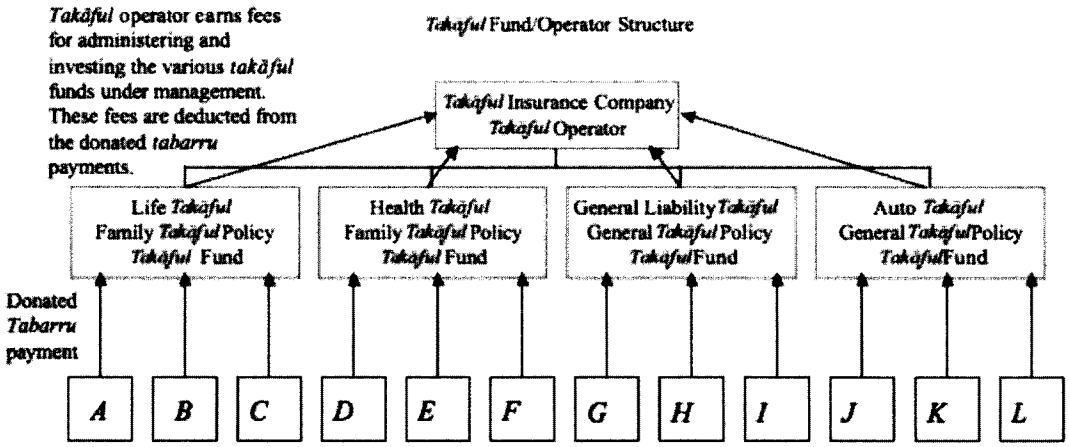

FIGURE 7. *Takāful* fund/operator structure. This diagram illustrates the separation of the operator and the funds, which is similar to the mutual insurance model. The insured parties are represented by variables *A* through *L* (and likely many more) who donate *tabarru* payments to the various *takāful* funds. Moreover, the number of insured parties is naturally large, reflecting the law of large numbers.[45] The operator earns its fees from the management of the various *takāful* funds' financial assets and the administration of actuarial functions needed by the respective funds.

Tabarru

In a *takāful* model, the role of *tabarru*, which is a donated "premium," presumably serves to avoid *gharar* or uncertainty—to a tolerable amount—and also

[44] See El-Gamal, *Islamic Finance*, 1.

[45] Op. cit., 55n.

emphasizes the mutual and reciprocal relationship between participants and insured.[46] The *takāful* fund participant/insured party donates money to the pooled fund, and in the event an insurance claim event arises, the fund will recompense the participant/insured party as per the *takāful* agreement.[47] By donating "premiums" into a collective pool, each *takāful* participant is contributing towards the well being of other *takāful* participants.[48] Most *takāful* policies are divided into two specific funds: (1) the participant fund; and (2) the shareholder fund.[49] This dichotomy is similar to conventional mutual insurance company structures.[50] The participant fund is the pool of capital that is used to payout insurance claim events. According to AAOIFI, the

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[46] "*Takaful*–Islamic Insurance: Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 14.

[47] The *takāful* fund models also require profit-and-loss sharing, whereby the policyholder/shareholder and the *takāful* operator have a vested interest in the success of the *takāful* fund. The emphasis on profit-and-loss sharing is integral to the *sharī'ah* compliance of most Islamic financial products, as it emphasizes reciprocity of potential profit and loss. Ibid. Also see Chapter 1.

[48] Although the *tabarru* payment may effectively serve the same function as the mandatory policy premium payment of conventional insurance, *tabarru* purports to be more altruistic in nature.

[49] "*Takaful*–Islamic Insurance: Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 17-22.

[50] Mishkin and Eakins, *Financial Markets and Institutions*, 550.

shareholder fund is used to establish the *takāful* operation, as well as finance the administrative and marketing operations of the fund.[51]

All distributions of surplus capital, if any, are derived from the shareholder fund, and they are distributed only after all expenses of the fund have been met. The shareholder fund may not be responsible for insurance claim payouts exceeding the aggregate shareholder capital.[52] In this case, the participants of the *takāful* policy must contribute additional capital to bridge the deficit. All surplus distributions are calculated at a year-end period, where all assets and liabilities are accounted for and valued at market prices. Based on this final accounting valuation, the *takāful* operator determines if the fund had a surplus, deficit or balance.[53] Similarly, the *takāful* operator is responsible for calculating the surplus or deficit by subtracting total insurance claims from the total participant *tabarru* collected for the same period, less any fees owed to the operator.[54] The operator of the *takāful* may also determine that reserves are necessary, and may allocate additional reserve capital for the upcoming year.[55]

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[51] "*Takaful*–Islamic Insurance: Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 17-22.

[52] Ibid.

[53] Ibid.

[54] Ibid., 23-4.

[55] The *takāful* operator may determine that a reserve—which is similar to reserve requirements in a fractional reserve banking model—may be required in anticipation of future policy payouts. Given the fact that much of the statistics used in actuarial sciences is based on a given population group (e.g., morbidity rates, crime rates, automobile accident rates, etc.), *takāful* operator are keenly aware of social health trends, social psychology, and other social science indicators. As with all insurance, such calculations

Additionally, there are three primary methods of surplus distribution in a *takāful* fund: (1) the surplus is distributed to all participants in proportion to their *tabarru* payment; (2) if a participant is the recipient of an insurance claim, then he/she is ineligible to receive any surplus distribution; (3) if a participant was the recipient of insurance claims exceeding his/her *tabarru* payment, then he/she is ineligible to receive any surplus distribution.[56] The purpose of the latter two methods of surplus distribution are in place to uphold the principle that participants may not profit from participating in an insurance paradigm.[57] Similar to the differences between *ribā*-free banking models and conventional interest-based banking models, the *sharī'ah* compliant versions are not solely driven by the profit motive. Instead, the Islamic models operate under a moral and ethical framework, and have an additional responsibility of espousing social equality, as determined by Islamic doctrine. As such, *takāful* policies are required to pay *zakat*.[58]

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involve the law of large numbers, which states "that when many people are insured, the probability distribution of the losses will assume a normal probability distribution, a distribution that allows accurate predictions." See Mishkin and Eakins, *Financial Markets and Institutions*, 550-1.

[56] "*Takaful*–Islamic Insurance: Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 23-5.

[57] Any profits derived from an insurance policy would likely be considered a product of excessive speculation and/or gambling. See Chapter 1.

[58] In an Islamic Moral Economy, wealth redistribution is a fundamental precept enforced by *zakat*. Payment of *zakat* is obligatory on an annual basis by Muslims if they meet certain net worth criteria (e.g., if an individual has 85 grams of gold or 595 grams of silver, then he or she is required to give one-fortieth of the gold or silver value in alms). See Sarwar, *Islām*, 74-5; and "*Takaful*–Islamic Insurance: Basic Elements and Operating Principles, Module VI, Lesson 2" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 29.

Mudārabah and *Wakālah* in *Takāful*

The *takāful* insurance model consists of two primary *sharī'ah* compliant contracts: *mudārabah* and *wakālah*.[59] The *mudārabah* model is typically a for-profit model whereby the *takāful* fund participants are the *rabb ul-māl* and the *takāful* operator is the *mudarib*. In this model, the *mudārabah* contract explicitly states the ratio of profit sharing between the *takāful* participants and the *takāful* operator. However, all expenses related to underwriting any *takāful* policies is the responsibility of the *takāful* participant and not the *takāful* shareholders.[60]

Although the *takāful* participants are also the effective shareholders of a *takāful* fund, it is possible for the *takāful* operator to have additional shareholders that are responsible for the marketing and administrative expenses necessary to establish the *takāful* insurance company.[61] Conversely, the *wakālah* model involves a *wakālah* or agency contract between the *takāful* operator and the *takāful* participants. In the *wakālah* model, the *takāful* operator is not eligible for profit sharing; instead, the *takāful* operator

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[59] "*Takaful*–Islamic Insurance: Business Models of *Takaful*, Module VI, Lesson 3" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 5.

[60] Ibid.

[61] The beneficiaries of the collective *tabarru* payments that comprise of the *takāful* fund are for policyholders only. However, the *takāful* operator is a separate legal entity that serves as a trustee or custodian of the collective *takāful* fund, and thus it may have separate shareholders that benefit from the *wakālah* agency fee earned from the management of a *takāful* fund. If the *takāful* fund is a for-profit organization with additional shareholders, it may also have a fiduciary responsibility to its shareholders and establishing founders. Ibid., 10-4.

is only eligible to receive a fee for the services of managing the underwriting and day-to-day management tasks of the *takāful* insurance company.[62]

Hybrid *Mudārabah* and *Wakālah* in *Takāful*

In addition to the *mudārabah* and the *wakālah* forms of *takāful* insurance, a hybrid or combination model has also been used as model for *takāful* insurance.[63] This hybrid or combination model incorporates elements of both the *mudārabah* and *wakālah* features, whereby the underwriting functions of the *takāful* operation are performed under the auspices of a *wakālah* agency fee-based agreement, and the investment portfolio management of the *takāful* participant funds is performed under a *mudārabah* profit-and-loss contract.[64] Both the *mudārabah* and *wakālah* models are typically used for for-profit *takāful* operations, and thus the hybrid or combination of *mudārabah* and *wakālah* model is also a for-profit structure.[65]

Family *Takāful*

The category of family *takāful* plan refers to insurance policies offered in a *sharī'ah* compliant manner that provide coverage for loss of income (i.e., an analog to conventional life insurance policies), health and medical insurance, mortgage insurance,

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[62] Ibid., 14.

[63] Ibid., 16-9.

[64] Ibid.

[65] Ibid.

"key man" insurance, and other insurance/savings programs designed to assist individual participants in retirement, education, or marriage financing.[66]

Family *takāful* plans are comprised of four primary subcategories: (1) individual, (2) group, (3), mortgage, and (4) credit.[67] The "individual" family *takāful* plan includes insurance policies similar to conventional life, health, and disability insurance products. However, unlike conventional insurance products, the "individual" category also includes products that finance *hajj*.[68] Additionally, it includes products that assist individuals in financing a child's higher education and/or marriage expenses.[69]

The "group" products are targeted toward organizations that need insurance products (e.g., "key man" insurance products, and retirement plans for employees).[70] Conversely, the "mortgage" product under the "family" *takāful* program includes a way for individual mortgagees to repay a mortgage on a primary residence in the event of death or disability.[71] Finally, the "credit" product is similar to the "mortgage" product

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[66] "*Takaful*–Islamic Insurance: Family *Takaful* Business, Module VI, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 20. Also see Mishkin and Eakins, *Financial Markets and Institutions*, 551-9.

[67] "*Takaful*–Islamic Insurance: Family *Takaful* Business, Module VI, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 20.

[68] *Hajj* is one of the five "pillars" of Islam and refers to the pilgrimage to Mecca, which every Muslim must make once in their lifetime (assuming that he or she is financially capable).

[69] "*Takaful*–Islamic Insurance: Family *Takaful* Business, Module VI, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 20.

[70] Ibid.

