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An Introduction to Islamic Finance

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An Introduction To Islamic Finance is a collection of works previously published either as chapters of books, seminar papers or journal articles. The collection has been organized in seventeen chapters classified into five thematic sections: The financial environment, *riba* interest, investment and resource allocation, forms of business organizations and modes of financing, and financial markets (see, appendix for details). The volume contains, acknowledgments to contributors, a preface and an introduction written by the editors, a foreword written by the Director General, Malaysian Institute of Islamic Understanding, two appendices, a glossary of Arabic terms and a combined index of names and subjects.

Practical developments of the last three decades in the field of Islamic banking and finance have created a large interest in academic and policy oriented studies. It is noticeable that the practical developments relate both to banking and non-banking areas of Islamic finance, whereas, the academic exercises have largely concentrated on monetary and banking fields, apparently ignoring the area of non-banking finance. The editors deserve commends for gauging this gap and making a timely and successful attempt to fill it. The volume can be considered as a good stock taking of research related to the area of non-banking Islamic finance up to 1991. The volume also invites the attention of researchers towards the rather neglected but fertile academic area of non-banking Islamic finance. In this way, it can be expected that the volume will provoke both individual and institutional researchers to allocate more resources to this important area. Such an inducement by itself is, without doubt, a valuable contribution.

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The type-setting and printing of the volume is of good quality, The editorial work generally conforms to standard practices. However, the quality of the work would have been improved if a number of editorial lapses were avoided. Some examples of such lapses are given here.

First, except for three instances, the original sources of the contributions are not given. Readers interested in knowing whether the collections are fresh contributions or selected from works published earlier would, thus, be disappointed. Keeping this point in consideration, we have provided the relevant information where available in the footnotes.

Second, to develop linkages between different contributions, in a number of places, the editors have apparently inserted some sentences. However, the use of this editorial discretion has not been mentioned anywhere. Moreover, in some places addition of the sentences has created grammatical problems. For example, the usage of a third person singular and first person plural in adjacent sentences on pages 145-46 is a mistake caused by an editorial oversight. In some other places where such linking sentences were really needed, these were not added. For instance, chapters two and three of an earlier book of Chapra have been combined in chapter three in the present volume and the title of the original chapter two has been retained. The reader is not informed about this. As a result, the otherwise useful chapter three of Chapra's book has lost prominence and has been eclipsed by its own chapter two.

Third, there are several other small but significant editorial oversights. For instance, an end-note on page 223 reads, "1. This part of the article has not been developed form (Sic.) Dr. Nijat Ullah's (Sic.) book". The same note is re-phrased and re-produced on page 224, "42. This part of the article has not been taken from Dr. Nijat Ullah (Sic.) Siddiqi's book". In the absence of any background explanation provided for this note (which parts of the article have been taken from which book, etc.,), the reader is bound to feel that some important linkage is missing. Readers may also recall that the famous Islamic economist mentioned in these notes writes his name as Mohammad Nejatullah Siddiqi.

Moreover, one can find inconsistencies in transliteration of Arabic terms; e.g., see, page 404 for the term Shari'ah and page 406 for Shari'a. One should also expect typing errors in writing the Arabic terms in a number of places; e.g., the second term in the glossary on page 404 is written as "*Ashad al-Mal"*, which was supposed to be "*Ashab al-Mal*"? The index of names and subjects would have been more useful provided the entries were consistent, one can find names of some scholars and cannot find those of other relevant scholars. Furthermore, the presentation of references, footnotes and bibliography should have been uniform throughout the volume.

Fourth, some selections may be considered overlapping. This is true particularly about the three chapters on *riba* as well as appendix one. Moreover, the two chapters contributed by Ismail have substantial text and argument of the same nature. Substantial part of chapter thirteen is related to Islamic banking and thus outside the scope of this volume (otherwise one would argue why some original works on Islamic banking are not included in the volume). Chapters thirteen and fourteen contain substantial common stuff. Whereas chapter fourteen is a good selection for the present volume, its logical sequence is Section Two as one Islamic alternative to *riba*.

Finally, different chapters of the volume have been organized under sections. In the standard practice however, a chapter comprises of sections and part of a book contains chapters. It would have been better if the merits of this non-conventional practice were explained.