[71] Ibid.

insofar that it involves repayment of other debt obligations owed by the insured in the event of death or disability.[72]

Life Insurance

Generally, Muslim scholars have argued that life insurance is impermissible in a *sharī'ah* compliant framework because it violates basic Islamic theological tenets. Like Judaism and Christianity, Islamic doctrine posits that God is omniscient, omnipotent, and perfect.[73] Accordingly, many jurists perceive life insurance as a bet predicting one's death. Any attempt to hedge or "bet" against this time of death is considered by many to be a bet against God's wisdom and is contradictory to basic Islamic proscriptions of *gharar*.[74] Additionally, the methods and practices used to generate profits and increase capital sums in the life insurance industry have been subject of criticism by Muslim scholars. While many Muslim scholars take issue with the fact that insurance may deal with speculation, other such as Dr. Muzammil Siddiqi, chairman of the Fiqh Council of North America says, "I do not believe [conventional insurance] is gambling because the

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[72] Ibid.

[73] Belief in an omniscient, omnipotent, and perfect result in an absence of choice and free will. Moreover, given this set of assumptions, all of reality is predetermined and set on an irrevocable course. Assuming God exists, and assuming that God is omniscient, omnipotent, and perfect, then God knows everything. Moreover, what God knows to be true must be true. If what He knows to be true is not true, God is either not omniscient, or not omnipotent because God is unable to make what He knows come to fruition. See Qur'ān 2:165, 3:26, 6:16, 6:39, 10:99, and 57:22.

[74] See Chapter 1.

purpose of gambling is to hope you'll win . . . The person who gets insurance is doing it to avoid risk."[75]

Moreover, the practice of paying a life insurance premium with the possibility of receiving a larger face value capital sum is also considered an unnecessary increase or *ribā*.[76] However, many proponents of life insurance vis-à-vis family *takāful* argue that life insurance is not a "bet" or "hedge" against a person's life.[77] Instead, life insurance is a method where insured individuals can systematically save money over periods of time—with the assistance of pooled resources of other insured individuals that also share attributes with the insured individual—to provide financial support to the insured individual's family and financial dependents.[78]

Although conventional life insurance can certainly be considered impermissible in Islam, especially if the insurance utilizes *ribā*-based financial instruments or payout sums exceeding the policy premiums, the element of *maysir* or gambling is becoming less of an issue in *takāful* policies. This is further illustrated in *takāful* models where *ribā* is absent, and the insurance function is more socially equitable; in the *takāful* model, the sole

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[75] "Islamic insurance gains toehold in U.S." *Association of Islamic Banking Institutions Malaysia*, http://aibim.com/content/view/1777/77/ (accessed February 10, 2010).

[76] See Chapter 2.

[77] "*Takaful*–Islamic Insurance: Family *Takaful* Business, Module VI, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 18.

[78] Ibid.

impetus for existence is not profit, but a cooperative solidarity that requires individual participants to provide for the group.[79]

Participant's Special Account

The *takāful* insurance model requires funds to be held in two separate accounts: (1) the Participant's Special Account (PSA); and (2) the Participant's Account (PA).[80] The PSA includes funds that have been irrevocably donated as *tabarru* for a given period's expected insurance claim payout.[81] On the other hand, the PA includes policy premiums paid throughout the course of the policy period, and accumulates investment income.[82] In the even that a participant wishes to surrender his/her policy prior to maturity, the participant is only eligible to receive a repayment of the PA funds.[83]

The PSA funds are *tabarru* donations and are not refundable. Moreover, the PSA fund is used exclusively for the communal pool of insurance claim payments. This is done to avoid *ribā*, as *tabarru* is fundamental to ensuring that *takāful* does not unintentionally incorporate *ribā* in the insurance claim payments. A *tabarru* payment is a donation made by the participant—and the PA to the PSA—with no expectation of

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[79] See Chapter One.

[80] This is in addition to the primary difference between the participant's account and the shareholder account. See "*Takaful*–Islamic Insurance, Family *Takaful* Business, Module VI, Lesson 4" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 22-3.

[81] Ibid.

[82] Because the *takāful* operator functions under a *wakālah* contract, and the operator is responsible for the investment of *tabarru* funds, all PSA income is charged an administrative fee payable to the operator. Ibid.

[83] Ibid.

return. The form of a donation and the lack of expectation inexorably results in the absence of contractual *ribā* in the event that a participant receives an insurance claim payout that exceeds premiums paid because the PSA fund includes monies granted as gifts from other individual participants' *tabarru* donations.[84]

General *Takāful*

The term "general" *takāful* refers to insurance products that are non-life insurance policies.[85] More specifically, "general" *takāful* policies involve insurable interest that is not based on individual life; instead, the insurable interest is a tangible asset (e.g., automobile, watercraft, building, business, etc.).[86] As such, the "general" *takāful* does not incorporate the investment elements that are present in the "family" *takāful* products. There is no differentiation between a PSA and a PA with regard to *takāful* accounting. Irrevocable *tabarru* payments between the PA and the PSA are also absent.[87]

However, irrevocable *tabarru* payments are present with regard to the policy "premium." For example, if a "general" *takāful* automobile policy is purchased, all policy "premiums" or *tabarru* payments are irrevocably donated to the PA fund.[88]

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[84] Ibid.

[85] "*Takaful*–Islamic Insurance, General *Takaful* Business, Module VI, Lesson 5" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 1.

[86] Ibid., 2.

[87] Ibid., 3.

[88] Ibid.

Unlike the "family" *takāful* products, which are often for longer terms, the "general" *takāful* products are typically issued for one year periods.[89]

Similar to the "family" *takāful* products, the "general" *takāful* products also require a cooperative aspect that emphasizes group solidarity within a specific population (e.g., businesses, automobile drivers within a specific age group, etc.).[90] As such, the day-to-day business functions of a "general" *takāful* insurance fund and company are not entirely dissimilar to the "family" *takāful* fund and company. Both require that an operator serve as the underwriter and investor of the policies and funds. However, unlike the "family" *takāful* products, the "general" *takāful* products do not permit the accumulation of premiums.[91] Additionally, any underwriting surplus is typically not refunded to the participant; instead, it is typically applied to the renewal of the policy for the upcoming year.[92]

Re-*Takāful*

Reinsurance is integral to the health and wellbeing of the conventional insurance industry.[93] Often, a single insurance firm is not capable of insuring something independently, where the use of reinsurance or coinsurance is necessary to bind coverage. Reinsurance allows an insurance firm to mitigate its risk where a concentration of risk for

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[89] Ibid.

[90] This is meant to induce the law of large numbers. Op. cit., 55n.

[91] "*Takaful*–Islamic Insurance, General *Takaful* Business, Module VI, Lesson 5" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 8.

[92] Ibid.

[93] Mishkin and Eakins, *Financial Markets and Institutions*, 559.

a specific sector is unfavorable.[94] In effect, the practice of reinsurance and retrocession, which is the reinsurance of reinsurance, allows an insurance company to mitigate and effectively diversify risk in any one sector.[95]

As stated earlier, the role of reinsurance is not exclusive to conventional insurance firms; *takāful* insurance companies also face similar problems, especially considering most *takāful* firms are newer and significantly small than their conventional counterparts. As such, *takāful* operators may elect to purchase a re-*takāful* policy from a re-*takāful* operator, whereby the re-*takāful* operator bears the excess portion of the risk. The two parties: the *takāful* operator and the re-*takāful* operator then share the profits (or losses) earned from the investment of the funds. Effectively, reinsurance enables stability in the insurance industry, and by extension the larger financial services industry, and the stability of economic societies.[96]

The re-*takāful* operator basically insures a *takāful* insurance company by binding insurance coverage on the excess risk that a *takāful* company cannot cover. Thus, it effectively becomes a coinsurer for a specific insurance portfolio. The re-*takāful* operator's objective is to: (1) promote stability amongst *takāful* operators and prevent excessive adverse underwriting events; (2) stabilize claims ratios by engendering stability amongst *takāful* operators; (3) mitigate and minimize risk from any single concentration of risk; (4) increase the capacity for coverage throughout the *takāful* insurance industry;

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[94] Ibid.

[95] "*Takaful*–Islamic Insurance, *Retakaful* or Reinsurance, Module VI, Lesson 6" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 11.

[96] Ibid., 4-5.

(5) promote profitability amongst the *takāful* and re-*takāful* industry by engendering stability amongst the financial performance of the firms and claims ratios; and (6) serve as a cooperative consultant to other *takāful* and re-*takāful* operators.[97]

Because of the relative infancy of the *takāful* and re-*takāful* industries, *takāful* and re-*takāful* operators typically seek reinsurance or retrocession coverage from conventional insurance firms.[98] Despite this need, AAOIFI requires conventional firms that reinsure *takāful* policies adhere to Islamic legal constraints.[99] Thus, if a *takāful* or re-*takāful* operator is required to acquire reinsurance or retrocession coverage from a conventional insurance firm, commissions may not be accepted as payment because it nullifies the reciprocity of risk between the operator and participant.[100]

Instead, it may only participate in profit-and-loss sharing between the contracting firms (i.e., *takāful* and reinsurance company, or re-*takāful* and retrocession company). Additionally, any interest income earned through reinsurance or retrocession must be "purified."[101] Thus, most *takāful* and re-*takāful* operators have a *Sharī'ah* Supervisory Board that counsel the operators with regards to *sharī'ah* compliant means of investing participant capital and mitigating insurance risk.[102]

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[97] Ibid., 6-7.

[98] Ibid.

[99] Ibid.

[100] Ibid., 11.

[101] Ibid.

[102] Ibid., 11-5.

Sharī'ah scholars argue that *takāful* and re-*takāful* firms should slowly discontinue the practice as the Islamic financial industry grows in strength and depth. However, if a *takāful* or re-*takāful* operator contracts with a conventional reinsurance or retrocession firm, several conditions must be met as per AAOIFI's current rules: (1) the arrangement must cause any harm to the economic interest of Muslims or the Islamic financial markets; (2) capital outflows from the *takāful* fund are discouraged; (3) the quantum of liability insured must be thoroughly examined; (4) all reinsurance and retrocession should be calculated on a net premium basis (net of tax liabilities); (5) contracts between the two firms should be analyzed annually with the intention of reducing conventional reinsurance or retrocession partnerships; (6) stipulate a restriction on *sharī'ah* compliant investments (e.g., *ribā*-free and *halal* instruments), or purify income; and (7) the use of a *Sharī'ah* Supervisory Board.[103]

Insurance Governance

Corporate governance for a *takāful* operator is different in comparison to a conventional insurance company, because the *takāful* operator is not only subject to the legal framework of a specific jurisdiction, but it must also comply with Islamic laws. Independence requirements generally include the individual members of the *Sharī'ah* Supervisory Board to refrain from ownership interests in the subject firm, or participants in the subject firm's *takāful* funds. Although the *Sharī'ah* Supervisory Board may be an internal part of a *takāful* operator, many critics have argued that a *Sharī'ah* Supervisory

[103] "*Takaful*–Islamic Insurance, *Retakaful* or Reinsurance, Module VI, Lesson 6" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 11-6.

Board should be an independent supervisory body similar to a public accounting firm that conducts a financial audit.[104]

Additionally, AAOIFI also requires an abstention from individual supervisors from holding *takāful* policies with the subject *takāful* operator.[105] The role of the *Sharī'ah* Supervisory Board is not only to provide regulatory oversight in terms of a *sharī'ah* compliance and religious law, but as a faith-based moral and socially just model, the *takāful* operator needs to be fiscally solvent to provide the service promised to its stakeholders. Thus, the *Sharī'ah* Supervisory Board in conjunction with other regulatory bodies is required to monitor and ensure that a *takāful* operator has the solvency and financial strength to provide insurance products and service to its existing and potential participants.[106]

Similar to the problem faced by Islamic banks, *takāful* operators are often subject to the conventional rules and regulations governing insurance firms. Because conventional insurance models are drastically different in their organization structure and product offering, the rules and regulations are often not applicable to the *takāful* models. To remedy this situation, many proponents of Islamic finance have lobbied for new rules and regulations specifically designed for the governance of *sharī'ah* compliant firms. Unlike *takāful*, conventional insurance firms often invest their premiums in interest-

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[104] "*Takaful*–Islamic Insurance: Corporate Governance, Regulation and Supervision of *Takaful*, Module VI, Lesson 7" (working paper, Institute of Islamic Banking and Insurance, London, n.d.), 1.

[105] Ibid., 1-2.

[106] Ibid., 4.

bearing debt instruments that mature in conjunction with a corresponding policy or annuity.[107]

Moreover, conventional insurance firms have the luxury of large and highly liquid debt markets.[108] Conversely, Islamic financial markets are much smaller in volume and size in comparison, and thus the liquidity often required by a *takāful* operator is unavailable.[109] Islamic financial products rely upon profit-and-loss sharing models, which intuitively require investments in equities. Equities, on the other hand, are significantly more volatile in terms of price than debt instruments.[110] More importantly, a *takāful* operator functions with dual account on family products: a participant fund and a shareholder fund. In a conventional insurance model, the dual system is non-existent, and thus conventional regulators often require additional education with regard to *takāful* operations.

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[107] Mishkin and Eakins, *Financial Markets and Institutions*, 551-9.

[108] Ibid.

[109] Although optimistic estimates place the total value of Islamic banking and finance industries at $500 billion, the global economy is typically valued at several trillion dollars. The Islamic banking and finance sectors remain a very small portion of the overall financial economy. See Carla Power, "Halal: Buying Muslim," *Time Magazine* (May 25, 2009), http://www.time.com/time/magazine/article/0,9171,1898247,00.html (accessed February 10, 2010).

[110] Equities are generally considered riskier than debt instruments because equities such as common stock have residual claims. This means that in the event of insolvency or liquidation, the common stockholder will be the last class of stakeholders to be repaid, potentially leaving the possibility that all of the investor's money will be lost. See Bodie et al., *Essentials of Investment*, 41-2.

CHAPTER 6

CONCLUSION

Predicated upon a singular God consciousness that instills moral and ethical values upon a society, the Islamic Moral Economy is more than interest-free money, banking and insurance. The Islamic Moral Economy is a utopian *ribā*-free universe where all unfairness and injustice are removed from reality; it promotes a reality that incorporates elements of the free market economy vis-à-vis the price function of supply and demand, as well as socialist elements of mutual ownership and care fostered by *takāful*.

It is important to distinguish modern "Islamic" banking from the Islamic Moral Economy. The former is simply a mechanical model that eliminates the role of financial interest and usury from financial instruments and practice, sometimes only superficially. While many Muslim economists argue that Islamic banking, finance and economics are inherently pragmatic because of the theological position that Islam addresses the practical needs of people for all time; the Islamic Moral Economy is arguably and potentially inextricably connected to utopian ideals. The Islamic Moral Economy assumes that all market participants are honest, generous and sincerely interested in the wellbeing of the community—values that are not always exercised by market participants in the real world.

Ultimately, Kuran and El-Gamal may be correct in their disenchantment with Islamic banking, finance and economics. The financial instruments in use today by Islamic banks and insurers are not fundamentally different from their conventional non-Islamic counterparts. Instead, the contract language is changed superficially to incorporate various Arabic terms that purport to adhere to some sort of Islamic authenticity. Moreover, governing bodies such as AAOIFI are not only subject to the problems of orthodoxy, but their "*sharī'ah*" compliance is often predicated on medieval jurisprudence that was never exposed to the complex financial systems in place today. Finally, it is important to reiterate that the authoritative positions of *sharī'ah* permissibility or lack thereof, are not my own determination; rather, they are applications generally accepted definitions of *ribā*—which are accepted by AAOIFI—applied to the existing instrument repertoire of Islamic banks and financial institutions.

Given that the entire "Islamic" banking and insurance industries are predicated upon the mainstream view that *ribā* is equivalent to all forms of interest and unfair or unwarranted financial increase, it appears that *ribā* is ubiquitous and inescapable. Although some instruments such as the *mushārakah* appear to embrace Islamic values of profit-and-loss reciprocity, the *murābaha* or cost-plus contract only semantically removes the role of interest. Yet, even the *mushārakah* is not completely devoid of interest if benchmarking is used for pricing purposes.

Based on Islam's emphasis of profit-and-loss reciprocity, the current *mudārabah* and *qard* models of Islamic depository relationships that guarantee a fixed rate of return simply do not comply with principles of Islamic economics. If each party must be exposed to existential risk, and neither party may be guaranteed protection from loss or a

fixed rate of return, the *mudārabah* and *qard* models of Islamic banking simply do not work. Moreover, as explained in Chapter 2, all Islamic banks continue to operate within the fractional reserve banking system, which results in the "creation" of money. Again, if *ribā* is defined as an illogical or unnecessary increase, or an unequal exchange, this too, is a violation of the rules of Islamic economics.

The role of money must also be addressed in the Islamic Moral Economy. Money cannot be a commodity itself that is traded for profit. Modern currency speculators in the foreign exchange market profit from the trade of money; this is problematic from an Islamic perspective. More importantly, the global economy is dependent upon fiat currencies; asset-based currencies were abolished in 1974.[1] If the Islamic conception of money were simply a mode of exchange, which cannot be profited from—either through fiat currency value appreciation or seigniorage—then the Islamic Moral Economy would probably have to disengage from global economic activity. Moreover, the currency would have to be an asset-based currency, an endogenous money system, or a hybridized combination of the two as described in Chapter 3.

At this point, I should point out that my recommendations are simply models of compliance. These recommendations do not purport to be more efficient than current interest-based or *ribā*-full models. Instead, these suggestions simply address the myriad constraints that Islamic economics places on society. Indeed, the Islamic Moral Economy is left with two primary options with regard to banking and money: (1) depository funds are kept in one hundred percent reserve requirement accounts which serve as cash, where the banking institution earns a fee for the storage of funds, and for

[1] See Chapter 3.

acting as a clearinghouse for all checks written on the account; and (2) an investment fund segregated by industry and risk level where the bank serves as the financial intermediary responsible for the prudent deployment of community capital in local entrepreneurial ventures.

More specifically, because *ribā* is almost unanimously considered forbidden in Islam, an Islamic bank would have to cease operating under the conventional fractional reserve banking system. The currency used by the market economy would need to be asset-based and collateralized by a basket of natural resource commodities (e.g., gold, silver, oil, land, etc.) to hedge price volatility stemming from any one commodity component. Instead of depositors receiving profit or interest from the bank, depositors would pay a fee for the storage of their funds. If the depositor wishes to potentially earn a return on excess financial capital, he or she may elect to invest it with the bank—who would then act as a financial intermediary by conducting due diligence for its depositors for a fee—into the local or broader economy.

If the principles of socialism are communal ownership in all assets of the community, then the Islamic Moral Economy arguably promotes such an objective. Yes, private ownership has never been shunned in Islam. However, the ethical value of mutual care is equally prevalent in Islam. The Islamic Moral Economy is predicated upon mutual cooperation and social investment; community development is fundamental to this principle, and thus community capital would likely be reinvested in community entrepreneurial ventures and public projects.

The community investment principle would not preclude members of the Islamic Moral Economy from investing in large-scale public projects. Large-scale projects

requiring financing would be executed through a concerted effort by several community banks collectively investing their funds for a common purpose. Again, the Islamic Moral Economy would exercise both market capitalism and socialist characteristics insofar that people and thus the government are the effective owners of all real and tangible assets in a community.[2]

This emphasis on mutual and reciprocal care is also found in the mutual *takāful* insurance mechanisms currently used by several Muslim countries and communities. It is the responsibility of the community to care for all members of society or *ummah* in the event that any one individual is incapable.[3] Through this collectivization of financial capital and the mobilization and deployment of said assets for community economic development and care, we see that the Islamic Moral Economy would be very similar to the utopian socialist model of egalitarianism and communal care. The primary difference, of course, being the fundamental role of God consciousness.

It naturally follows that the constraints placed on economic activity by Islam appear to be utopian in nature. It is not practically possible to ensure that all market participants are honest, generous and considerate. Neither is it practical to assume that all market participants have equal knowledge about prices in the marketplace. Indeed, the Islamic Moral Economy, like Marx's communism, has a great deal of appeal:

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[2] This is similar to the Thompson and Scott's vision of a utopian and moral economy in England. See Chapter 1.

[3] The Qur'ān is very specific about the community's responsibility to care for orphans, widows, elderly, and needy. See Qur'ān 2:83, 2:177, 2:215, 4:8, 4:36, 8:41, 9:60, 17:26, 22:28, 24:22, 30:38, 59:7, and 93:9. Moreover, the mutuality espoused by Islam is not only the modus operandi of *takāful*, but it is also the impetus behind the mandatory alms known as *zakat*. See Sarwar, *Islām*, 74-5.

elimination of hunger, poverty, mutual care, and so forth. However, the problem is that the Islamic Moral Economy and Islamic economic doctrines in general assume that each market participant will exercise the basic principles and values expected of Muslims. However, what is expected (i.e., the ideal) and what actually occurs (i.e., reality) are often very different.

By taking labeling the Islamic Moral Economy as utopian, many would argue that it is impossible to implement. In fact, this is not very far from the truth. Such critics are probably taking a religious position because Islam is considered a very practical religion. If the Islamic Moral Economy is utopian, then it is clearly insoluble with the pragmatism that is believed to be inherent in the divine message of Islam. However, as a student of religious studies, I hope that I am bracketing out all personal opinions and judgments. If the Islamic Moral Economy places restrictions on money, banking and insurance as we have discussed, and it expects impeccable moral character from all market participants, it is certainly not very practical.