The contributions can be grouped into three categories: works relating to the nature of *riba* and its Islamic alternatives, Islamic business forms and their policies and the market environment which makes the assets of firms divisible and tradable. As the volume is a compendium of twenty different articles, it is difficult to have an in-depth view of the contents of each contribution. A description of these is however, given in the appendix.

A large part of the volume is related to *riba*, and the proposed Islamic alternatives. Indeed, these are known positions which require no further elaboration or comments. In this category of selections, chapter fourteen contributed by Ismail provides a good conceptualization of the difference between *riba* and *dayn*-based financing. The work provides valuable additional elaboration on the subject following the experience of Islamic banks. It may be a reasonable criticism that in the framework of this conceptualization, participatory modes of financing become subordinate to the non-participatory modes which has blurred the true vision of the Islamic finance movement.

Issues relating to business forms, nature of the firm, organization of production, business decisions, financing, dividend, investment and management compensation policies and the market environment constitute the core of any text on finance. The abolition of interest must have important implications in all these domains. Rest of this review concentrates on some of the issues emerging from the volume rather than contents of specific contributions.

On Behavior of the Firm

Behavior of the firm is central to most economic considerations and is discussed by al Habshi[(1)] (2)[(2)]. He considers that instead of profits, the Islamic firm should maximize *falah*. According to the author, this position is also taken by a number of other Islamic economists. This may be true as far as earlier writings are concerned. But at the present, although all scholars continue to cherish moral considerations, dichotomization between *falah* and profit maximization can no more be found in the mainstream Islamic economic thinking.

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(1) Paper presented to Seminar on Islamic Economics, IIU, KL, July 6-7, 1987.
(2) Number in parentheses refer to chapters of the volume.

It is interesting to note that the concept of *falah* covers the behavior of both the consumers and producers. However, while suggesting the maximization of *falah* in production, al Habshi does not keep a crucial point in view - compared to consumption, the production process is a complex one. To consider some aspects of this complexity and its implications for the objective function of the producer, knowledge about the way production is organized is needed. The contributions of Chapra (3 [(3)], 19[(4)]) and Khan (11)[(5)] provide a good insight about forms of business enterprises in an Islamic economy. According to these contributions, there would be four distinct groups of enterprises in an Islamic economy: sole proprietorships, partnership, *mudarabah* enterprises and joint stock companies. From the managerial perspective, these are actually two groups of enterprises - the first two are in general owner-operated and the last two are manager-operated.

The neo-classical theory explains the behavior of owner-operated firms and ignores those operated by managers. According to the neoclassical theory, owner-operated firms maximize profits. According to al Habshi, however, "producers would not be maximizing profits if, and when, they feel that by lowering their profit margins they can further the good of the society by satisfying unsatisfied needs", page 28. Baumol type revenue maximization premises would modify al Habshi's statement to: "producers would not be maximizing profits if, and when, they feel that by lowering their profit margins they can further revenue maximization".

The problem with al Habshi's proposed premises is that it ignores the limitations of the firm's discretion. In the real world situation, neither the producer is independent nor the social consideration suggested is the only cherishable possibility. The producer, even in an owner-operated firm, unlike the consumer, has to enter into contractual relations with other parties. For instance, it may owe debts to others as a result of installment purchase or accumulated rents. Such a producer can maximize *falah* only by truthfully rendering his various contractual obligations. For example, to be able to repay the debts in time, the producer must maximize profits within the framework of the Islamic law. Moreover, if a profit maximizing firm re-invests its profits and grows, it can offer valuable employment opportunities enabling the individuals to participate in the market, effectively taking care of the cherished social concern of al Habshi.

Growth considerations are particularly relevant for manager-operated enterprises. In many respects, a *mudarabah* enterprise is similar to what Maris[(6)] calls the 'managerial enterprise'. Unlike profit maximization by an owner operator, the manager-operated firms maximize growth by retention, subject to a minimum profit (dividend) distribution acceptable to the owner of funds. Since most modern corporations are manager-not owner-operated, Maris's argument for growth

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(3) Chapter 2-3, *Towards a Just Monetary System*, Leiceser: The Islamic Foundation, 1985.