The Islamic Moral Economy and the values it stands for is certainly commendable and notable. But, it is not necessarily practical or feasible. Similarly, if an Islamic country wanted to implement an economic system predicated upon egalitarianism, mutual care, and the absolute elimination of *ribā*, it would have to be insular. Trade with non-Islamic partners would not be possible. In which case, one must ask if trade with non-Muslims is insoluble with Islamic doctrine? Historically, this has not been the case. In

fact, when Muslims controlled the Iberian Peninsula, trade with Christians and Jews was not only common it was normative.[4]

Ultimately, the Islamic Moral Economy is an idea. As an idea, it must be tested. For us to definitively say that the Islamic Moral Economy and the absolute proscription of *ribā* is good requires substantive data, which qualifies the statement. While modern Islamic banks and insurers were established under this aegis, I fear they have now veered off course. It is very easy to agree with Kuran and El-Gamal's position that virtually all Islamic banking, financial and economic contracts only superficially adhere to Islamic law. Instead of embracing the Islamic Moral Economy's spirit of reciprocity, honesty and mutual care, the industry has become obsessed with ritualistic elimination of the word "interest" and "usury," which has resulted in an arguably less efficient and not-Islamic system of money, banking, and insurance.

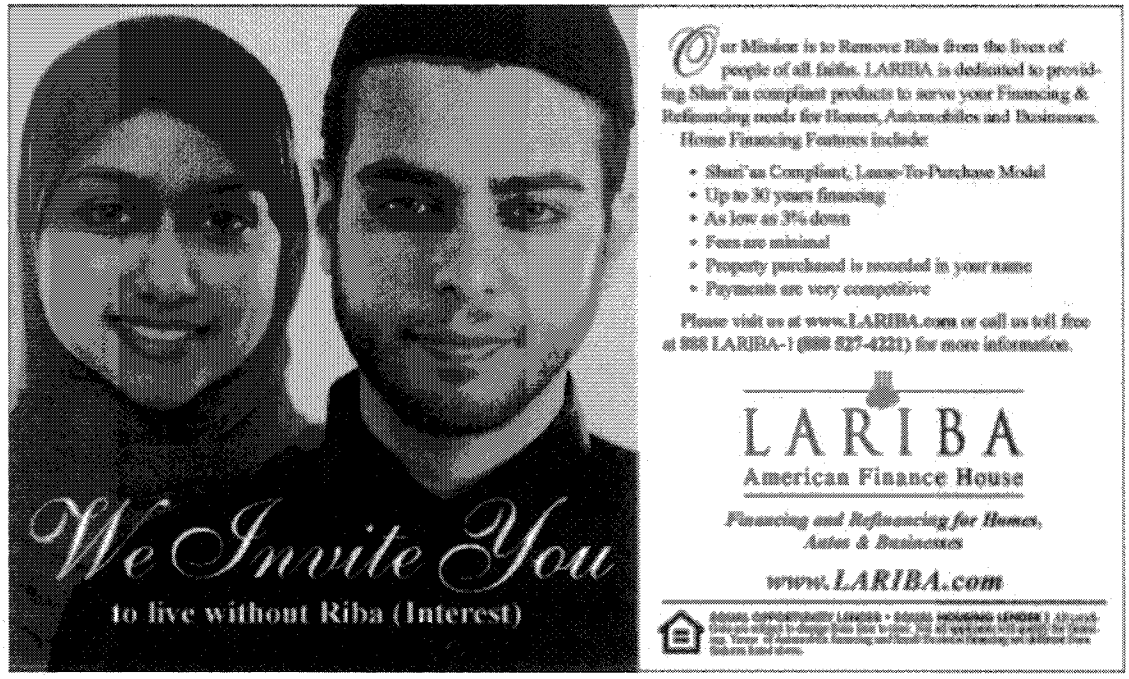
[4] Karabell, *Peace Be Upon You*, 136-56.

APPENDICES

APPENDIX A

LARIBA ADVERTISING CAMPAIGN

LaRiba Advertising Campaign



The above advertisement appears in several news publications catered towards the Muslim-American public. Notable publications include *Southern California InFocus* and *Pakistan Link*. Similar to secular advertisements, the LaRiba campaign not only describes the company's products and services, but it also appeals to its target market by selling a lifestyle; in this particular instance, a culturally Islamic one underpinned by the Islamic doctrine of proscribing *ribā*. Critics such as Timur Kuran certainly make a valid point when they argue that Islamic banking may serve to strengthen cultural ties instead of solely being a means to mechanically eradicate *ribā* from the lives of Muslims in the Western world.

APPENDIX B

LIST OF ISLAMIC BANKS IN THE UNITED STATES

List of Islamic Banks in the United States[1]

Islamic banks in the United States: breaking through the barriers

Abdi Shayesteh, senior associate with the King & Spalding law firm in New York and a member of the Middle East and Islamic finance practice group, takes a look at what the US Islamic finance market has to offer.

The question of whether US regulators will be accommodating towards the growth of Islamic banking is now moot. Today, the United States is home to at least nineteen providers of Islamic banking products and services, including retail banks, investment banks, mortgage companies, investment advisors and community-based finance providers *(see the chart on pp38–39)*. With the estimated number of Muslims living in the country ranging from three to eight million (based on various private surveys) it now appears that real market demand and viability for offering Islamic banking products and services in the US either exists or is being developed and penetrated by these early-to-market providers.

Given these positive factors and the push by Gulf-based Islamic institutions to establish a strong presence in the United Kingdom, their absence from the US is puzzling. One explanation is that Gulf-based Islamic institutions are most likely suffering from a mirage of barriers and a set of misunderstandings when it comes to entering the US market.

One significant mirage relates to a misperception that US regulators are not interested in the growth of Islamic banking. Unfortunately, many believe that they are resistant towards the growth of the industry in the US, just because the country's officials are not as vocal or direct about expressing their interest as their counterparts are in the UK. Many Gulf bankers have noted that they would like to hear the same type of 'cheerleading' speeches like the ones made by Gordon Brown (UK's prime minister) or Kitty Ussher (formerly a Treasury minister and now parliamentary under secretary at the Department of Work and Pensions) in recent years – where London has been declared to be 'the next global hub for Islamic banking'. The important thing to note, however, is that just because US officials don't offer the same type of direct declarations, it does not mean that they are not interested in accommodating the growth of the industry. The reality is that US regulators have significant constitutional, policy and economic reasons to accommodate the growth of Islamic banking in the country. From a constitutional perspective, US regulators are (and will continue to be) involved, in part, because it is their duty as public servants under the US Constitution to make sure they accommodate the free exercise of religion, even as it relates to banking practices. There is a limit to this accommodation, however, in that the constitution also prohibits the promotion of a particular religion over another by a public official or agency. This limit may explain why we don't see the same type of direct encouragement from US officials like the ones witnessed in the UK.

From a policy perspective, US regulators may have an interest in accommodating the growth of Islamic banking as a means of providing banking services to the unbanked population. For example, many Muslims in the country currently do not bank at a conventional bank because doing so violates Shari'ah restrictions on the receipt and payment of interest. US regulatory involvement

with Islamic-centric banks or banks that seek to offer Islamic products and services would be seen as a means to enhance community development activities in such unbanked segments.

Finally, from a macro-economic perspective, the United States, like other western countries, has every interest in attracting Gulf-based capital that has built up over the last five years due to the bullish oil market. Accommodating Islamic finance may be one way to entice this capital to come back to the country after some left post-9/11.

One significant misunderstanding that is deterring some Gulf-based Islamic institu-

[1] This is an authorized duplication of Shayesteh, *New Horizon*, 36-9.

tions from entering the US market relates to the complexity of the US regulatory regime. So far, the investors launching Islamic finance operations in the UK predominantly had to deal with one regulator, the Financial Services Authority (FSA), which is the country's primary regulator of banks, insurance companies, securities dealers and other financial institutions. Unfortunately, many Gulf bankers mistakenly think that they only need to deal with one regulator when it comes to managing their entire chartering process in the United States as well. But this is not the case. Depending on the types of products and services a prospective bank would offer, an applicant would likely have to deal with a variety of US regulators, including the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, state banking authorities, the Internal Revenue Service and the Securities Exchange Commission. This misunderstanding has often led to confusion and frustration as well as a lot of wasted time and resources for many prospective applicants, sometimes leading to unnecessary suspicion and a mistaken perception that the US authorities are being deliberately unaccommodating and not interested in facilitating any Islamic banking-related applications. In the light of this, it would be prudent for the applicants to first engage with the right advisors that have deep experience in understanding both Shari'ah law and US laws and bank regulations. Equally important, applicants should develop a thorough business plan early on in the process that identifies the range of products and services they want to offer, as this will ultimately dictate the relevant authorities to work with.

Another area of misunderstanding relates to the actual time and investment involved in launching a Shari'ah-compliant financial institution in the United States. A conventional bank application there may typically take up to a year and a half to be approved due to the various regulatory approvals that may be needed. Launching a bank that has Shari'ah components may take up to two years or more depending on the types of products and services the institution plans to offer. Many Middle East investors have a difficult time understanding this and are often discouraged when they learn about the potential lengthy timeframes. Of course, no application is the same and there are no exact timescales to go by, but many are often surprised that any application could take longer than six months. If it took the Islamic Bank of Britain in the UK almost two years to get all of the right approvals in place, why should it take less time in the US?

Fortunately, we are finally beginning to see more potential investors from the Gulf region getting a deeper understanding of the situation and gaining the necessary knowledge to overcome the mirage of barriers and take advantage of the upcoming opportunistic US market. Over the last few months, US legal and consulting firms have witnessed a surge in interest from Gulf-based institutions and individual investors wanting to venture into the United States to make Shari'ah-compliant investments or to offer Shari'ah-compliant banking products and services — both at a retail and wholesale level. There is an increasing realisation that the perceptions about the US regulatory environment regarding Islamic banking were simply incorrect. This, of course, is attributable to the fact that the country's Islamic finance market is now more populated with players and offerings than it used to be. More and more investors are also recognising the opportunities that will exist for them in the American market by mid to end of 2009. Many are seeing this downturn as an opportunity to utilise the down time to build the appropriate infrastructure, obtain the necessary (and time consuming) regulatory approvals, and establish the important relationships with the right advisors, service providers and managers, so that all the right pieces are in place by the time the US economy picks up.

Given the positive financial position that many Islamic financial institutions (including Gulf-based ones) are reporting to have in this current global financial crisis (as compared to their conventional counterparts around the world), the timing could not be more perfect for them to take the industry to the next level in the United States. While initially the analyst reports were mixed concerning how Islamic financial institutions will weather the current financial crisis, it is now clear that they, while not immune from the crisis, are being less impacted than conventional institutions. This is because Islamic financial institutions, by their nature, have not invested in toxic assets or derivative structured instruments that many conventional institutions invested in. While some Islamic banks in the Middle East have recently taken a hit due to their over-investment in the Gulf real estate market, on the whole, many were not as impacted because they either took a more diversified approach or they have enough cash to absorb the temporary losses. Let's not forget that many Gulf-based Islamic financial institutions also benefited from a five-year windfall due to the bullish run in the oil markets.

On the demand side of the equation, the picture looks quite encouraging, as economically distressed western countries have not been shy at all recently about using the unique healthy position of Gulf-based Islamic institutions to their advantage. For example, in November last year, the US Treasury department hosted a seminar in Washington DC, called 'Islamic Finance 101'. A large number of Islamic scholars and banking professionals from around the world were invited to this event to engage in discussions focused on the provisioning of Islamic finance products in the US. Just a few weeks prior to this seminar, the US Treasury department deputy secretary, Robert Kimmit, travelled to the Middle East and publicly expressed the US's positive and accommodating attitude towards the development and growth of the industry in the country.

Given this continued spirit of accommodation in the current US economic environment, Gulf-based Islamic financial institutions, if they are as healthy as they say, are perhaps at the most optimal position they have ever been concerning the prospects for growing their industry in the US. It is encouraging to see that more investors are waking up and taking advantage of this opportunity today.

FINANCIAL INSTITUTION	GEOGRAPHIC PRESENCE	COMPANY STRUCTURE/ FUNDING SOURCE	PRODUCTS OFFERED	STRUCTURES USED
University Bank	• Headquarters: Detroit, Michigan • Shari'ah-compliant products offered in: California, Connecticut, Idaho, Illinois, Maryland, Michigan, New Jersey, New York, Ohio, Pennsylvania, Virginia	• State chartered bank • Financing products are offered through its wholly owned subsidiary, University Islamic Financial	• Residential real estate financing • Deposit product • Money market product • Mutual funds	• Murabaha and Ijara • Profit sharing deposits • Mutual funds offered by HSBC Amanah
Devon Bank	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered in: Alaska, Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Idaho, Indiana, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, North Carolina, North Dakota, New Hampshire, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington DC, Wisconsin, Wyoming	• State chartered bank • Financing products are offered through its wholly owned subsidiary	• Residential real estate financing • Commercial real estate financing • Real estate construction financing • Lines of credit • Cash management • Business & trade financing • Institutional deposit products • Investment products • Trust and advisory services	• Murabaha and Ijara • Musharakah • Profit sharing deposits • Mutual funds offered by third party providers (Amana, Ariel, Iman, and Saturna)
Broadway Bank of Chicago	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered in: Illinois only	Community bank	• Residential real estate financing • Commercial real estate financing	Ijara
ShariAxis Bank	Headquarters: Monmouth Junction, New Jersey	State chartered bank	To be determined	To be determined
Lincoln State Bank	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered in: Illinois only	State chartered bank	Residential real estate financing	Ijara
Mutual Bank	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered in: Illinois only	State chartered bank	Commercial real estate financing	Murabaha
Cole Taylor Bank	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered in: Illinois only	State chartered bank	Commercial real estate financing	Murabaha and Ijara
Aizen Finance	• Headquarters: Chicago, Illinois • Shari'ah-compliant products offered: nationwide	• Non-bank mortgage company • Funding provided by foreign investors	Commercial real estate financing	Diminishing musharakah and Ijara
Guidance Residential	• Headquarters: West Falls Church, Virginia • Shari'ah-compliant products offered in: California, Connecticut, Washington DC, Florida, Georgia, Illinois, Indiana, Massachusetts, Maryland, Michigan, Minnesota, Missouri, North Carolina, New Jersey, New York, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Washington	• Non-bank mortgage company • Funding provided by Freddie Mac and/or foreign investors	Residential real estate financing	Diminishing musharakah
Lariba – American Finance House/Bank of Whittier	• Headquarters: Pasadena, California • Shari'ah-compliant products offered: nationwide	• Non-bank mortgage company • Brokers/offers its financing products in some states through its affiliate, Bank of Whittier • Funding provided by Freddie Mac, Fannie Mae and/or Bank of Whittier	• Residential real estate financing • Commercial real estate financing • Home construction • Business & trade finance • Current account/deposit product	Ijara plus diminishing musharakah, musharakah and murabaha
Bonad Group	• Headquarters: Ypsilanti, Michigan • Shari'ah-compliant products offered in: Michigan only	Non-bank mortgage company	Residential real estate financing	Ijara

FINANCIAL INSTITUTION	GEOGRAPHIC PRESENCE	COMPANY STRUCTURE/ FUNDING SOURCE	PRODUCTS OFFERED	STRUCTURES USED
COMMUNITY-BASED				
City of Minneapolis – Alternative Financing Programme	Headquarters: Minneapolis, Minnesota	• Government sponsored programme for small business owners • Co-financing arrangements with other community providers (i.e. African Development Center, or other banks)	• Real estate construction financing • Microfinancing	Murabaha
Minnesota Housing Finance Agency, State of Minnesota	Headquarters: Minneapolis, Minnesota	• Government sponsored programme for low income participants • Funding provided by State of Minnesota	• Low-income residential real estate financing; wholesale provider to Dawn Bank's residential real estate financing products	Murabaha
African Development Center	Headquarters: Minneapolis, Minnesota	Non-profit community development corporation	• Microfinancing • Residential real estate financing • Residential mortgage broker for Dawn Minnesota Housing Finance Agency Project	Murabaha
Neighborhood Development Center – Riba Free Programme	Headquarters: Minneapolis/St. Paul, Minnesota	Non-profit community development corporation	Microfinancing	Murabaha and musharakah
World Relief	Headquarters: Nashville, Tennessee	• Non-profit community development corporation • Funding provided by Office of Refugee Resettlement in the US Department of Health and Human Services	Microfinancing	Murabaha
Ameen Housing Co-operative	Headquarters: Palo Alto, California	• Funding provided by co-op and investors	Co-op residential financing programme	Co-operative financing structure with rebates distributed as dividends
INVESTMENT FIRMS				
Saturna Capital	Headquarters: Bellingham, Washington	Investment advisor; asset manager	Public investment funds (Amana Mutual Funds)	
Azzad Asset Management	Headquarters: Falls Church, Virginia	Investment advisor; asset manager	Public investment funds (Azzad Mutual Funds)	
North American Islamic Trust/Allied Asset Advisors	Headquarters: Burr Ridge, Illinois	Investment advisor; asset manager	Public investment funds (The Iman Fund)	
BANKS				
Arcapita	Headquarters: Atlanta, Georgia	Subsidiary of Arcapita Bank (Bahrain)	• Private equity • Real estate focused investments • Venture capital	
Innovest Capital	Headquarters: Cleveland, Ohio	Subsidiary of Gulf Investment House (Kuwait)	Real estate focused investments	
TransOcean Group	Headquarters: Boston, Massachusetts	Subsidiary of Gulf Investment House (Kuwait)	Private equity	
UIB Capital – Chicago	Headquarters: Chicago, Illinois	Subsidiary of Unicorn Investment Bank (Bahrain)	Private equity	
Oakland Capital Group	Headquarters: Boston, Massachusetts	Investors include Gulf-based financial institutions and investors	• Real estate focused investments • Equipment leasing • Asset management	

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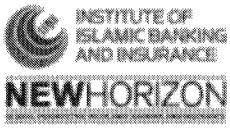


APPENDIX C

MORE ON *ZAKAT*

More on *Zakat*[1]

The Islamic doctrine of zakat: finance or faith?

Dr Azeemuddin Subhani, who completed a PhD in Islamic Law and Finance at McGill in 2007, offered an original interpretation of riba on the pages of NewHorizon in 2008. He returns here to reassess the importance of zakat, the Islamic principle of charitable giving.

Aqimu 'l-salatwa atu 'l-zakat.
Holy Quran

The above quoted command in The Quran – to establish salat (prayer) and give zakat (alms) – sets the tone for the central position of the concept of zakat in the belief system of Islam. The practice of zakat, being one of the five pillars of Islam, is an element of faith, although the historically evolved technical usage of the term colours it as a financial levy.

The resolution of this apparent lack of congruence between the scriptural and the technical usage lies in an examination of the term from a normative, historical and conceptual perspective.

The normative perspective

The zakat obligation, based on the Quranic, Prophetic/Companion Sunnaic and Ijmaic evidence, is enjoined by the repeated Quranic command to establish salat and give zakat, and is ranked as the third element of faith (thalit al-iman) by the Quran. The Sunnah of the Prophet treats zakat among the five pillars of faith. Ijma justifies it because the entire Muslim community has agreed upon zakat being fard (compulsory).

The belief in zakat as an obligation of faith predates Islam to antiquity as, according to clear Quranic evidence, zakat (as well as salat) was prescribed in the earlier revealed Scriptures as well, through Prophets Abraham, Isaac and Jacob, Prophet Ismail, the Children of Israel, and finally, Prophet Jesus.

While warranting further research in the case of Judaism and Christianity, the practice of zakat in Islam has evolved and has come to be established as a well defined financial institution – from the concept of general charity and poverty alleviation to a fiscal levy – with specific definitions and evasion penalties.

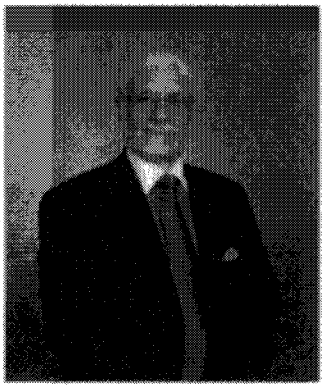
The Islamic normative perspective of zakat is reflected in several Quranic stipulations which juxtapose zakat with salat, in at least 20 verses, describe zakat as purification, juxtapose charity (of property) with zakat and salat, contrast zakat with riba, associate denial of zakat with shirk (and consequent afflictions), juxtapose sadaqah (charitable giving), zakat and salat, declare Divine exaction of sadaqah, reserve sadaqah for the eligible eight categories of recipients, and contrast sadaqah with riba.

The historical perspective

The early Quranic injunction stipulated the concept of obligatory help for the poor, the orphans and the deprived, as a rightful sharing between the rich and the poor, with the basic motive and enforcing power being the fear of God and the concept of individual responsibility before God in the Hereafter. The terms in vogue to describe this obligatory spending included infaq fi sabil Allah, sadaqah and zakat. However, the historical evolutionary process of these terms is complicated by the fact that the term infaq fi sabil Allah, spending in the way of Allah, which most closely describes this obligatory spending, got discarded and the term sadaqah, with its intrinsic meaning of truthfulness, acquired the status of general usage. The term zakat, with its intrinsic meaning of purification, acquired the status of technical/legal usage for this obligatory spending.

The textual support for the term sadaqah comes from the Quran and the Prophetic Hadith, both of which describe this obligatory spending as sadaqah and not as zakat. But the Prophetic Hadith also equates sadaqah with "impurities of the people" (awsaq al-nas) unfit for consumption by the Prophet and his family. Finally, in the older Companion/Successor jurists' period zakat as the technical term and its treatment as a state financial levy enforceable with punitive means were finalised and confirmed, except for a fundamental controversy as to whether the zakat obligation was discharged by payment to the state publicly, or by direct payment to the beneficiary privately? The answer, with terminological and conceptual implications, is clearly dependent upon the

[1] This is an authorized reproduction of Subhani, *New Horizon*, 14-8.