(4) Taken from *Towards a Just Monetary System.*

(5) *Islamic Literatuere*, Lahore, 17(**8**), 1971, pp. 5-16.

(6) For Maris's model of a managerial enterprise, see**, Koutsoyiannis, A.**, *Microeconomics*, Second Edition, New York St. Martin's Press, 1984. The book also contains an excellent review of other competing premises for analysis of behavior of the firm, namely, profit maximization, revenue maximization, managerial discretion, behavioral models etc.

maximization is broadly relevant. Given that the firm does not produce prohibited items, and does not generate negative externalities, growth of the firm is beneficial for both the present and future generations of the society. Thus, a manager operator should look after the best interests of its owners. We cannot expect a manager to tell the owners that "since I had to maximize my *falah*, I made charity from your money"! The theoretical merits of dichotomizing *falah* and other objectives of the firm such as profit or growth maximization are thus, mere exaggeration. An Islamic firm must be growth oriented, look after the interests of its owners, generate valuable employment opportunities and accumulate value over time.

On Transformation of Enterprises

Chapra's above-mentioned contribution makes a potent point regarding the evolution of Islamic business organizations. Although the Islamic economy will have sole proprietors, *mudarabah* and *musharakah* enterprises and joint stock corporations, Chapra suggests that we shall also expect to have hybrid forms of business organizations. This suggestion has come true practically. Most Islamic business organizations are neither pure *mudarabah* nor pure *musharakah*. For instance, share-holders own the Islamic bank on the principle of *musharakah*, yet, depositors own it on the principle of *mudarabah*; promoters of the Pakistani Modaraba companies own these companies on the basis of *mudarabah* and *musharakah* certificate holders own the companies on the basis of *mudarabah*, the Islamic Development Bank is a *mudarib* in the Unit Investment Fund and Islamic Banks' Portfolio, yet, the bank has its capital contribution in both schemes. The existence of mixed forms of enterprises has become a rule not an exception for the emerging Islamic economy. This phenomenon has an important implication for the theory of Islamic finance. It implies that provided the prohibition of *riba, gharar*, etc., are complied with, no new form of an enterprise need to rigidly follow the specific rules of any traditional Islamic contractual arrangements.

On Financing Growth Opportunities

With the preceding optimistic note about the positive tendency in institutional development, we now turn to another important consideration - financing policies of a firm. How to finance growth opportunities of a sole proprietorship *mudarabah*, *musharakah* or a hybrid enterprise? This question will remain as an important concern in Islamic finance. Chapra raises the question of financing the growth opportunities of a sole proprietor and suggests that credit purchase is an important source of finance for such an organization. In principle, this is a valid position. However, its practical scope is limited. Through credit purchase the firm can acquire assets. Indeed, this can relieve some cash of the firm which it can use to meet other urgent needs. Nevertheless, if a firm only needs cash, credit purchase becomes invalid. In Islamic finance, cash requirements can only be met by a profit sharing mechanism. If substantial additional cash is required, Chapra suggests that the sole proprietor must resort to *musharakah* or *mudarabah* (page 47). For a number of reasons, this proposal to merge into a *mudarabah* is not much of a solution. Re-structuring ownership is not purely a part of the firm's financing policy. Every small firm may not be able to re-structure its ownership every now and then when new funds are needed. Moreover, from justice point of view, it could be extremely unreasonable and may not even be feasible to ask a firm to change its ownership structure if it needs additional finance.

Financing growth opportunities is important for owner-operated firms as most large manager-operated companies must have been small owner-operated firms at some stage. Growth opportunities keep the firm always thirsty for readily available cash. Three options are open for such cash thirsty firms: change their ownership structure and allow partners, do not seek or even forego growth opportunities or resort to interest-based borrowing. Evidence shows that a good number of firms rather than compromising on their ownership structure either forego growth opportunities or resort to debt finance. As debt does not interfere in ownership structure of the firm and conveniently meets the requirements for cash, in the process of growing, firms get deeply involved in debt finance.

Recent empirical research conducted by different researchers for a capital abundant economy, namely, Saudi Arabia(7) and for a capital scarce market(8), namely, Sudan found that owner-managers do not prefer *mudarabah* and *musharakah*. The difficulty perhaps lies in the eminent interference of these two in the ownership structure of the firm. This is due to the fact that these contracts are perpetual, permanent and non-retiring. Perhaps, exactly there lies the solution of the problem. The funds available on the basis of profit sharing may also be temporary in addition to being based on *mudarabah* and *musharakah*. The temporary nature of such profit sharing funds will reduce their interference in the ownership structure of the firms. The practical viability of this line of thinking is a matter to be seen in the future. Introduction of redeemable *musharakah* certificates by the Modaraba companies in Pakistan, after some practical experience, can be expected to provide an empirical evidence.

Researchers in the field of Islamic finance must confront the challenge to devise Islamic financial instruments which can enable firms, sole proprietors in particular, to finance their growth without compromising on their ownership structures. In this regard, in addition to ownership sensitivities, retention and re-investment of profits is also worth mentioning. As sole proprietorships transform into large corporations by the process of growth, interest-free growth financing is extremely crucial for the development of interest-free enterprises. Therefore some departure from the permanent characteristics of the traditional *mudarabah* and *musharakah* funds is imaginable. If we can make sure that such departures are possible without violating any of the shari'ah rules, it can be in the interest of the on-going firms.

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(7) **Al Hajjar, Bandar** and **John R. Presly** (1992), "Preferences of Small Enterprises in Saudi Arabia for Islamic Modes of Finance", paper presented to the Third International Conference on Islamic Economics, International Islamic University Kuala Lampur.

(8) **Babikir, Osman A.** (1990*) The Contribution of Islamic banking to Economic Development: The Case of the Sudan,* Ph.D. thesis, submitted to the University of Durham, 1990.

The contributions of Zaman (17)[9] and Mohsin (10)[10] largely fall in the framework of ideas mentioned in the last paragraph. They aim to expose the salient features of stocks, bonds, warrants, options etc., to the shari'ah scholars. Their emphasis is both on the requirement of the firms and investors for various forms of funds and investment opportunities and the need for financial instruments to meet these requirements. Mohsin explicitly suggests that common stocks are the source of permanent capital of the firm. Too much reliance on this form is quickly reflected in a depreciated earning per share of the firm. To overcome this difficulty, firms resort to temporary funds in the form of debts and temporary equity such as temporary preference shares. The author criticizes the fixed return on the conventional preference shares but highlights the need for sources of temporary capital of the firm. Citing the practice of some Islamic banks which redeem some of their *musharakah* investments, the author proposes some form of Islamic preference shares in which the preferential return would be negotiated rather than fixed. Moreover, implicit in this arrangement is a guaranteed principal. Since the owners of preference shares will not have voting rights, the proposal falls in the framework of *mudarabah*.

In its spirit, the proposal of flexible sources of funds for firms is need of the hour in Islamic finance. The related problems, namely of guaranteeing the principal capital and offering a preferential share to one group of the financiers, however, need acceptable solutions. The acceptance of a third party’s guarantee of the principal, reduces the intensity of the first problem. On the other hand, the owners of the permanent capital, can negotiate on the possibility to offering preferential rate of profit share and facilities to the owners of temporary capital[11].

Short of these arrangements, owners of *mudarabah* certificates (holders of non-voting shares) will always be at a disadvantage compared to owners of *musharakah* certificates (common stocks). This is particularly so because, technological progress has made the use of voting rights highly convenient. Such rights must be valuable. In their absence, the assets will naturally be valued lesser and need to be compensated. Evidence from the experience of Modaraba Companies in Pakistan shows that institutional investors, such as the International Finance Corporation prefer redeemable *musharakah* certificates over *mudarabah* certificates. Thus, the availability of temporary equity which has the potential to make the sources of funds flexible can be ensured by compensating for the foregone voting rights.

On Capital Budgeting Criteria

Other important questions posed by the abolition of interest are related to time value of money, discounting and criteria for selecting between different investment opportunities? The contributions of Zarqa (6)[12] and Khan(7,8)[13] deal with these considerations.

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(9) *American Journal of Islamic Social Sciences*, 3(**1**), 1986, pp. 25-40.