Dr Aseemuddin Subhani

perception of zakat – either as a governmental financial levy or as a faith obligation.

The conceptual perspective

The central conceptual question that this analysis will attempt to deal with – and perhaps answer – is 'Why is zakat a fundamental pillar of religion if it is only a state financial levy and thus apparently not a faith issue?' – or conversely – 'Why is zakat a financial levy when it is a faith issue?' and then, 'What is the faith issue at stake?' The conceptual model(s) to answer these questions rely on certain crucial relationships – Quranic and Sunnaic, above, and lexical and juridical, below:

Lexical relationship

The lexical meanings associated with zakat and sadaqah are the foundation of the conceptual lexical model *(see p16)*.

The verb zaka means:

Verb form I: to be pure, just, righteous, good, fit, suitable; to thrive, grow, increase;
Verb form II: to increase, augment, make grow; purify, chasten; to justify, vindicate, vouch for, bear witness to integrity, honesty, uprightness; to attest to the truth, validity, credibility; to commend, praise; to recommend;
Verb form III: (not applicable to this verb);
Verb form IV: to cause to grow;
Verb form V: to be purified, be chastened.

It is significant, as above, that the verb zaka does not include almsgiving and, as below, the noun zakat does not include growth/increase.

The noun zakat means:

Meanings common to the verb and the noun: purity; justness, integrity, honesty; justification, vindication;
Meaning of the verb but not of the noun: to grow, increase, augment;
Meaning of the noun but not of the verb: almsgiving, alms, charity; legally prescribed alms tax, obligatory donation of food before Eid al-fitr prayer.

The verb sadaqah means:

Verb form I: to be true, correct, right; fit exactly, apply, keep promise; advise sincerely;
Verb form II: to deem credible; to believe; to consent, approve, sanction, certify, confirm, substantiate, attest, ratify;
Verb form III: to befriend, consent, agree, approve, grant, sanction, certify, confirm, substantiate;
Verb form IV: to fix a bridal dower (for a woman);
Verb form VI: to give alms, donate.

The noun sadaqah means:

The noun conforms to verbal Form V only; meaning *charitable gift*; almsgiving, charity, voluntary alms; legally prescribed alms tax; obligatory donation of food before Eid al-fitr prayer.

The noun sadaaq means: a bridal dower.

The noun sidq means: truth; sincerity; veracity, correctness; efficiency.

The noun sadaaqa means: friendship.

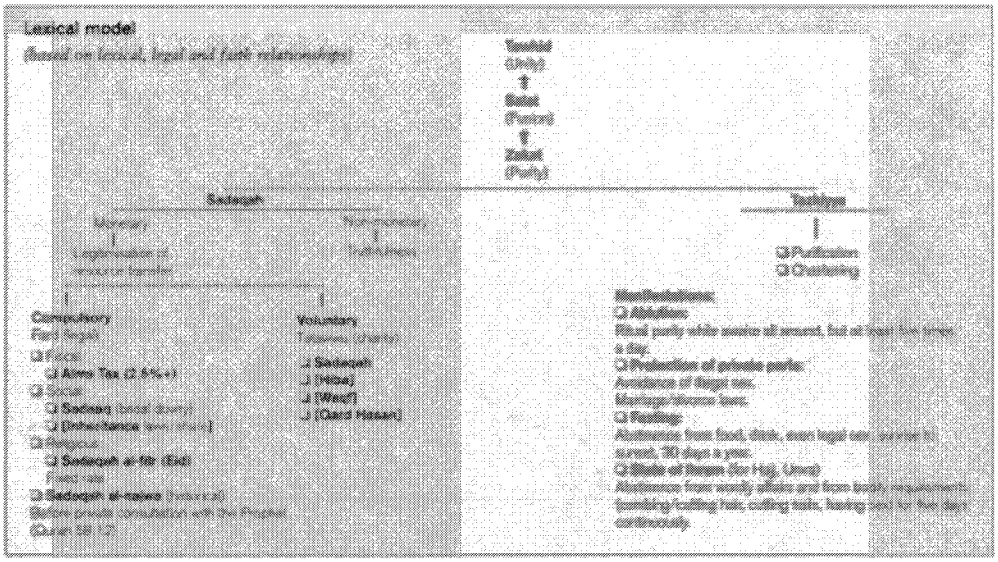
Juridical relationship

The technical Hanafite juridical definition of the obligatory alms is:

The giving (tamlik: transfer of ownership of a property), as an act of piety, of a legally stated portion of one's property to a poor Muslim who is not of the Hashim family or their clients (mawla), in such a way as to preclude for the giver any sort of benefit. This absence of 'reciprocity', above, is the foundation of the conceptual philosophical model *(see p17)*.

Proposed conceptual models

Based on the above relationships, the author of this article has developed three models – lexical, monetary and philosophical – in an effort to reconcile and synthesise the various, often conflicting, relationships outlined above.



Monetary model

Based on a translation of Quranic/Sunnaic injunctions in financial terms

Postulate 1

A simple but necessarily very lengthy mathematical model, constructed by this writer, shows that the run out period to reduce a balance of 100 to near zero at 2.5 per cent per annum on declining balance is a staggering 540-plus years. The balance is reduced to 50 per cent in about 28 years, to 25 per cent in about 55 years, to eight per cent in 100 years, and one per cent in 180 years.

Postulate 2

In a riba-based loan transaction, the interest rate, say 2.5 per cent, remains the same at 2.5 per cent for both the lender and the borrower because it is expressed as a function of the loan amount and not of the net worth of either party.

Postulate 3

In zakat, however, the 2.5 per cent rate is expressed as a percentage of the giver's net worth (over nisab – the minimum threshold), which, when expressed as a percentage of the recipient's net worth (under nisab), equates to more than 2.5 per cent.

Giver	Recipient
2.5% of 100 N.W = 2.50	= 50% of 5 N.W (assumed nisab) = 100% of 2.50 N.W (below nisab) = 200% of 1.25 N.W (below nisab etc.)

The Postulates 2 and 3 provide a financial explanation of the Quranic verse (30:39) that riba does not increase, but zakat increases manifold.

Philosophical model

This model is structured around the mathematical concept of 'reciprocity' – a function of 'inverse correspondence' – which finds a religious use in the juridical definition of zakat, above, which reads in part 'the giving (tamlik) in such a way as to preclude for the giver any sort of benefit'. Reciprocity finds religious expression also in the prohibition of riba and the permission of bai.

Exchange of similarity

Action 'Give'	Reciprocity 'Take'	Interaction result	Implication	
1	Excess 1.1/1	1x1.1/1 =1.1	Growth (self-generating) (prohibited by Quran/Hadith)	= Riba
1	Equal 1/1	1x1/1 =1	Subsistence made meaningless = prohibited by Gold for Gold Hadith	= [illegible]
1 1	Less .9/1 Nil 0/1	1x.9/1 =.9 1x0 = 0	Annihilation (Zakat) (enjoined by Quran/hadith)	= Fana

Exchange of dissimilarity

Action 'Give'	Reciprocity 'Take'	Interaction result	Implication	
1	Excess 1.1/1	1x1.1/1 =1.1	Increase (co-generating) (permitted by: Quran 2:275, Gold for Gold Hadith)	= Bai

Conclusion

The lexical model demonstrates that zakat – the third pillar of faith of Islam – is a concept much broader and deeper than a mere financial levy which has come to be its popularly understood technical meaning. The Quranic zakat obligation, enjoined repeatedly with the salat obligation on all humanity, represents a whole process of legitimatisation, truthfulness, and purification. In the area of legitimatisation of transfer of resources, it regulates the process of growth – actual or potential productivity.

Through the fiscal levy (2.5 per cent zakat), it legitimatises and regulates material growth. Through the social levy (bridal dower and inheritance), it legitimatises and regulates procreational growth. Through the religious levy (sadaqah al-fitr and the historical sadaqah al-najwa), it legitimatises and regulates bodily and spiritual growth, respectively. This process of resource transfer and the financial levy thereon is part of the concept of zakat, because it is a process of regulation of growth, which has deeper theological and metaphysical implications. In the area of purification, zakat covers the whole state of purity and chastity represented by ablution, sexual discipline, fasting and state of ihram in pilgrimage.

The monetary model demonstrates the growth characteristics of riba and zakat. It illustrates that riba is a process of static growth, while zakat is a more than a lifetime process of purification (for the giver) and of unlimited growth (for the recipient).

Furthermore, this principle of unlimited growth, through self-sacrificing zakat as against self-seeking riba applies to all resources – whether physical or non-physical, i.e. monetary, physical, intellectual, political, social, cultural or human. For example, what a teacher shares with his student may be a fraction of the teacher's knowledge reservoir but it could represent a 100 per cent increase in the student's knowledge. The transfer from higher resource base to a lower resource base always triggers this unlimited growth.

In the case of riba, the growth of the loan is intra-active because the growth measurement agent is 'single', i.e. the common loan amount, and the interest received by the lender is growth thereon – thus a growth of similarity. This intra-active growth of similarity is prohibited (haram), as being self-generating and hence an incursion in the Divine domain.

In the case of zakat, the growth is inter-active because the growth measurement agent is 'dual', i.e. the different net worth of the giver and the net worth of the recipient. For the giver, zakat is a reduction of similarity – the zakat on each property was originally payable for that property alone. For the recipient, the zakat received and his net worth do not necessarily represent the same property. Thus this growth is an inter-active growth – a growth of dissimilarity. This inter-active growth of dissimilarity is not only permitted (halal) – through bai permission, but also enjoined (fard) – through zakat injunction. A metaphysical explanation for the prohibition of intra-active growth and the permission of inter-active growth has been posited elsewhere by this writer. The main thesis is that intra-active growth is strictly prohibited to mankind because, being self-generating and self-subsisting, it is a sole divine attribute, and inter-active growth is prescribed for mankind because, being co-generating, it is the only mode of existence (duality) in

full commonance with the mode of human creation, i.e. inter-action in pairs.

While the full treatment of these metaphysical questions is beyond the scope of this paper, the profound nature of zakat, beyond a mere financial levy, is clearly established in the process.

The philosophical model, based on the mathematical concept of reciprocity, demonstrates that growth from exchange of similarity (riba) is prohibited. Even the permitted growth from exchange of dissimilarity (from bai and from other legal resource transfers – dowry, inheritance, gift, waqf) is then subjected to a process of decrease through enjoinment of absence of reciprocity on a fractional basis, i.e. through the imposition of 2.5+ per cent zakat on actually or potentially productive properties. This entire process emanating from reciprocity is thus a process of regulation of growth. In a universe of finite resources, infinite growth is not sustainable. Circularity and not linearity is the law of our existence.

In sum total, zakat (self-annihilation) is antithesis of riba (self-generation) and both extend beyond the monetary/fiscal manifestations. The relevant Quranic verses are not focused merely on the external manifestations of positive and negative growth. They in fact provide a mode of behaviour for mankind, which is:

- Meaninglessness (= prohibition) of self-subsistence (baqa);
- Prohibition of self-generating growth (riba) and permission of co-generating growth (bai);
- Enjoinment of self-annihilation (fana – zakat), on fractional basis.