(10) International Center for Research in Islamic Economics, 1983, Mimeograph No. 16.

(11) *Fiscal Policy and Resources Allocation in Islam*, **Ziauddin Ahmad**, et. al., eds., Islamabad: IPS, 1983, pp. 159-215.

(12) See, also **Zarqa, M.A** (1992) “*Sharia'h Permissible Preference Shares*”, paper submitted to the Third International Conference on Islamic Economics, International Islamic University, Kuala Lampur.

(13) Sources not available. Perhaps new contributions.

Zarqa's basic point is that discounting future cash flows to arrive at present values of competing projects' outlays is equally important for investment decision making in an Islamic economy. However, it is not an imperative that discounting should be based on the rate of interest. Even in the conventional economies, the time preference of different individuals could be positive, negative or neutral. Therefore, with regard to time preference, even in the conventional sense, nothing can be conclusively said a priori. Khan re-affirms the non-existence of time value of money in an Islamic economy but in general refutes the importance of discounting in conditions where rates of return of projects are different. For him, discounting would be needed only if the rates of return of competing projects happened to be equal.

Both Zarqa and Khan suggest that the discount factor of an all equity firm should be the rate of return of its risk class. For public projects such rates should be adjusted to achieve social optimality. The theoretical essence of Zarqa's message on both counts is upheld by a number of other Islamic economists.

However, the situation on the practical ground is different. The decision of the Islamic banks to finance given sets of operations is an investment decision. Broadly speaking, Islamic banks arrange finance on the basis of the price mechanism (as in renting and installment sale) and profit sharing as in participatory arrangements. The pricing mechanism is overwhelming and also guides the Islamic financial institutions to imagine the implicit cost of capital in the meager amount of funds they extend under participation. This is reflected in the relative sharing ratios for the bank and the client determined in any specific contract.

In determining the deferred price of goods and services, the Islamic banks have to consider spot prices, transaction and insurance costs for the bank as a trader and a rate of return comparable to alternative investment opportunities in similar risk class. At the present, the Islamic banks are utilizing the London Inter Bank Offering Rate (LIBOR) as a bench-mark for a comparable rate of return of deploying funds in investments of similar risk class. There has been no shari'ah objection to this practice of the Islamic banks. However, in addition to Zarqa and Khan, other Islamic economists have shown reservations on the economics of this practice.

The "no objection" of the shari'ah scholars may have something related to the fact that in Islamic economics we have a clear notion of two prices: spot and deferred. Thus, the present legality of taking Islamic investment decisions on the basis of the market bench-mark may continue or may be replaced with the difference factor between spot and deferred prices, irrespective of the feelings of economists! This shall not mean that the academic works to de-link Islamic investment decisions from the market bench-mark should not continue. Khan (8) is an attempt in this direction. The central issue is to suggest a project evaluation criteria which can be used by managers of firms for making long-term capital expenditure decisions in the absence of an ax-ante implicit time value of money. After reviewing and rejecting a number of conventional criteria including the Net Present Value (NVP) method, Khan suggests that the generation of investible surplus could be reasonable criteria for selecting projects in an Islamic economy.

In this regard he is not alone. If LIBOR or interest has to be avoided in the process of investment decision making, its natural contender, in addition to Khan's proposal, would be some form of profit index. One recent unpublished research at the Islamic Research and Training Institute, for example, is daringly captioned as, "Profit-index: As a Substitute to LIBOR in Islamic Banks' Mark-up based Operations".

Recently, there has been a rigorous criticism of the NPV method by Dixit and Pindyck[(14)]. This contribution is being termed as most influential for decades to come in the area of investment and finance. Two points of the central theme of this work are relevant in our present context. First, the authors challenge the rationale of the significance assigned to interest rates in the theory of corporate finance, in particular in the NPV-led investment decision process. The authors contend that "Econometric tests of the orthodox theory generally find that interest rates are only a weak or insignificant determinant of investment demand"[(15)]. Secondly, the authors treat investment opportunities valuable options, not non-waiting take-it or leave-it opportunities as treated by the NPV method. Since investment decisions are irreversible, waiting for additional information to arrive to utilize the option is in fact a valuable contrary to the NPV "take-it or leave-it" approach.

The point is that it is not only scholars like Zarqa or Khan who question the foundations of the conventional theory of finance but there are also influential conventional economists who find objective reasons for doing so. Having said that we must not neglect the need for a rigorous approach to long term investment decision making, it is in this context that an emphasis need to be put on the necessity of simultaneously using more than one criteria. Empirical research on the use of capital budgeting criteria by 189 companies shows that almost all companies use more than one criteria with different degree of reliance on different methods. As for popularity of the individual methods concerned, these were found to be: payback method 74%, internal rate of return method 65%, return on investment method 59% and net present value method 57%[(16)].

Hedging Instruments

Arbitrage, hedging and speculation are used as survival strategies by both financial and non-financial companies. This has given rise to the often un-understood hedging instruments known as derivatives. Efficiency of the markets for real as well as financial assets is being greatly effected by these hedging instruments. Without much discussion of the role of arbitrage, hedging and speculation in the financial markets, Metwally (16)[(17)], Zaman (17) and Mohsin (10) suggest that these methods of the conventional financial markets should not be acceptable in Islamic economics. Neither of the authors provide any alternatives to these strategic methods. In today's fastly

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(14) See, **Dixit, A. K.** and **Pindyck, R. S.** *Investment Under Uncertainty*, New Jersey: Princeton University Press, 1994.

(15) Ibid, p 13.

(16) See, **Shall, L.D.** et. al., "Survey and Analysis of Capital Budgeting Methods", *Journal of Finance*, 33 March 1978.

(17) *Journal of Research in Islamic Economics*, 2(**1**) 1984, pp. 21-30.

globalizing financial markets, companies which do not use hedging through derivatives, and practice speculative and arbitrage strategies, have to bear in mind that they have to compete companies which use these strategies. This is a crucial area of research. Without exploring different options and alternatives of the challenges involved, the authors' observations remain at best unsubstantiated.

For researchers interested in this area it may be useful to critically evaluate the contribution of Hassanuzaman (12)[(18)] together with the recent contributions of al Qari[(19)] and Khan[(20)]. Khan extends the concept of *salam* to future markets and al Qari provides an exposure to an Islamic view on options.

Important Omissions

Two important areas are not included in the volume. First and foremost, the editors did not include any article on the economics of profit sharing. Profit sharing is central to Islamic finance. It establishes a relationship between the developments in the monetary side of the economy with the balance sheet positions of firms. For example, under the profit sharing system, monetary authorities will regulate a real variable, the profit sharing ratio (p/s ratio) between depositors and banks on one hand, and between banks and users of funds (firms) on the other to discipline a financial variable, the level of credit in the economy. In the Islamic economy, the p/s ratio works as a substitute for the rate of interest. Hence, the p/s ratio is equally relevant for banking and non-banking finance. Therefore, the monetary model of profit sharing[(21)] must have been included in the volume.

Second, the concepts of risk and return and their trade-off are central to any book on finance. The volume under review does not contain any contribution in this area too. A number of articles could have been candidates for inclusion including the work of Tag El Din[(22)] which was available at the time of editing the volume.

Inclusion of articles in these two areas of Islamic finance would have further enhanced the usefulness of this valuable work. Nevertheless, this timely work by the editors is hoped to provoke more research in the important area of Islamic corporate finance.

(18) Paper presented to a Seminar on *Islamic Financial Instruments*, International Islamic University, Islamabad, December, 1984.

(19) **Al Qari, M. Ali** (1993), "Towards an Islamic Stock-Market.", *Studies in Islamic Economics*, Vol. 1, No. 1, 1993.

(20) **Khan, M. Fahim** (1995), *Islamic Futures and Their Markets*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah.

(21) **Siddiqi, M. Nejjatullah** (1983), "Economics of Profit Sharing", in Ahmad Ziauddin, M. Fahim Khan and Munawar Iqbal (eds.), *Fiscal Policy and Resource Allocation in Islam*, Islamabad: IPS.

(22) **Tag El-Din, Ibrahim, S.** (1991) "Risk Aversion, Moral Hazard and Financial Islamization Policy", *Review of Islamic Economics*, Vol. **1**, Number 1, 1991.