In this prescribed scale of actions, if fractional self-annihilation (zakat) is practised, as required, the self-subsistence and self-generating growth modes are further automatically precluded. The practice of zakat, signifying self-annihilation through giving and perhaps also through waging jihad leading to martyrdom, being the only positive command in this scale, is included in the fundamentals of faith of Islam. The other two commands, prohibitions of baqa and riba, by virtue of being negative commands are not appropriate for inclusion in a listing of fundamentals, but are nevertheless inherently covered by the list.

In fact it appears that the five fundamentals of Islam can be captured by two foundations – salat and zakat. Salat regulates relations with God, while zakat regulates relations with man himself.

The relevant question, then, is not what is embodied in the title of this paper – whether zakat represents finance or faith – but why is it misrepresented?

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APPENDIX D

GLOSSARY

GLOSSARY

***Al-āqilah*:** A pre-Islamic practice of mutual care, which results from the wrongful death of a clan member.

Arbitrage: The immediate purchase and sale of an asset, typically currencies for profit when a simultaneous price discrepancy is present between two parties.

Asymmetric Information: An economic and legal concept where one transacting party has more information about a given transaction than the other, giving said party an unfair advantage.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI): an independent auditing organization established in 1990 as a governing body to ensure Islamic banks comply to a standardized understanding of *sharī 'ah* compliance with regard to banking, economics and finance.

Balance Transfer Facility (BTF): A mode of financing effectively similar to refinancing debt through the purchase and sale of equity interest in asset by existing or new partners in a *mushārakah* profit-and-loss partnership agreement in Islamic finance.

Basel II: A regulatory initiative to harmonize banking governance that establishes a minimum capital adequacy multiplier of eight (8) percent in addition to minimum reserve ratio requirements; an extension of the original Basel Accord signed in Basel, Switzerland designed to prevent systemic bank failures and stabilize the global banking system.

Benchmark Rate: A reference interest rate such as the London Inter-Bank Offer Rate (LIBOR) or the U.S. Federal Reserve's Federal Funds Rate used by Islamic Banks to price "*sharī 'ah*" compliant financial products such as the cost-plus *murābaha* or *ijārah* lease.

Bond: A securitized debt obligation representing fractional ownership of the aggregate debt accompanied by periodic interest payments for a fixed period of time, and repayment of the original debt principle upon maturity.

Bretton-Woods: A global fixed currency valuation system, which began in 1945 and ended in 1971; under the system central banks and governments could freely convert currencies into U.S. Dollars, which were then convertible into gold.

Burden of Proof: In the insurance industry, the insured responsibility for proving the existence of a claim.

Capital Lease: A conventional rental agreement where the lessor grants usufruct privileges of the rented or leased asset to lessee; although the lessor is legal owner of the rented or leased asset, ownership risk is effectively transferred to the lessee through insurance, who also assumes and is responsible for operational risk; in a capital lease, the lessee is also responsible for fixed rental or lease payments at the inception of the lease contract and thus is not considered in concordance with Islamic economic laws of risk reciprocity.

Central Bank: Typically a government or quasi-government institution responsible for the regulatory oversight of banking operations in a given country, as well as for the establishment and management of monetary policy in an economy; policies include the manipulation of the money supply through open market operations or purchases and sales of highly liquid debt obligations in the secondary markets thereby increasing or reducing the aggregate money supply of an economy.

Common Stock: A securitized and fractional representation of ownership in a corporation or public limited company that grants the owner rights to said corporation or public limited company's profits (as issued in the form of dividends) and net assets (in the event of liquidation) after debtors and preferred stockholders are paid; common stock often grants stockholders one vote per share.

***Dayn*:** A debt obligation that is payable at some future date in time; similar to a liability in conventional accounting.

***Dinar*:** Historically, a commodity mode of monetary exchange that was most frequently monetized by silver as the numeraire.

***Dirham*:** Historically, a commodity mode of monetary exchange that was most frequently monetized by gold as the numeraire.

Equilibrium: An economic principle where the aggregate supply and aggregate demand curves (or equations) reflecting the price and quantity of any given commodity is equivalent to the other; it is the market price where both buyer and seller agree on a price resulting in a purchase/sale.

Endogenous Money Supply: A relatively new monetary theory whereby money does not grow beyond the needs of an economies real productive use of money; unlike exogenous money, endogenous money grows organically within the economy to finance real and productive purposes.

Excess Reserve: Surplus funds held in excess of the Required Reserve as mandated by the Central Bank or other regulatory body under a Fractional Reserve Banking model.

Exogenous Money Supply: A monetary theory advanced by Keynsian and monetarist economists that embrace the creation of money through fractional reserve banking, and resulting in an external increase in the money supply exceeding the real and productive requirements of an economy.

***Fatwa*:** An official religious opinion reached by an Islamic jurist.

Federal Funds Rate: The interest charged by the U.S. Federal Reserve on overnight loans often used as a benchmark "profit" rate by Islamic financial institutions.

Fiat Currency: A mode of currency or money that is secured by a government promise endorsing it as a mode of exchange and store of value as opposed to a commodity or asset such as gold or silver.

Fractional Reserve Banking: A banking model where a depositor bank holds a fraction of all deposit liabilities for demand withdrawals by the depositors, and lends the excess funds for profit, which results in the artificial "creation" of money on the balance sheets of banks in the Fractional Reserve banking system.

Forward Transaction: The purchase or sale of a given asset at time T_0 for a discounted price with the agreement to receive or procure the asset at time T_1; the purpose is to generate an influx of cash for the seller or provide the purchaser a discounted price on an asset with the opportunity to profit by selling purchased at assets on the spot at time T_1.

Full Reserve Banking: A depositor banking model where a bank keeps 100 percent of all depositor funds available for withdrawal at any given time, eliminating the possibility of lending depositor funds and the "creation" of money through the Fractional Reserve Banking model.

Gambling: A stochastic process that incorporates random probability of a given favorable outcome, characterized by a zero-sum game where one party must lose in order for the other to win.

***Gharar*:** An Arabic term used in the context of contracts and economic transactions whereby excessive uncertainty or speculation exists for a valid contract or transaction to be executed; prohibited on the basis that two parties cannot enter into a contractual transaction or obligation because excessive uncertainty or ambiguity is present in the contract language or terms of the transaction.

Gold Standard: A method of pricing and/or valuing money by using gold as the numeraire or measure of value for money because of gold's historical inelastic demand and relatively useless character.

***Halal*:** An Arabic term for all things permissible in Islam as articulated by the Qur'ān and the Ḥadīth literature.

***Haram*:** An Arabic term for all things explicitly proscribed in Islam as articulated by the Qur'ān and the Ḥadīth literature.

***Ijārah*:** An Arabic term for a capital lease whereby the lessor rents an asset to the lessee for a fixed sum and grants usufruct privileges of the asset to lessee; lessor assumes and is responsible for all ownership risk of the asset and the lessee assumes and is responsible for all operational risk of the asset.

***Ijmā'*:** An Arabic term referring to a consensus by Islamic religious jurists on an issue not addressed in the Qur'ān or the Ḥadīth literature, and thus requiring an opinion for the applicable use in society.

***Ijtihad*:** An Arabic term referring to the right to individual interpret the permissibility of issues not addressed in the Qur'ān and Ḥadīth literature.

Inflation: A general price level increase for goods and services in an economy.

Insurable Interest: The legal right to insure a person or asset because usufruct privilege, ownership, or financial dependence relationship exists.

Insurance: A conventional financial instrument used to hedge and remunerate individuals and entities from the potential losses resulting from unexpected and unforeseen circumstances.

Interest: The time-value of money calculated in credit sales and loan transactions for profit where money is charged for the borrowing of money; the rental fee denominated in money for the usufruct privileges of borrowing a stock quantity of money.

***Istisna'ā*:** An Arabic term referring to a forward sale of non-existent goods that are to manufactured or constructed; effectively equivalent to a construction loan or a working capital credit facility for a real estate developer or a manufacturer respectively.

***Ju'ālah*:** A contract structure used for wages, especially for project-specific job functions.

***Kafālah*:** The Arabic root derivative for *takāful*, which refers to mutual care in an Islamic society; it is also used to refer to guarantees in Islamic financial contracts.

Lease: A rental agreement between two parties where the lessor is the owner of the asset lent, and the lessee is the borrower of the asset lent; the lessor maintains ownership of the asset and the lessee is granted usufruct privileges for the use of the asset for the duration of the lease agreement with the condition that it be returned in its original or equivalent form at the conclusion of the agreement.

London Inter-Bank Offer Rate (LIBOR): An interest rate associated with the United Kingdom's Pound Sterling currency established by the Bank of England, its central bank.

***Maysir*:** An Arabic term equivalent to gambling or participating in games of chance characterized by a stochastic process whereby a zero-sum game results; one party must lose in order for the other party to gain.

Money: Any mode of exchange and store of value that has inelastic demand in an economy; historically, it has varied by society ranging from precious metals, livestock, and more recently fiat currency (i.e. paper money that is not backed by any asset or commodity, but simply imbued value through political hegemony and the rule of law).

Money Supply: The aggregate stock quantity of money in an economy that is manipulated by central banks for the purpose of curbing inflation, stabilizing the economy and employment.

Moral Hazard: In an economic and legal setting within the context of banking and insurance, it is the risk of default by borrowers or economic participants because of a lack of incentive to repay or conclude a given transaction.

Mortgage: An etymological derivative of the medieval English practice of *vif-gage*; literally translated to "dead-agreement" because the agreement lacks reciprocity between lender and borrower; the lender is guaranteed a fixed rate of return regardless of the borrower's profitability or yield of the financed asset; considered usurious in medieval England.

***Mudārabah*:** An Arabic term referring to a profit-and-loss sharing arrangement used in pre-Islamic Arabia whereby an investor(s) or *rabb al-mal* provide financial or real capital to an entrepreneur or *mudārib* and all profits are shared in a predetermined and mutually agreed upon ratio, and all financial losses are borne by the *rabb al-mal*, assuming they were not the result of negligence.

***Mudārib*:** An Arabic term referring to the entrepreneur or managing partner in a *mudārabah* arrangement responsible for the day-to-day management of the partnership's business activity; the *mudārib* is eligible to receive profits from the partnership, but may not bear any financial loss resulting from the *mudārabah* partnership's operations unless such losses are the direct result of negligence.

***Murābaha*:** An Arabic term referring to a cost-plus transaction where the purchase price, mark-up or profit, and sale price of an asset are disclosed to both purchaser and seller; used as a mode of financing in Islamic banking where the mark-up or profit is often linked to an interest rate benchmark such as the London Inter-Bank Offer Rate (LIBOR) or the Federal Funds Rate (FFR).

***Mushārakah*:** An Arabic term referring to a partnership arrangement whereby all profits and losses are shared by investment partners, either in proportion to capital invested or some other mutually agreed upon ratio.

Numeraire: An economic measure of value typically used to price money.

Operating Lease: A rental agreement between a lessor and lessee where all ownership and operational risk is borne by the lessee who has usufruct privileges of the asset leased; the lessor is guaranteed a fixed rate of return on capital invested in an asset; considered prohibited by *sharī'ah* because it eliminates reciprocal risk.

Parallel *Salām*: A type of forward sale contract where the seller also agrees—although not legally bound—to repurchase the goods or assets sold in the initial contract.

Participant's Account (PA): The primary type of fund accounting used for both family and general *takāful* insurance policies; funds are typically not accumulated beyond the maturity date of the *takāful* policy.

Participant's Special Account (PSA): A type of fund accounting used for family *takāful* insurance policies where *tabarru* or donated policy "premiums" are accumulated for the payment of insurance claim events if they arise.

Preferred Stock: A securitized and fractional representation of ownership in a corporation or public limited company that grants the owner rights to said corporation or public limited company's profits (as issued in the form of dividends) and net assets (in the event of liquidation) after debtors are paid; preferred stock may incorporate elements of bond whereby it guarantees fixed periodic payments or grants more than one vote per share.

Proximate Cause: Legal jargon that refers to the legitimate traceability or lack thereof, to an injurious event resulting in the assignment or dismissal of responsibility

***Qard al-Hasan*:** A loan of financial or real capital where the borrower is completely forgiven by the lender for all capital borrowed by the borrower.

***Rabb*:** An Arabic term for "Lord" referring God in the Qur'ān and Ḥadīth literature; according to Subhani, it may be a reason for the Islamic proscription of *ribā* as it is a cognate of *rabb* and thus the ultimate form of *shirk* or polytheism.

***Rabb ul-māl*:** Providers of financial or real capital in a *mudārabah* partnership agreement; equivalent to limited partners in a modern day limited partnership with the exception that all financial losses resulting from the business operation of the *mudārabah* are borne by the *rabb ul-māl*, and all profits are shared in a mutually agreed upon and predetermined ratio between the *rabb ul-māl* and *mudārib*.

Reserve Ratio: A government mandated bank requirement where x percent of depositor funds must be kept in reserves and not lent out under a fractional reserve banking model.

Re-*takāful*: Equivalent to conventional reinsurance with the exception that it is mutual cooperation amongst *takāful* operators and invests in only *sharī'ah* compliant financial instruments; a means for *takāful* operators to distribute risk among a larger number of *takāful* and re-*takāful* operators.

***Ribā*:** An Arabic term referring to "growth," "swell," and/or "unequal" exchange depending on the context in which it appears in the Qur'ān and the Ḥadīth literature; typically interpreted in an economic context where it generally refers to financial interest and/or usury characterized by associating a time-value of money and pricing fungible money for fungible money in a for-profit rental (lending) transaction.

***Ribā al-fadl*:** A type of *ribā* where a transaction results in an increase in quantity or kind (e.g., barter transactions involving the same commodity which are exchanged for different quantities or qualities of the commodity transacted).

***Ribā al-nasiah*:** A type of *ribā* that is most analogous to modern financial interest; however, it can also be interpreted as an unnecessary increase.

***Ribbet*:** A Hebrew term that is similar to the Arabic term *ribā* and referring to financial interest and/or usury in economic transactions.

***Sadaqah*:** An Arabic term referring to a voluntary gift.

***Salām*:** A *sharī'ah* compliant forward sale typically used for fungible commodities in pre-Islamic economic transactions where a seller agrees to sell a specific fungible commodity x in a credit transaction at time T_0 with delivery to be made at time T_1 for a discounted price P' with the caveat that the purchaser pays on the spot; effectively finances the production, cultivation or farming of x until the seller has physical possession of x.

Seigniorage: The profit made by governments through the purchase and sale of their own currencies in the foreign exchange currency markets.

***Sharī'ah*:** Islamic law derived from the Qur'ān and the Ḥadīth literature and interpreted through *ijmā'* and *ijtihad* of the *ulama*.

***Sharī'ah* Based:** Terminology that refers to permissible financial instruments that are developed using Islamic laws as opposed to "purifying" financial interest and/or usury from existing conventional financial instruments to either nominally or legally comply with Islamic economic principles.

***Sharī'ah* Compliant:** Terminology that refers to financial instruments that are generally considered permissible by most *sharī'ah* technicians and scholars (*ulama*); nominally or legally considered to be *ribā*-free.

***Sharī'ah* Supervisory Board (SSB):** According to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a governing body necessary for all financial institutions that purport to be compliant with Islamic economic laws; responsible for "purifying" *ribā* in the form of financial interest and/or usury from financial instruments and/or transactions in an Islamic bank.

***Sharī'ah* Tolerant:** A new term referring to superficially or nominally permissible financial instruments that likely contain elements of *ribā*, but continue to remain in use by Islamic banks as a means to remain competitive or viable; examples include the practice of pricing *murābaha* and *ijārah* financial instruments to an interest-based benchmark such as the London Inter-Bank Offer Rate (LIBOR) or the Federal Funds Rate (FFR).

***Sharik*:** An Arabic term referring to a "partner" in the context of a *shirkah* or *mushārakah* partnership agreement.

***Shirk*:** Associating anything or anyone with the monotheistic unity of God in Islam; equivalent to a conservative understanding of polytheism.

***Shirkah*:** An Arabic term referring to a partnership agreement; the root cognate of the Arabic word *mushārakah*, a prevalent financial structure used in Islamic banking.

***Shirkah al-Aqd*:** A type of *mushārakah* partnership contract where profits may be distributed disproportionately relative to the ratio financial capital invested in the partnership; it is also used in "diminishing" *mushārakah* contracts where the price of repurchasing shares in the partnership's assets are not predetermined at the time of contract extension—instead, the price of each share is determined at the time of each purchase/sale.

***Shirkah al-Milk*:** A type of *mushārakah* partnership contract where profits must be distributed proportionate to the ratio of financial capital invested in the partnership; it is also used in "diminishing" *mushārakah* contracts where the price of repurchasing shares in the partnership's assets are predetermined at the time of contract execution.

Short-Sale: A conventional financial transaction that profits from the anticipated depreciation of fungible asset x by borrowing x at time T_0 and price P, and then purchasing x at time T_1 at price P', which is theoretically lower than P, and therefore keeping the difference as profit; a financial transaction that theoretically promotes price equilibrium in a market; a transaction which is not considered to be in accordance to Islamic economic laws because of the inexorable presence of *gharar*.

Speculation: In the context of Islamic economics, permissible conjecture about future outcomes that may be leveraged or capitalized for profit assuming that such conjecture does not incorporate unnecessary or excessive uncertainty.

Spot Transaction: A cash transaction where delivery and payment of goods is exchanged immediately.

Stochastic Process: In economics and mathematics, a random statistical process where the outcome does not follow any predictable outcome.

Subrogation: A legal term referring to an insurance company's right to secure monetary payments on behalf of an insured party covered by the insurance company's insurance policies.

***Sukkuk*:** An etymological derivative of the medieval Arabic word *sakk*, which later evolved into the Latin "check"; a financial instrument that is often used in Islamic finance, specifically in capital markets to raise capital for private and public projects; unlike bonds, *sukkuks* must incorporate reciprocal risk, and are generally structured for fixed periodic payments through financial engineering (especially for variable return projects utilizing *mudārabah* and *mushārakah* structures).

***Sukkuk al-Ijārah*:** The securitization of a *sharī'ah* compliant lease transaction that effectively results in an instrument that is equivalent to a bond because of its fixed period payments.

***Sukkuk al-Mudārabah*:** The securitization of a *sharī'ah* compliant *mudārabah* structure with a variable rate of return, and thus variable payments throughout the course of the *sukkuk* term; however, in modern Islamic financial transactions, *sukkuk al-Mudārabah* transactions are marketed as fixed return instruments through the manipulation of profit expectations and distributions by projecting downwards and the creation of reserve accounts.

***Sukkuk al-Murābaha*:** The securitization of a *sharī'ah* compliant *murābaha* structure with a variable rate of return, and thus variable payments throughout the course of the *sukkuk* term; however, in modern Islamic financial transactions, *sukkuk al-Murābaha* transactions are marketed as fixed return instruments through the manipulation of profit expectations and distributions by projecting downwards and the creation of reserve accounts.

***Sukkuk al-Mushārakah*:** The securitization of a *sharī 'ah* compliant *mushārakah* structure with a variable rate of return, and thus variable payments throughout the course of the *sukkuk* term; however, in modern Islamic financial transactions, *sukkuk al-Mushārakah* transactions are marketed as fixed return instruments through the manipulation of profit expectations and distributions by projecting downwards and the creation of reserve accounts.

***Sunnah*:** An Arabic term referring to the practices of the Prophet Muhammad, which are not only considered permissible but ideal; orthopraxy as described in the Ḥadīth literature.

***Tabarru*:** A "donated" policy premium used to accumulate funds in a *takāful* insurance policy; because the funds are donated, they are not refundable and are only paid to insured parties in the event of a insurance claim event.

***Takāful*:** A mutual cooperative that effectively serves as a form of insurance for all participants; similar to socialist ideas of communal care and ownership of capital.

***Tawārruq*:** An Arabic term referring to a reverse forward transaction such as a *salām* typically involving commodities.

***Tawhīd*:** An Arabic term referring to the theological precept of monotheistic unity of God in Islam.

***Tawīhīdi* Framework:** A utopian construct that juxtaposes Islamic theology, social justice, communal accountability, and free-market capitalism in a socio-economic system.

***Ujrāh*:** An Arabic root term for *ijārah* and a form of an employment contract between two parties.

***Ulama*:** An Arabic term referring to a collective of Islamic religious scholars that are responsible for legal jurisprudence.

***Ummah*:** An Arabic term referring to an Islamic community.

Usury: Generally understood as the practice of charging excessive financial interest in economic activities; universally proscribed by religious traditions such as Buddhism, Hinduism, Judaism, Christianity and of course Islam.

***Vif-Gage*:** A Latin term referring to a "live" agreement used in medieval English loan contracts that financed real assets such as land; repayment of the loan would be contingent upon the yield or productive output of the asset financed and thus engendered reciprocal risk for both parties and did not violate anti-usury laws that were rooted in Judeo-Christian precepts.

***Wa'd*:** An Arabic term referring to an intent to purchase a given asset typically referring to credit *murābaha* transactions.

***Wakālah*:** An Arabic term referring to "agency" reflecting the Islamic theological concept of human vicegerency; an independent *wakālah* agreement is required for all circumstances where one individual or entity exercises a power of attorney to engage in trade on behalf of another party; used in various *sharī'ah* compliant financial instruments including *murābaha*, *mudārabah*, *ijārah*, *salām*, *tawārruq*, *istisna'ā*, etc.

***Zakat*:** One of the five "pillars" of Islam requiring all Muslims who have a certain minimum net worth to tithe one fortieth of their net worth to orphans, widows, and others in need.

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